
UNIT 7 BALANCE OF PAYMENTS: INTRODUCTION

Structure

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7.0 OBJECTIVES

After reading this Unit, you will be able to

- explain the balance of payments accounts of a country;
- describe current account of balance of payments;
- spell out capital account of balance of payments;
- give explanation of the errors and omissions in balance of payments; and
- give a picture of the surplus and deficit in balance of payments.

7.1 INTRODUCTION

In this Unit, we have discussed the concepts of balance of payments. Balance of payments of country records its economic transactions with the rest of the world. The entries are recorded in double-entry book keeping method. Monetary receipts are recorded in the credit side of the accounts, and the payments in the debit side. Balance of payments has two parts – current account and capital account. Current account of the balance of payments records transactions on account of trade in goods and services, unilateral transfers etc. Different financial capital inflows and outflows are recorded in the capital account. Balance of payments should always balance in the accounting sense, meaning that the sum of all the debit side entries must match with the credit side entries. On account of various reasons some entries do not get properly recorded in the balance of payments. Due to this reason debit and credit side entries often fail to match with each other. Errors and omissions take care of them. Balance of payments in accounting sense must always balance. But that does not imply that balance of payments will always be in equilibrium. By equilibrium in balance of payments it is meant that present liabilities are perfectly matched by the present asset positions of the country with respect to the rest of the world. For this purpose, one has to take into consideration the three basic balances namely, merchandise trade balance, service trade balance and current account balance.

7.2 BALANCE OF PAYMENTS

The balance of payments accounts are an integral part of the national income accounts for an open economy. They record (in principle) all transactions between 'residents' of the country concerned and those of other countries, where 'residents' are broadly interpreted as all individuals, businesses, and governments and their agencies; international organisations are also classified as 'foreign' residents for this purpose.

The balance-of-payments accounts, however, serve another purpose. The balance of a country's foreign transactions, and the accompanying issues of the exchange rate and reserves (whether of gold or of foreign currencies) has long been a focus of interest for policy-makers.

7.2.1 The Balance of Payments: Book-Keeping

The balance of payments is essentially an application of the double-entry book-keeping, since it records both transactions and the money flows associated with those transactions. Transactions, which give rise to money receipts from the rest of the world, are recorded in the credit side of the balance of payments. On the other hand, transactions, which lead to monetary payments abroad, are recorded in the debit side of the balance of payments accounts. If we do this in a proper way debits and credits will always be equal, so that in an accounting sense the balance of payments will always be in balance. An accounting balance is however not synonymous with balance of payments equilibrium.

It is important to keep in mind that a balance-of-payments account records flows between countries over a specified period of time (usually a year for the full accounts, but often less for some components of the accounts). Some items in the balance of payments are readily identified as flows, such as exports. Other items, however, are flows arising from changes in stocks.

Traditionally there are two basic elements in a perfectly compiled set of balance-of-payments accounts: the current account and the capital account. Each of these is usually subdivided, the former into visible and invisible trade and unrequited transfers, the latter into long-term and short-term private transactions and changes in official reserves. The essential difference between the two is that capital account transactions necessarily involve domestic residents either acquiring or surrendering claims on foreign residents, whereas current account transactions do not. In practice there is a third element, the 'balancing item' or 'errors and omissions', which reflects our inability to record all international transactions accurately.

Check Your Progress 1

1) What do you mean by balance of payments?

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2) Explain the statement “Balance of payments always balances”.

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7.3 THE CURRENT ACCOUNT

The current account records imports and exports of goods and services and unilateral transfers. Balance-of-payments accounts usually differentiate between trade in goods and trade in services. The balance of exports and imports of the former is referred to as the balance of visible trade or as the balance of merchandise trade. It is often useful for economic purposes to distinguish between factor and non-factor services. Trade in the latter, of which shipping, banking and insurance services, and payments by residents as tourists abroad are usually the most important, is in economic terms little different from trade in goods. That is, exports and imports of such services are flows of outputs whose values will be determined by the same variables that would affect the demand and supply for goods. Factor services, which consist of interest, profits and dividends, are on the other hand payments for inputs.

Unilateral transfers, or ‘unrequited receipts’, are receipts, which the residents of a country receive ‘for free’, without having to make any present or future payments in return. Receipts from abroad are entered as positive items, payments abroad as negative items.

The net value of the balances of visible trade and of invisible trade and of unilateral transfers defines the balance on current account. Table 7.1 shows the various components of the current accounts of India in 2004-05. Notice that there is a large deficit in merchandise trade, but an almost equally large surplus in miscellaneous services, which would include export revenues earned by call centres and other information technology enabled services (ITES). Also notice that private transfers (mainly remittances from NRIs) far exceed official transfers (foreign aid in the form of grants from other countries).

Table 7.1 Current Account Balance of India (2004-05)

(In Rupees crores)

Items	Credit	Debit	Net
I. Merchandise	362661	533778	-171117
II. Invisible (a+b+c)	347098	205477	141621
a) Service	229682	164524	65158
i) Travel	22537	24817	-2280
ii) Transportation	22645	20363	2282
iii) Insurance	4564	3249	1315
iv) n.e.c.*	1812	1172	640
v) Miscellaneous	178124	14923	163201

Of which Software Services	77609	3021	74588
b) Transfers	96318	1939	94379
i) Official	2785	142	2643
ii) Private	93533	1797	91736
c) Income	21098	39014	17916
i) Investment Income	20486	33327	-12841
ii) Compensation of Employees	612	5687	-5075
Total Current Account (I+II)	709759	739255	-29496

* not elsewhere classified

7.4 THE CAPITAL ACCOUNT

The capital account records all international transactions that involve a resident of the country concerned changing either his assets with or his liabilities to a resident of another country. As we noted earlier, transactions in the capital account reflect a change in a stock - either assets or liabilities.

It is often useful to make distinctions between various forms of capital account transactions. The basic distinctions are between private and official transactions, between portfolio and direct investment, and by the term of the investment (i.e. short or long term).

Direct investment is the act of purchasing an asset and at the same time acquiring control of it (other than the ability to re-sell it). Portfolio investment by contrast is the acquisition of an asset that does not give the purchaser control. An obvious example is the purchase of shares in a foreign company or of bonds issued by a foreign government. Loans made to foreign firms or governments come into the same broad category. Such portfolio investment is often also distinguished by the period of the loan (short, medium or long are conventional distinctions, although in many cases only the short and long categories are used). The distinction between short-term and long-term investment is often confusing, but usually relates to the specification of the asset rather than to the length of time for which it is held.

The purchase of an asset in another country, whether it is direct or portfolio investment, would appear as a negative item in the capital account for the purchasing firm's country, and as a positive item in the capital account for the other country. That capital outflows appear as a negative item in a country's balance of payments, and capital inflows as positive items, often causes confusion. One way of avoiding this is to consider the direction in which the payment would go (if made directly). The purchase of a foreign asset would then involve the transfer of money to the foreign country, as would the purchase of an (imported) good, and so must appear as a negative item in the balance of payments of the purchaser's country (and as a positive item in the accounts of the seller's country).

The net value of the balances of direct and portfolio investment defines the balance on capital account. Table 7.2 shows the various components of the

capital accounts of India in 2004-05. Official long-term transactions are subsumed in 'Other long-term capital'. Notice that private capital flows (portfolio investment, commercial borrowings, and banking capital) are much higher than external assistance (foreign aid in the form of loans). This is very different from the situation that prevailed upto the 1980s.

Table 7.2 Capital Account Balance of India (2004-05)

(In Rupees Crores)

Capital Account	Credit	Debit	Net
1. Foreign Investment (a+b)	206696	153377	53319
a) Foreign Direct Investment (i+ii)	25267	11569	13698
i) In India	24914	45	24869
Equity	15158	45	15113
Reinvested Earnings	8159	-	8159
Other Capital	1597	-	1597
ii) Abroad	353	11524	-11171
Equity	353	6672	-6319
Reinvested Earnings	-	3146	-3146
Other Capital	-	1706	-1706
b) Portfolio Investment	181429	141808	39621
In India	181429	141808	39621
2. Loans	138170	86125	52045
a) External Assistance	16984	8463	8521
i) By India	108	576	-468
ii) To India	16876	7887	8989
b) Commercial Borrowing (MT+LT)	43168	16601	26567
i) By India	5673	1036	4637
ii) To India	37495	15565	21930
c) Short Term To India	78018	61061	16957
3. Banking Capital (a+b)	109032	91446	17586
a) Commercial Banks (i+ii)	107792	89740	18052
i) Assets	48771	37189	11582
ii) Liabilities	59021	52551	6470
Of which Non Resident Deposits	43898	48786	-4888
b) Others	1240	1706	-466

7.5 THE REMAINING ITEMS IN THE BALANCE OF PAYMENTS

The balance-of-payments accounts are completed by the entry of: other minor items that can be identified but do not fall comfortably into one of the standard categories; errors and omissions, which reflect transactions that have not been recorded for various reasons and so cannot be entered under a standard heading, but which we know must appear since the full balance-of-payments account must sum to zero; and changes in official reserves and in official liabilities that are part of the reserves of other countries.

Errors and omissions (or the balancing items) reflect the difficulties involved in recording accurately, if at all, a wide variety of transactions that occur within a given period (usually 12 months). In some cases there may be such a large number of transactions that a sample is taken rather than recording each transaction, with the inevitable errors that occur when samples are used. In other cases, problems may arise when one or other of the parts of a transaction takes more than one year. For example, with a large export contract covering several years some payment may be received by the exporter before any deliveries are made. But the last payment will not be made until the contract has been completed. Dishonesty may also play a part, as when goods are smuggled, in which case the merchandise side of the transaction is unreported although payment will be made somehow and will be reflected somewhere in the accounts. Similarly, the desire to avoid taxes may lead to under-reporting of some items in order to reduce tax liabilities.

Finally, there are changes in the reserves of the country whose balance of payments we are considering, and changes in that part of the reserves of other countries that is held in the country concerned. Reserves are held in three forms: in foreign currency, usually but not always the US dollar, as gold, and as Special Drawing Rights (SDRs) borrowed from the IMF. Note that reserves do not have to be held within the country. Indeed most countries hold a proportion of their reserves in accounts with foreign central banks.

The changes in the country's reserves must of course reflect the net value of all the other recorded items in the balance of payments. These changes in reserves will of course be recorded accurately, and it is the discrepancy between the changes in reserves and the net value of the other recorded items that allows us to identify the errors and omissions.

Check Your Progress 2

- 1) What do you mean by current accounts of balance of payments?

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- 2) What items are recorded in capital account of balance of payments?

7.6 AUTONOMOUS AND ACCOMMODATING ITEMS

Economists have often found it useful to distinguish between autonomous and accommodating items in capital account of the balance of payments. Transactions are said to be autonomous if their value is determined independently of the balance of payments. Accommodating items on the other hand are determined by the net consequences of the autonomous items. An alternative nomenclature is that items are 'above the line' (autonomous) or 'below the line' (accommodating). Obviously the sum of the accommodating and autonomous items must be zero, since all entries in the balance-of-payments accounts must come under one of the two headings.

Whether the balance of payments is in surplus or deficit depends on the balance of the autonomous items. The balance of payments is said to be in surplus if autonomous receipts are greater than autonomous payments and in deficit if autonomous receipts are less than autonomous payments.

Unfortunately, the distinction between autonomous and accommodating items is not as straightforward as it may seem. Essentially the distinction lies in the motives underlying a transaction, which are almost impossible to determine. There is nevertheless a great temptation to assign the labels 'autonomous' and 'accommodating' to groups of items in the balance of payments. That is, to assume that the great majority of trade in goods and of long-term capital movements are autonomous, and that most short-term capital movements are accommodating.

Whether that is a reasonable approximation to the truth may depend in part on the policy regime that is in operation. For example, what is an autonomous item under a system of fixed exchange rate and limited capital mobility may not be autonomous when exchange rates are floating and capital may move freely between countries.

In the current system, however, the exchange-rate system is one of managed flexibility', with the official reserves used to smooth exchange rate fluctuations rather than to maintain the rate within a given band, and capital is much more mobile. A case can be made for regarding capital movements as autonomous under this system (determined by investment opportunities, savings rates, etc.). Movements in capital then determine the exchange rate which in turn determines the current account balance, so that trade in goods and services is the accommodating item.

7.7 DEFICIT AND SURPLUS IN THE BALANCE OF PAYMENTS

The conventional focus is on three main imbalances that may occur within the balance of payments. The first is the current account and/or the trade account.

7.7.1 The Basic Balance

The basic balance is defined as the sum of the current account balance and the net balance on long-term capital, which were then seen as the most stable elements in the balance of payments, and so placed ‘above the line’. A worsening of the basic balance (an increase in a deficit or a reduction in a surplus, or even a move from surplus to deficit) was seen as indicating a deterioration in the (relative) state of the economy.

An alternative approach is to consider whether the net monetary transfer that has been made by the monetary authorities is positive or negative - the so-called settlements concept. If the net transfer is negative (i.e. there is an outflow) then the balance of payments is said to be in deficit, but if there is an inflow then it is in surplus. The basic premise is that the monetary authorities are the ultimate financiers of any deficit in the balance of payments (or the recipients of any surplus). These official settlements are thus seen as the accommodating item, all others being autonomous.

The monetary authorities may finance a deficit by depleting their reserves of foreign currencies, by borrowing from the IMF, or by borrowing from foreign monetary authorities. The latter source is of particular importance when other monetary authorities hold the domestic currency as part of their own reserves. A country whose currency is used as a reserve currency (such as the United States) may be able to run a deficit in its balance of payments without either depleting its own reserves or borrowing from the IMF since the foreign authorities may be prepared to purchase that currency and add it to their own reserves. The settlements approach is more relevant under a system of pegged exchange rates than when exchange rates are floating. You will read about exchange rates in the following Unit in this block.

Check Your Progress 3

- 1) What do you mean by surplus or deficit in balance of payments?
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- 2) What purpose autonomous and accommodating flows serve in balance of payments?
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7.8 LET US SUM UP

In this Unit, we have learnt about balance of payments. Balance of payments is a record of transactions of a country with the rest of the world. In accounting

sense it is a double entry book keeping system and does always balance. By balance of payments surplus/deficit is meant the gap between the country's receipts and payments with the rest of the world. The Unit also explains to you the various components of the balance of payments. These are current account, capital account, the remaining items and the autonomous and accommodating items.

7.9 KEY WORDS

Balance of Payments: Accounts of monetary transactions of a country with the rest of world on account of trade in goods and services, unilateral transfers, different types of capital flows etc.

Current Account: Accounts of monetary transactions of a country with the rest of the world on account of trade in goods and services, unilateral transfers etc.

Capital Account: Accounts of different capital flows (real or financial) between the country and the rest of the world.

Capital Flows: A net flow of capital, real and/or financial, from (into) a country, in the form of reduced holdings of domestic assets by foreigners and/or increased purchases of foreign assets by domestic residents. Capital inflows (outflows) are recorded as negative (positive), or a debit, in the balance on capital account.

Trade Balance: Exports of goods and services minus imports of goods and services.

Current Account Balance: Sum of credit side entries minus the sum of debit side entries in the current account.

Financial Capital: The value of financial assets, which is an asset whose value arises not from its physical embodiment (as would a building or a piece of land or capital equipment) but from a contractual relationship: stocks, bonds, bank deposits, currency, etc. This is opposite to real assets such as buildings and capital equipment.

International Reserves: The assets denominated in foreign currency, plus gold, held by a central bank, sometimes for the purpose of intervening in the exchange market to influence or peg the exchange rate. Usually includes foreign currencies themselves (especially US dollars), other assets denominated in foreign currencies, gold, and a small amount of SDRs.

7.10 SOME USEFUL REFERENCES

Dornbusch, Rudiger, and Fischer, Stanley. 1990. *Macroeconomics*. Fifth Edition, Mc-Graw Hill International Editions.

Sodersten, Bo. and Reed, Geoffrey. 1994. *International Economics*, Third Edition, Macmillan.

7.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1. Read Section 7.2
2. Read Sub-section 7.2.1

Check Your Progress 2

1. Read Section 7.3
2. Read Section 7.4

Check Your Progress 3

1. Read Section 7.7
2. Read Sub-section 7.7.1

UNIT 8 INTERNATIONAL MONETARY SYSTEM AND EXCHANGE RATE REGIME

Structure

- 8.0 Objectives
- 8.1 Introduction
- 8.2 Fixed Exchange Rates under Gold Standard (1880-1914)
 - 8.2.1 Salient Features of the Gold Standard
 - 8.2.2 Experiences with the Gold Standard Regime (1880-1914)
- 8.3 Fixed Exchange Rates under the Dollar based Gold Exchange Standard (1947-1973)
 - 8.3.1 The Background
 - 8.3.2 The Rise of Bretton Woods System
 - 8.3.3 Salient Features of the Bretton Woods System
 - 8.3.4 The Demise of the Bretton Woods System
- 8.4 Principles of Adjustments
 - 8.4.1 Income Adjustment (Foreign Trade Multiplier with and without Foreign Repercussions and Determination of National Income and Output)
 - 8.4.2 Price Adjustment (Marshall-Lerner Condition)
- 8.5 Floating Rates and Managed Floating
- 8.6 Monetary Theory of Balance of Payments
- 8.7 A Critical Review of Monetary Theory of Balance of Payments Adjustment
- 8.8 Relative Merits and Demerits of Fixed and Flexible Exchange Rates
- 8.9 Let Us Sum Up
- 8.10 Key Words
- 8.11 Some Useful References
- 8.12 Answers/Hints to Check Your Progress Exercises

8.0 OBJECTIVES

After reading this Unit, you will be able to

- describe the history of international monetary system;
- discuss the fixed exchange rate regime under Gold Standard;
- explain the dollar based Gold Exchange Standard System;
- justify the Price and Income Adjustment;
- give reasons for the floating rates and managed floating regime; and
- critically examine the Monetary Approach to Balance of Payments.

8.1 INTRODUCTION

Economic transactions between residents of different countries require some sort of arrangement to effectuate payments and settle the trade or exchange involved. In modern times, these transactions have been effectuated by a wide array of monetary arrangements. In this Unit, we will discuss different International Monetary Systems (henceforth, IMS), which have been evolved through time since 1873. We will begin with the fixed exchange rate regime as evolved under the Gold Standard and then proceed to discuss the Bretton Woods System, which came into existence immediately after the Second World War. It was a different version of the earlier Gold Standard regime in which dollar served as the reserve currency to settle any BoP disequilibrium. The Gold

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

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

From antiquity to modern times, countries operated on a *specie commodity standard*, implying the predominance of metals like gold and silver as the circulating media of the economy. Because of some particular attributes gold and also silver have been considered as the most suitable commodity money. These attributes include scarcity, durability, divisibility, homogeneity, and consistency of quality. The acceptability of these metals as money was also aided by the fact that they were widely recognised to have value in non-monetary uses (e.g. jewellery, industrial), they enjoyed relatively stable value in terms of other commodities, and their quality could be verified or certified by experts. In their purest form, specie commodity standards operated on the basis of full-bodied coins, the monetary value of which equalled the value of the metals they contained. Sovereigns themselves frequently reduced the gold (or silver) content of the coins they minted, a practice called *debasement*. Coin debasement is the predecessor of the modern devaluation of currency, usually led to a loss of coin's value. Both full-bodied and debased coins were in circulation. People generally tend to hoard fuller bodied coins for their own accumulation and used debased coins for transaction purposes. Fuller bodied coins could also be melted to be sold as metal, exported, or even sent to the coinage to be exchanged or coined into new, debased coins. Same face values were assigned to fuller bodied and debased coins. Debased coins were overvalued since they were assigned a higher face value than their metal contents justified. Going by this logic, fuller bodied coins were overvalued relative to the debased coins. The end product was that debased money – overvalued as a medium of exchange – would remain in circulation, while full bodied coins – undervalued as a medium of exchange – would disappear.

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

8.2.1 Salient Features of the Gold Standard

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

game". They are as follows:

- i) A country fixed the value of its currency in terms of gold. It was done by the government setting a fixed price of the gold in terms of its own currency and intervening in the gold market (through purchase and sale) to maintain that price. This establishes a two-way convertibility between the domestic currency or coin and gold. For instance, the US set the gold price at \$20.67 per ounce and the US government was ready to buy or sell gold at this price to maintain the price of gold at that level. Gold values of any two currencies operating under the Gold Standard, specified their relative value. This relative value was referred to as *mint parity* or *mint exchange rate*. For example, the gold value in Britain was set at £4.24 per ounce. Given the US price of gold \$20.67 per ounce, the implicit relative value of the dollar in terms of the pound or the mint parity exchange rate of dollar in terms of pound was approximately \$4.87 ($=\$20.67/£4.24$) per pound, which remained so during 1880-1914. Note that the mint parity exchange rate of dollar in terms of pound was an implicit exchange rate. The direct market exchange rate between dollar and pounds was decided by the interaction of demand for and supply of dollar in the British foreign exchange market. The direct rate did not deviate much from the mint parity rate due to the free flow of gold among the countries. We will now learn why this was the case.
- ii) Under pure gold standard, free trade in gold was assured. Both imports and exports of gold were free and unrestricted. This free trade in gold ensured that market exchange rates would not deviate much from the mint parity. Let us consider an example here. Suppose the US dollar-pound exchange rate is \$5.00/£, which is significantly different from the mint parity of \$4.87/£. In this case, one would purchase say an ounce of gold in the US at a cost of \$20.67 and sell it in Britain to get £4.24, and then exchange this pound in the British foreign exchange market to obtain \$21.20 ($=£4.24 \times \$5.00/£$). Thereby, he would make a profit of \$0.53 per ounce of gold ($=\$21.20 - \20.67) by freely buying and selling gold across countries. This process of buying and selling to take advantage of different prices in different markets is known as arbitrage, and those who engage in these transactions are known as arbitrageurs. Returning to the above example, market exchange rate would fall, as arbitrageurs tend to sell more pounds to acquire dollar in the British market. In the absence of transaction costs, market exchange rate of dollar in terms of pound would match with the dollar-pound mint parity rate. However, the transaction costs in the form of shipments of gold, prevented the market exchange rates to equate with the mint parity rate. But the market rates confined within narrow limits around mint parity rates. These limits were known as *gold points*.
- iii) The Central Bank or the monetary authority has to hold gold reserves in a direct relationship to the money notes it issues. With this provision the monetary authorities could engage smoothly in their purchases and sales of gold and would not land up in situations of not being able to fulfil sudden demand for gold on the part of the public. The gold backing provides for a certain amount of gold behind the currency issued, thereby assuring the convertibility of the currency into gold. This gold provisioning imposed some discipline on monetary expansion in the economy. The Central Bank can issue new currency only by acquiring gold from the public. The main

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

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

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

Gold Standard regime can definitely be claimed as the fixed exchange rate regime as the countries adhering to this regime did not change their mint parities during the period and hence, there was hardly any deviation of the exchange rates of the major currencies from the respective mint parities. One can claim that the *first rule* of the Gold Standard was strictly followed. This was also true for the *second rule* as the period witnessed free flow of gold between the major countries adhering to the Gold Standard. There were almost no barriers to gold trade and exchange or capital control was seldom used. However, the *third rule* bearing on the connection between gold reserves and the supply of domestic currency does not appear to have been closely followed. Central Banks often tried to offset the effects of gold flows on the domestic money supply. The period of Gold Standard (1880-1914) was one of price stability, which fell with the outbreak of World War I in 1914.

The War period saw rising inflation rates as governments oriented their monetary policies toward financing war expenditures. The inflation was higher in Europe than in US as the War was physically fought in Europe and the US was late in entering the War. This disrupted production in Europe. The result was increased competitiveness of US products abroad and the rapid growth of US international trade. Further, countries after countries withheld the convertibility of currency into gold. The system of fixed exchange rates gave way to the floating or flexible rates. The inconvertibility of the major European currencies into gold together with the convertibility of dollar into gold resulted in a growing attractiveness of dollar-denominated assets as safe haven for investment. The dollar became increasingly involved in international transactions. Since gold remained at the heart of the system, the growing demand for dollars resulted in rising gold inflows to the United States and ballooning US gold reserves. The Gold Standard virtually came to a halt

during the War period. During the inter-war period (1925-31) there was attempt to re-establish the gold parity at the pre-war level by Britain and similar attempts (but undervaluing their currencies from the pre-war level) by other countries gave rebirth to the Gold Standard, which no way was similar to the pre-war classical Gold Standard regime. This return proved to be short-lived ultimately with the emergence of Great Depression in 1929 and the outbreak of World War II

Check Your Progress 1

1) What do you mean by Gold Standard?

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2) Why Gold Standard is considered to be a fixed exchange rate regime?

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3) What is debasement?

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4) Why was Gold Standard abandoned during the World War I?

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5) Mark T for True and F for False:

- a) Gold Standard regime is characterised by instability in prices and exchange rates. ()
- b) Gold mint parity implies the value of one ounce of gold in the domestic currency. ()
- c) Major European countries and USA followed Gold Standard during 1890-1914. ()
- d) Under Gold Standard regime the Central Banks had to hold gold reserves directly proportional to the money they issue. ()

8.3 FIXED EXCHANGE RATES UNDER THE DOLLAR BASED GOLD EXCHANGE STANDARD (1947-1973)

8.3.1 The Background

Before the First World War, for almost half a century (1870 - 1914), the international financial system was based on the classical gold standard. As we have seen according to this system, each national currency had a precisely fixed gold content, and the exchange rate between any two currencies is given by the rigidly fixed ratio between the gold content of the two currencies. But during the First World War, when different national governments suspended the conversion of their currencies to gold, the whole system broke down. After the First World War was over in 1918, instead of returning to traditional gold standard, there was a period of flexible exchange rate regime lasting for a short period of time. This period also witnessed a rise in protectionism on a large scale after the war. There was massive hyperinflation and competitive devaluation among countries in order to maintain their competitive positions. Inability to raise taxes forced governments to use inflation as a hidden measure of tax, thus leading to hyperinflation in many countries. All these ultimately forced Britain (the most powerful country of that time) to return to gold standard by 1927. But the system was no longer sustainable and England was forced to devalue its currency in 1931. Under the pressure ensuing from the Depression in the 1930s, USA's position was also weakened and eventually it was also forced to devalue in 1933. The devaluations of dollar and sterling ultimately resulted in breakdown of the gold standard and, for a few years, there was no proper internationally accepted exchange rate regime, until the end of the World War II.

8.3.2 The Rise of Bretton Woods System

During the Second World War, plans for an international institution, that would monitor a new international monetary system circulated among the Allied forces. Ultimately, after the end of the war a conference was held among 44 nations at Bretton Woods, New Hampshire in USA in which among other things it was agreed that two new international institutions the International Monetary Fund (IMF), and the International Bank for Reconstruction and Development (IBRD) would be created. Their functions would be to regulate the important aspects of the new economic order after the World War. Agreement was also reached to formulate a new exchange rate system, known as the Bretton Woods System, which would help to maintain a stable exchange rate throughout the globe.

The Bretton Woods system was somewhat similar to the limping gold exchange standard regime during the inter-war period but with a little modification. According to the regime, each country declared a par value or parity of its own currency in terms of gold. However, the only currency that could be converted to gold was dollar. The rate for conversion, which prevailed during the period, was \$35 per ounce of gold. This status made US dollar the key currency. The non US currencies could be converted into gold through US dollars. The system came to be qualified as gold exchange standard. Further the convertibility of dollar into gold was restricted only to the requests from the Central Banks. The Central Bank of the member countries of the IMF were

asked to maintain the required parity in the foreign exchange market by buying and selling foreign exchange. Further, a variation of 1% above and below parity of the original exchange rate was allowed to give slight flexibility to the system.

But there were also certain modification, later added to the system. In case any fundamental disequilibrium was faced by the member countries in its balance of payment situation, the country was allowed to revise its exchange rate up to 10% within a year of the initial selection of the exchange rate.

Thus this obligation to maintain the declared parity, together with the possibility of changing it gave the system the name 'adjustable - peg'. The idea behind the system was actually to establish an exchange rate regime, which would be a modification of the rigidly fixed and flexible exchange rate regime. But the fact that parity has to be defended at all costs except under unavoidable situation made the exchange rate more biased towards the fixed exchange rate regime.

The responsibility to defend the declared parity was entrusted with the Central Banks of the member countries. They could maintain it by constantly intervening in the foreign exchange markets. Any excess demand for foreign exchange, which would devalue the exchange rate from its declared parity should be checked by the Central Bank by supplying the required amount of foreign exchange and any excess supply of foreign exchange should be purchased by the Central Bank to maintain the required parity. But the sole dependence on US dollar, as the only currency convertible to gold, was a severe drawback of the system and it ultimately led to its downfall.

8.3.3 Salient Features of the Bretton Woods System

Following are the salient features of the Bretton Woods regime:

- i) The IMF's Articles of Agreement stipulated that each participating country would set a fixed value – called par value – of its currency in terms of gold (or the US dollar). The par values of two currencies determined the official exchange rate (also called parity) between them. Exchange rate fluctuations were to be limited to a narrow band around the official exchange rate. The Bretton Woods system was characterised by adjustable peg regime in which alterations in the official exchange rates were allowed subject to the approval of the IMF to correct the fundamental disequilibrium in the balance of payments. It had not been made clear what is meant by the fundamental disequilibrium. The whole rationale for this adjustable peg was to smooth out the high cost of adjustment toward payments equilibrium in the form of recession and unemployment.
- ii) Only the US currency was made directly convertible to gold at a fixed price. This meant that the US stood ready to sell gold to foreign Central Banks, but not to private citizens, in exchange for US dollars at a fixed price of \$35 per ounce. Aside from the US, however, countries were not committed to exchanging their money into gold. Thus, the Bretton Woods system was a Dollar-based Gold Exchange Standard regime. Under this system, the countries are expected to redeem their currencies into gold-convertible currencies (but not necessarily into gold directly), and Central Bank reserves are held in convertible currencies (under Bretton Woods it is

dollar). Most Central Banks kept a large part of their international reserves in the form of dollar-denominated assets, such as dollar deposits or US Treasury bills. The dollar became the main reserve currency of the system.

- iii) Exchange rates were maintained within the narrow limits allowed by the IMF by means of Central Bank intervention in foreign exchange markets. The US dollar played a predominant role in this respect, since it was used as an intervention currency by foreign Central Banks. For instance, when a depreciating (appreciating) French franc reached the limit allowed by the IMF, the Bank of France would buy (sell) francs and sell (buy) dollars in exchange so as to support the value of franc (dollar) in the process. In effect, France was in charge of determining the French franc-US dollar exchange rate. The same pattern applied to other foreign countries. The US, therefore, could not devalue or revalue the dollar vis-a-vis other currencies by itself. The US was spared the need to intervene in foreign exchange markets in order to keep its exchange rate fixed. Other countries fulfilled the function.

8.3.4 The Demise of the Bretton Woods System

The Bretton Woods system at the very beginning was criticised by Keynes due to its sole dependence on US dollar for international liquidity. All the countries at that time had to keep huge dollar reserves in order to participate in the world trade. Keynes suggested an international system based on a new currency unit called the "Bancor". But his idea was rejected at the time and it was not until 1960 that the inevitable collapse of the Bretton Woods arrangement was recognised by economist Robert Triffin on the lines suggested by Keynes.

According to the Triffin Paradox, a growth in the world trade can only be financed by increase in US dollar reserve holdings in the countries involved in trade. Hence to keep the volume of world trade growing the balance of payments in USA must continuously run in a deficit, as these deficits are the means, via which other countries acquire dollars. Thus rather than converting dollar into gold, most of the countries were keeping it as reserves to facilitate trade. But the problem, in this system, was that, if the dollar liability of USA [due to deficit] continued to increase in respect to its holding of gold, then other countries would slowly lose their belief in the credibility of US to convert dollar into gold at the fixed rate [\$35 per ounce]. This was what actually happened the late 1960s.

The initial blow to the Bretton Woods System came from France in 1962, when it began to exchange dollar for gold. France was not only doubtful about the future value of dollars but it was also objecting to the seigniorage gains [profit from printing money], which the USA was accumulating by printing dollars. This increased conversion of dollars to gold eventually created doubts in the minds of other countries about USA's potential gold reserves to support the US dollars.

The situation was further worsened when USA was forced to increase its deficits to meet the expenses of the Vietnam War. The increases in deficits were mainly due to increase in inflation within the country. But this caused trade

partners and to maintain their exchange rates fixed, foreign governments had to purchase the excess reserves thus increasing money supply in the domestic circuit and hence inflation in their respective countries. This increase in dollar reserves among the countries further raised doubts about the US credibility to repay dollar for gold.

Ultimately under pressure from huge BoP deficits, USA suspended gold convertibility into dollars in August 15, 1971, and a 10 per cent surcharge was placed on US imports. Many currencies were allowed to float against dollar and by the end of 1971 most of them had appreciated. Unable to bear the cost of being a reserve currency country, USA finally called for a meeting with the 10 largest countries of the world at the Smithsonian Institution at Washington, D.C. At the Smithsonian Agreement, US raised the price of dollars from \$35 per ounce of gold to \$38 per ounce of gold. But even after its devaluation, dollar was under heavy selling pressure. Therefore, in 1973, it was again devalued to \$42.22 per ounce. But this removed all confidence from US dollar, and by the next month all major currencies were floating. This eventually marked the end of the Bretton Woods System.

Check Your Progress 2

- 1) Why is the Bretton Woods system referred to as a variant of the Gold Standard regime?

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- 2) Discuss the mechanism of adjustable peg system as envisaged in Bretton Woods system.

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- 3) Describe the salient features of the Bretton Woods system.

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- 4) Explain the reasons behind the demise of the Bretton Woods system.

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5) What is meant by reserve currency?

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6) Mark T for True and F for False:

- a) US dollar served as the reserve currency under the Bretton Woods system. ()
- b) Triffin dilemma failed to point out the exact reason behind the fall of Bretton Woods regime. ()
- c) Central Banks' intervention was not at all necessary under the Bretton Woods system. ()
- d) Under the pressure of huge BoP deficits USA suspended the gold convertibility into dollar. ()

8.4 PRINCIPLES OF ADJUSTMENTS

To understand the adjustment process in an open economy one need to understand well the basic national income accounting framework in an open economy context. It breaks down GNP – the value of all the goods and services produced by a country's residents during a given period – into various spending categories. The goods produced by the domestic residents can be purchased by foreign and domestic residents. The total spending of domestic residents is given by

$$A_N = C_N + I_N + G_N \quad \text{.....(1)}$$

where A_N refers to the domestic absorption i.e. total spending by the domestic residents, C_N is the total consumption spending, I_N is the total investment spending and G_N is the total government spending.

If imports spending by the domestic residents are subtracted from the total domestic absorption, then one obtains that part of the total spending by domestic residents, which falls exclusively on domestic goods:

$$A_N - M_N = C_N + I_N + G_N - M_N \quad \text{.....(2)}$$

The value of national output (GNP), symbolised by Y_N , is accounted for by the sum of domestic and foreign expenditures on domestic goods. Symbolically,

$$\begin{aligned} Y_N &= C_N + I_N + G_N - M_N + X_N \\ &= A_N + X_N - M_N \end{aligned} \quad \text{.....(3)}$$

where X_N is the expenditures on domestic goods by foreign residents i.e. exports of goods and services. $(X_N - M_N)$ is the net value of exports minus imports. In the absence of unilateral transfers, this is equivalent to current account balance (CAB) i.e. $CAB = X_N - M_N = Y_N - A_N$.

When $CAB > 0$, there is current account surplus and the country accumulates foreign assets in the form of foreign currencies or foreign stocks or bonds. When $CAB < 0$, there is current account deficit and the country will encounter net decumulation of foreign assets. This does not necessarily mean that the country's total asset holding will decline. The domestic residents may increase their holding of domestic assets when foreign asset holdings go down.

We now turn our attention to the factors determining the national income accounting categories examined above and how they interact to determine equilibrium output in the open economy. We shall focus on trade balance only and ignore trade in services, capital flows, and monetary considerations. Our purpose here is to introduce the simple analytics of the economy, within the context of a simple Keynesian Model. We assume here that the prices of domestic goods are fixed and that firms producing these goods can supply all the output that is demanded of them at the given prices. That is aggregate supply curve of domestic goods is perfectly horizontal. Since sales are constrained only by the level of demand, it is the level of aggregate demand for domestic goods, as represented by the total domestic absorption that determines the output of the economy.

We can express the value of net exports or trade balance as

$$T_N = X_N - M_N \quad \dots\dots\dots(4)$$

The value of exports and imports are obtained by the product of their prices and quantities or volumes. So, we can write:

$$T_N = PM^* - EP^*M \quad \dots\dots\dots(4a)$$

where P and P^* refer to prices of domestic and foreign goods respectively, M^* is the volume of exports and M is the volume of imports, and E is the nominal exchange rate defined as price of foreign currency in terms of domestic currency (say, Rs. per US dollar).

To express the trade balance in real terms we divide both sides of the above equation by the domestic price level, P to obtain:

$$T = T_N/P = M^* - (EP^*/P).M = M^* - e.M \quad \dots\dots\dots(5)$$

where $e = (EP^*/P)$ is the relative price of imports in terms of domestic goods, which allows us to convert quantities of foreign goods (M) into their equivalent in domestic goods. The variable e is known as the real exchange rate, defined as the ratio of price of imports to the price of domestic goods in domestic currency.

Domestic exports (M^*) depend crucially on the real exchange rate, e as that is the relative price of foreign to domestic goods, as exports correspond to the foreign demand for domestic goods. Also, like any demand relationship M^* depends on foreign real income Y^* . So, we can write:

$$M^* = M^*(e, Y^*) \quad \dots\dots\dots(6)$$

Note that as e goes up i.e. as the relative price of foreign goods increases foreign residents switch their spending out of foreign goods and into domestic

goods, with a consequent positive effect on domestic exports, M^* . Similarly, an increase in foreign income Y^* will raise the demand for domestic goods and hence, will increase M^* .

Similarly, domestic imports, i.e. the demand for foreign goods by domestic residents will be influenced by the relative price of foreign to domestic goods, e and domestic real income Y :

$$M = M(e, Y) \quad \dots\dots\dots(7)$$

Therefore, we can write:

$$\begin{aligned} T &= M^*(e, Y^*) - e.M(e, Y) \\ &= T(e, Y, Y^*) \\ &= T^0 - m.Y \end{aligned} \quad \dots\dots\dots(8)$$

where T^0 is the autonomous trade balance, which is that part of trade balance that does not depend upon domestic income Y . The second term depicts that part of trade balance, which depends on the domestic income Y where m is the marginal propensity to import, defined as the fraction of additional income spent on imports. We have assumed that foreign income Y^* is exogenously determined. You will notice that the trade balance T deteriorates as domestic income Y rises. Given the assumption that P and P^* are given, e can change only if there is a change in the nominal exchange rate e , i.e. when there is either devaluation or revaluation of exchange rate.

You may note that the domestic absorption is influenced by a whole range of factors. Consumption is influenced by the domestic income Y . Investment spending is influenced by the domestic interest rate, which is assumed to be determined exogenously. Government expenditures are also considered to be exogenously determined. Therefore, we can write:

$$A = A(G^0, Y) \quad \dots\dots\dots(9)$$

where G^0 is the exogenously determined government expenditure. Assuming a linear relationship between A and Y we can write:

$$A = A^0 + c.Y \quad \dots\dots\dots(9a)$$

A^0 is the autonomous absorption which is not dependent on domestic income but is induced by exogenously given government expenditures. The second term shows that part of domestic absorption, which is dependent on income, where c is the marginal propensity to consume, defined as the additional consumption spending due to increase in domestic income Y . The value of c must lie between 0 and 1 i.e. $0 < c < 1$.

Generally, entire income is not spent. The excess of domestic income over domestic absorption is defined as hoarding H :

$$H = Y - A \quad \dots\dots\dots(10)$$

Hoarding means the acquisitions of monetary assets on the part of the whole country. We can rewrite (10) as:

$$H = Y - A = Y - (A^0 + c.Y) = -A^0 + (1-c).Y = -A^0 + s.Y \quad \dots\dots(11)$$

where $s = (1 - c)$ is the marginal propensity to save

You may notice that hoarding of monetary assets increase with rise in the domestic income. When domestic absorption is greater than domestic income i.e. $H < 0$ then there is what is called dis-hoarding.

8.4.1 Income Adjustment (Foreign Trade Multiplier with and without Foreign Repercussions and Determination of National Income and Output)

The Keynesian goods market equilibrium condition expressed in real terms states that domestic output Y is determined by the aggregate demand for domestic goods, which is equal, in turn, to absorption A , plus the trade balance. Therefore, in equilibrium

$$Y = A + T \quad \dots\dots\dots(12)$$

Rearranging, we can write:

$$Y - A = T \quad \dots\dots\dots(12a)$$

which states that an excess of equilibrium income over absorption is associated with a trade balance surplus. Let us remember that aggregate demand variables used in (12) are all planned expenditures whereas Y represents the actual expenditures. So, at equilibrium actual expenditures must match the planned expenditures.

Equation (12a) means that the economy is in equilibrium when hoarding is equal to trade balance. Equilibrium output in the economy is then equal to Y_0 which we get by solving $H = -A^0 + s.Y = T^0 - m.Y = 0$ We obtain:

$$Y_0 = (1/s+m)(A^0 + T^0) = \alpha(A^0 + T^0) \quad \dots\dots\dots(13)$$

where α is the Keynesian open economy multiplier. The implication is that any change in the autonomous absorption or autonomous trade balance will tend to have a magnified effect on domestic income. Expressing (13) in terms of changes yields

$$\Delta Y = \alpha \Delta(A^0 + T^0)$$

where ΔY indicates changes in income, and ΔA^0 indicates changes in autonomous absorption, and ΔT^0 indicates changes in autonomous trade balance.

In an open economy, the attainment of internal as well as external balance is the two-pronged aim. The goal of internal balance implies attainment of full employment. External balance implies that there is no surplus or deficit in the balance of payments. In the absence of capital mobility and trade in services it corresponds to balanced trade. A trade deficit in the present Keynesian framework implies that the domestic spending is in excess of domestic income ($A > Y$).

This suggests that the policies for correcting a deficit can be classified into two types: those that tend to reduce spending, at any given level of income and those that tend to increase domestic income at any given level of domestic spending by domestic residents. The first type of policies is known as

expenditure reducing policies, characterised by contractionary fiscal policy i.e. reduction in government expenditure. As (13) above, suggests, this would contract domestic income due to multiplier effect and thereby would reduce trade deficit as $\Delta Y = \alpha \Delta A^0 = \alpha G^0$. The reduction in government spending has a contractionary effect on domestic income and the trade deficit is reduced as $\Delta T = \Delta T^0 - m \Delta Y$. Since $\Delta T^0 = 0$, $\Delta T = \Delta T^0 - m \Delta Y = -m \Delta Y = -m \Delta G^0$. How much trade deficit will be reduced will depend upon the value of the marginal propensity to import (m).

Foreign Trade Multiplier with Repercussion Effect

Let us now relax the earlier assumption that foreign income Y^* is fixed. Then we can write (8) as:

$$T = T^0 + m^* Y^* - mY \quad \dots(8a)$$

You will notice that the domestic trade balance deficit (surplus) must be equal (but in opposite sign) to the trade balance surplus (deficit) of the rest of the world, that is $T = -T^*$, where T^* is the foreign trade balance.

Equilibrium in the domestic goods market is

$$Y = A + T = A^0 + \alpha Y + T^0 + m^* Y^* - mY$$

Then, equilibrium in the foreign goods market is:

$$Y^* = A^* + T^* = A^{*0} + \alpha^* Y^* - T^0 - m^* Y^* + mY$$

Where A^* , A^{*0} and α^* stand for foreign absorption, foreign autonomous absorption and foreign multiplier respectively. By solving this we get:

$$Y^* = \alpha^* A^{*0} - \alpha^* T^0 + \alpha^* mY$$

where $\alpha^* = 1/(s^* + m^*)$ is the foreign income multiplier ($s^* \equiv 1 - \alpha^*$). Substituting the value of Y^* in the expression for Y above and simplifying we now obtain:

$$Y = \alpha' (A^0 + m^* \alpha^* A^{*0} + s^* \alpha^* T^0)$$

where $\alpha' \equiv 1/(s + m - \alpha^* m^*)$ is the Keynesian income multiplier with repercussion effects. This multiplier measures the impact of a change in autonomous spending on domestic income taking into account repercussions.

8.4.2 Price Adjustment (Marshall-Lerner Condition)

A domestic currency devaluation i.e. an increase in e changes domestic economic variables by affecting the relative price of imports in terms of exports. If exchange rate increases, the relative price of imports in terms of exports increases ($e = E.P^*/P$ increases), a result of the assumption that P and P^* are fixed. As can be recalled from (8) above, the trade balance is:

$$T = M^*(e, Y^*) - e.M(e, Y^0) \quad \dots(8)$$

where superscript 0 on Y implies that we are keeping domestic income constant for the moment. A devaluation increases the relative price of imports in terms of exports, which tends to raise exports (i.e. M^* increases) and decrease autonomous imports (i.e. M decreases). The reason is that as e increases, domestic goods become cheaper relative to foreign goods, so both foreign and domestic residents tend to buy the domestic goods more. This tends

to improve the trade balance. The net effect of devaluation however, is not clear. The improvement in trade balance will depend on the responsiveness of the physical amounts of exports and imports to devaluation. This responsiveness is measured by the respective price elasticity of imports and exports. The price elasticity of exports, η^* measures the percentage change in quantity of exports due to a 1% change in the relative price of foreign goods in terms of domestic goods. That is,

$$\eta^* = (\Delta M^* / M^*) / (\Delta e / e)$$

The higher η^* is, the more responsive exports are to a change in e . The price elasticity of domestic imports, η measures the (negative of the) percentage change in the domestic imports due to a 1% increase in the relative price of foreign goods in terms of domestic goods. Symbolically,

$$\eta = -(\Delta M / M) / (\Delta e / e)$$

Let us understand that since $(\eta_M / \eta_e) < 0$, that is, a rise in relative price of foreign goods reduces imports, the import elasticity, η is positive. The higher the η is, the more responsive imports are to a change in e . Expressing (8) in terms of changes, we can write:

$$\Delta T = \Delta M^* - e \Delta M - M \Delta e$$

Now dividing both sides by ηe we get:

$$\begin{aligned} (\Delta T / \Delta e) &= \Delta M^* / \Delta e - e(\Delta M / \Delta e) - M(\Delta e / \Delta e) \\ &= (M^* / e)[(\Delta M^* / \Delta e)(e / M^*) - e / M(\Delta M / \Delta e) - (\Delta e / \Delta e)], \\ &\quad \text{assuming that the economy devalues from a starting} \\ &\quad \text{point of external balance } (M^* = eM). \\ &= (M^* / e)[(\Delta M^* / \Delta e)(e / M^*) - e / M(\Delta M / \Delta e) - 1] \\ &= (M^* / e)[\eta^* + \eta - 1] \end{aligned}$$

$$\text{or, } \Delta T = M^*[\eta^* + \eta - 1](\Delta e / e) \quad \dots\dots\dots(14)$$

From (14) it is clear that the devaluation will have a positive effect on trade balance if and only if

$$[\eta^* + \eta - 1] > 0 \quad \dots\dots\dots(15)$$

The inequality (15) is called the Marshall-Lerner condition stating that the direct effect of devaluation on the trade balance will be positive when the sum of the price elasticities of the demand for exports and imports exceeds 1.

$$\text{Note that } \Delta Y = \alpha(\Delta A^0 + \Delta T^0) = \alpha \Delta T^0 \quad \dots\dots\dots(16)$$

since we ignore any possible effects of devaluation on autonomous absorption, A^0 . Substituting (14) into (16) we get

$$\Delta Y = \alpha M^*[\eta^* + \eta - 1](\Delta e / e) \quad \dots\dots\dots(17)$$

$$\begin{aligned} \text{Now, } \Delta T &= \Delta T^0 - m \Delta Y \\ &= M^*[\eta^* + \eta - 1](\Delta e / e) - m \alpha M^*[\eta^* + \eta - 1](\Delta e / e) \\ &= s \alpha M^*[\eta^* + \eta - 1](\Delta e / e) \quad \dots\dots\dots(18) \end{aligned}$$

which is positive if Marshall-Lerner condition holds as other parameters are positive. This means devaluation, considered as an expenditure switching policy, improves trade balance if the sum of price elasticities of exports and imports exceeds 1 i.e. if the Marshall-Lerner condition holds.

Check Your Progress 3

- 1) Suppose that you are given the following absorption and trade balance relationships for a certain fixed exchange rate economy:

$$A = A^0 + \alpha Y = 390 + 0.75Y$$

$$T = T^0 - mY = 50 - 0.25Y$$

With symbols having their usual meanings and all variables are measured in real terms.

- (a) What is the equilibrium level of income in the economy? What is the value of the Keynesian multiplier? What is balance of trade? Is this surplus or deficit?
- (b) Suppose that there is an exogenous increase in the foreign demand for domestic exports reflected in an autonomous increase of trade balance of 50 billion. What is the effect on the equilibrium level of income and the trade balance?
- (c) Consider the impact of an exogenous increase in government spending of 50 billion. What is the effect on equilibrium level of income and trade balance?

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- 2) Suppose the price elasticity demand for imports is equal to 1.1 and that of exports is 0.8. Now, if the government decides to devalue the domestic currency by 10% what would be the impact on the trade balance and equilibrium level of income?

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- 3) Discuss the foreign trade multiplier with repercussion effects.

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8.5 FLOATING RATES AND MANAGED FLOATING

The definitive breakdown of the Bretton Woods regime in March 1973 represented a fundamental shift from a system of adjustable pegs to one of wider flexibility in the management of exchange rates. This change in international monetary arrangements was officially sanctioned in 1978, when the IMF's Article of Agreement was amended to take into account the exchange rate flexibility that had already become a fact of life half a decade before. The amended Articles allowed a large degree of freedom to countries in choosing their exchange rate regime. Currencies could float or be pegged to the dollar, Special Drawing Rights (SDRs), or any other basket of currencies.

The present regime can be described as being a hybrid system, although its free-for-all nature has led some to refer to it as a nonsystem. The currencies of the major industrial countries have been floating against the dollar. At the same time, about 50 other countries – including most of Latin America – keep adjustable pegs to US dollar, while still another group pegs to the French franc, the SDR, or other currency baskets. Some countries, particularly developing countries, have adopted a so-called crawling peg regime, under which exchange rates are subject to small but frequent adjustments, as opposed to the generally large and infrequent devaluations or revaluations typical of Bretton Woods. Finally, perhaps the best illustration of the hybrid character of the present international monetary regime was the exchange rate arrangement of the European Monetary System, adopted by all members of the European Economic Community except the United Kingdom and Greece. These countries kept a regime of pegged rates among their currencies, which floated jointly against other currencies, such as US dollar, the Canadian dollar, and the Japanese yen. Established in 1979, the EMS was associated with a long-standing tradition of efforts toward European monetary integration since World War II. Finally, the EMS turned into a single currency area (Euro) since the beginning of this decade.

The floating exchange rate arrangement followed by most industrial countries after 1973 has been characterised by active intervention of Central Banks in foreign exchange markets. In other words, the regime is one of managed or dirty floating rather than one of free-floating exchange rates. Paradoxically, the general extent of Central bank intervention in foreign exchange markets during the period of increased exchange rate flexibility after 1973 has exceeded that under the Bretton Woods' fixed exchange rate regime. The intervention is called for in order to smooth out excessive fluctuations in exchange rates so as to avoid the effects of these fluctuations on domestic economic activities.

Check Your Progress 4

- 1) Describe the salient features of floating exchange rate regime since 1973.

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- 2) Why the Central Banks' frequent intervention in the foreign exchange market is necessary under floating rate regime?
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- 3) Why the exchange rate regime since 1973 is known as hybrid system as well as non-system?

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8.6 MONETARY THEORY OF BALANCE OF PAYMENTS

Monetary approach to balance of payments was developed during the early seventies. The monetary approach stresses that the balance of payments involves essential monetary phenomena. The basic starting point of this approach is the money market equilibrium condition. The market for money will be maintained in equilibrium when the changes in money demand occurring over any given time period are equal to the changes in the money supply forthcoming in the economy. Symbolically, we obtain

$$\Delta M^D = \Delta M^S \tag{19}$$

where ΔM^D indicates changes in the money demand and ΔM^S changes in the money supply. Changes in the money supply, ΔM^S , are proportional to changes in high-powered money, ΔH , that, in turn can be represented as the sum of changes in the international reserves of the Central Bank, ΔIR , plus changes in Central Bank credit, ΔCBC i.e.

$$\Delta M^S = \mu \Delta H = \mu (\Delta IR + \Delta CBC) \tag{20}$$

Now let us note that the balance of payments expression B_N , in nominal terms, is equal to the changes in international reserves of the Central Bank. Therefore, we can write:

$$B_N = \Delta IR \tag{21}$$

Putting (21) into (20) we obtain:

$$\Delta M^S = \mu (B_N + \Delta CBC) \tag{22}$$

Since the money multiplier μ , is fixed we can assume $\mu = 1$. Now, using (19) in (22) and rearranging the terms we get:

$$B_N = \Delta M^D - \Delta CBC \tag{23}$$

Equation (23) states that the balance of payments corresponds to those additions to (or subtractions from) money balances that domestic residents demand but are not provided by the Central Bank in the form of changes in credit. For example, a balance of payments surplus ($B_N > 0$) represents a situation in which credit creation by the Central Bank outpaces the growth of money demand.

8.7 A CRITICAL REVIEW OF MONETARY THEORY OF BALANCE OF PAYMENTS ADJUSTMENT

The monetary approach states that balance of payments is a monetary phenomenon. But this does not take into account the following things:

- i) The balance of payments is not only a monetary phenomenon. Money no doubt plays an important role in understanding the balance of payments of a country. But the approach does not include the importance of non-monetary factors (such as productivity changes, tariffs, government spending and taxation) on the balance of payments.
- ii) It gives only a monetary view of the economy. It is therefore not consistent with the variety of economic environments including inflation and recession, unemployment and full employment, stagflation and so on.
- iii) The approach stresses monetary adjustment to balance of payments. It does not stress the important role that overall government policies have in the economy, especially in the balance of payments.

8.8 RELATIVE MERITS AND DEMERITS OF FIXED AND FLEXIBLE EXCHANGE RATES

We will discuss here the relative merits and demerits of the fixed and floating exchange rate regimes in the light of the experiences of the Bretton Woods regime and the managed or dirty floating regime since 1973.

Monetary Policy Autonomy: Under fixed exchange rate regimes, the Central Banks are obliged to intervene in the foreign exchange market to keep the exchange rate fixed. But under floating rate regime such obligation is not there. Hence, the governments can use monetary policy to reach internal and external balance.

Symmetry: Under Bretton Woods system the United States was able to set world monetary conditions all by itself. Such is not the case under floating rate regime. Hence, the inherent asymmetries would go under floating rate regime. The United States with all other countries have the same opportunity to influence its exchange rate against foreign currencies.

Exchange Rates as Automatic Stabilisers: Under Bretton Woods system, there used to be long periods of speculation preceding exchange rate realignments. Policy-induced changes in exchange rates were sought to stabilise the economies. However, the swift adjustment of market-determined exchange rates would help countries to maintain internal and external balance in the faces of changes in aggregate demand under floating rate regime.

Discipline: Central banks freed from the obligation to fix their exchange rates might engage in inflationary policies under floating rate regime, the chances of which are limited under fixed exchange rate regime. There is thus a trade-off with monetary policy autonomy.

Speculation: Under floating exchange rate regime, speculation in changes in exchange rates may lead to tremendous instability in foreign exchange markets, adversely affecting countries' internal and external balance.

International Trade and Investment: Flexible exchange rates render international prices more unpredictable and thus injure international trade and investment.

Uncoordinated Economic Policies: Under floating exchange rate regime, competitive currency practices may harm the world economy. Countries may adopt policies without considering their beggar-thy-neighbour aspects.

Uncertainty: Floating exchange rate actually increases exchange rate volatility. To prevent wild fluctuations in exchange rate Central Banks need to intervene more frequently than under fixed rate regime. Floating exchange rate regime fuels greater uncertainty in the economy than the fixed exchange rate regime due to volatile nature of exchange rate movements.

Check Your Progress 5

- 1) Explain the statement that "Balance of payments is a monetary phenomenon".

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- 2) Explain the fact that balance of payments surplus means excess of central bank credit over the demand for real money balances in the economy.

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- 3) Provide a critical evaluation of the monetary approach to the balance of payments.

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- 4) Critically discuss the relative merits and demerits of fixed and floating exchange rate regime.

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8.9 LET US SUM UP

In this Unit, you have learnt about the history of International Monetary System and Exchange Rate Regime from 1880 onwards. You have also learnt the fixed exchange rate regime under Gold Standard. The Unit explains to you the dollar based Gold Exchange Standard System. It also introduces you to the principles of adjustments both Price and Income Adjustment. The Unit also discusses the reasons for the floating rates and managed floating regime. It critically explains the Monetary Approach to Balance of Payments. The Unit ends with a discussion on the relative merits and demerits of the fixed and flexible exchange rates.

8.10 KEY WORDS

Bancor: An alternative currency unit suggested by Keynes as against the dependence of Bretton Woods system on US dollar for international liquidity and trade. His idea was, however, rejected at that time until in 1960 economist Robert Triffin recognised this idea.

Contractionary Fiscal Policy: It means a decrease in government spending or a tax increase. The intention is normally to cause aggregate output (GDP) and/or the price level to fall and to correct deficit in the economy.

Coin Debasement: To reduce the value of coins. It is predecessor to the concept of devaluation. Classically, a currency is debased if its value in terms of gold or other precious metal is reduced.

Crawling Peg Regime: An exchange rate regime followed normally by developing countries, which is pegged, but for which the par value is changed frequently in a pre-announced fashion in response to signals from the exchange market.

Fixed Exchange Rate Regime: Under fixed exchange rate regime the countries did not change their mint parities during the Gold standard period and hence, there was hardly any deviation of the exchange rates of the major currencies from the respective mint parities. This regime is usually synonymous with a pegged exchange rate.

Floating Exchange Rate Regime: A regime in which a country's exchange rate is allowed to fluctuate freely and be determined without intervention in the exchange market by the government or central bank.

Gold Exchange Standard Regime: A monetary system that sought to restore

System. Under this regime, instead of money being backed directly by gold, central banks issued liabilities against foreign currency assets (mostly U.S. dollars under Bretton Woods) that were in turn backed by gold.

Specie Commodity Standard: Under the gold standard, this was the mechanism by which international payments would adjust. A country with high inflation would export less, import more, and thus lose specie, i.e., gold. With the money supply fixed to the quantity of gold, the resulting monetary contraction would reduce prices.

Pegged Exchange Rate: A regime in which the government or central bank announces an official par value of its currency and then maintains the actual market rate within a narrow band above and below that by means of exchange market intervention.

8.11 SOME USEFUL REFERENCES

Jacob Frenkel and Harry Johnson (ed) 1976. *The Monetary Approach to the Balance of Payments*, University of Toronto Press and George Allen & Unwin Ltd.

Krugman, P. and M. Obstfeld. 2000. *International Economics : Theory and Policy*, Addison Wesley Longman : Singapore.

Sodersten, Bo. and Reed, Geoffrey , 1994. *International Economics*, Third Edition Macmillan,.

8.12 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1. Read Section 8.2
2. Read Section 8.2
3. Read Section 8.2
4. Read Sub-section 8.2.2
5. a) F b) F c) T d) T

Check Your Progress 2

1. Read Section 8.3.2
2. Read Section 8.3.2
3. Read Section 8.3.3
4. Read section 8.3.4
5. Read Section 8.3.3
6. a) T b) F c) F d) T

Check Your Progress 3

- 1) Read Sub-section 8.4.1. (a) -880, 0.75, -170, deficit (b) increase in both Y (980) and T (-195) (c) Y to increase by 37.5 and trade deficit by 12.5.
- 2) Read Sub-section 8.4.2. Yes, the devaluation will have positive impact on trade balance since the sum of import and export elasticities exceed one according to Marshall-Lerner Condition.
- 3) Read Section 8.4.1

Check Your Progress 4

- 1) Read Section 8.5
- 2) Read Section 8.5
- 3) Read Section 8.5

Check Your Progress 5

- 1) Read Section 8.6
- 2) Read Section 8.6
- 3) Read Section 8.7
- 4) Read Section 8.8

UNIT 9 INTERNATIONAL FINANCIAL INSTITUTIONS

Structure

- 9.0 Objectives
- 9.1 Introduction
- 9.2 The International Monetary Fund
 - 9.2.1 Purpose and Objectives of the IMF
 - 9.2.2 Organisation and Functioning of the Fund
 - 9.2.3 Process and Pattern of Funding in the Fund
 - 9.2.4 Convertibility of the IMF Credit Facilities
 - 9.2.5 Functions of the IMF
 - 9.2.6 Critical Evaluation of the IMF
 - 9.2.7 Special Drawing Rights (SDRs)
- 9.3 The World Bank
 - 9.3.1 Objectives and Policies of the Bank
 - 9.3.2 Organisation and Structure of the Bank
 - 9.3.3 Lending Policies of the Bank
 - 9.3.4 Functions of the World Bank
 - 9.3.5 Affiliates of the World Bank
 - 9.3.6 Critical Evaluation of the World Bank
- 9.4 Asian Development Bank (ADB)
- 9.5 Let Us Sum Up
- 9.6 Key Words
- 9.7 Some Useful References
- 9.8 Answers/Hints to Check Your Progress Exercises

9.0 OBJECTIVES

After reading this Unit, you will be able to

- understand the objective, functions, process of funding and conditionalities of IMF;
- learn the objectives, organisation structure functions and lending policies of the World Bank; and
- know the functioning of ADB.

9.1 INTRODUCTION

The International financial institutions are an important source of external finance. With the changing world economy since 1945 partly due to Bretton Woods system or partly due to various trade rounds first under GATT and then under WTO., the role and functions of these financial institutions have also changed. Thus the evolving global coordination of macro-economic and finance policies, in general and trade and finance policies in particular is not an accidental or casual occurrence. It is, in fact, a very formalised process that interlinks and defines the policies and activities of key international financial institutions like IMF and the World Bank. They have a set of mechanisms by which these international financial institutions influence the trade and investment policies of the borrowing countries and their stand in trade negotiations under WTO. These mechanisms can be broadly grouped into four categories. These are policy based conditionalities, trade-related assistance, training and research and ex-ante mechanisms (country policies and

institutional assessment of the borrowing countries). In the present Unit, you will learn about some of these aspects, related to international financial institutions like, International Monetary Fund (IMF), The World Bank and Asian Development Bank (ADB).

9.2 THE INTERNATIONAL MONETARY FUND

The International Monetary Fund (IMF) was set up at the Bretton Woods Agreement in 1944. The chaos prevailing during the interwar period led the industrialised countries of the world to set up multilateral financial institution to monitor the international monetary system after the end of World War II. The IMF was entrusted mainly with the short run balance of payments adjustments of the member countries.

At the time when IMF was established in 1944, its membership was limited to 44 countries. But over time it increased continuously and in 2006 the total number stood at 184.

9.2.1 Purpose and Objectives of the IMF

The main objectives of the IMF were listed in the Article I of its Articles of Agreement. They are listed below:

1. To promote international monetary cooperation through a permanent institution.
2. To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high level of employment in member countries.
3. To promote exchange rate stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange rate depreciations.
4. To assist in the establishment of multilateral system of payments in respect of current transactions between members and in elimination of foreign exchange restrictions.
5. To give confidence to members by making the Funds resource available to them under safe guards, thus providing them with the opportunity to correct their balance of payments disequilibrium.

The objective of maintaining exchange rate stability was done away with in 1979 after the formal collapse of the Bretton Woods system in 1973. With this amendment in its Article, the Fund recognised formally the market-determined flexible exchange rate regime in the member countries.

9.2.2 Organisation and Functioning of the Fund

The Structure of the Fund

The management of the IMF is controlled by a Board of Governors (which is the highest body), the Executive Board, and an international staff. Every member country sends a representative to the "Board of Governors", which must meet

once in a year. Most of the decisions on fundamental matters are taken by this board during the meeting (like electing new members or changing quotas). The day-to-day management activities are run by an Executive Board, which consists of 24 Executive Directors. Among them five directors are appointed by the countries having largest quotas [namely, USA, UK, Germany, Japan and France]. The remaining directors are elected by the members divided into regional voting groups. The Managing Director of the Fund is a non-voting Chairman of the Executive Board, who is elected for a period of five years.

Each IMF member is allotted a quota, which determines the ir rights and obligations. The quota for each country determines the subscriptions made by each of them at the Fund. The size of the quota roughly reflects importance of the each member in the world economy. These quotas can be revised every five years by a general agreement. The quota is, therefore, a very important aspect for the IMF functioning. A member country's quota has four important aspects:

1. It specifies a Member County's subscription to the Fund;
2. It defines a country's drawing rights, i.e. how much a country can borrow from the Fund;
3. It indicates the country's voting power; and,
4. It determines its share of any allocation of SDRs reserves.

Special Drawing Rights (SDRs as they are known as), is a form of international reserves among participants in the Special Drawing Accounts, and is described in greater detail in section 9.2.7 in this Unit.

The quota of each country is calculated by the formula known as the Bretton Woods formula. The formula focuses in the following variables while calculating the quota-size - fluctuations of a country's foreign trade and its export dependence, gold and foreign exchange reserves and sometimes its national income, current account transactions etc. For most decisions in the Fund a straightforward majority is sufficient with voting rights of each member country being proportional to their quotas. In general, each member country has 250 basic votes plus one vote for each 100,000 SDRs of its quota. USA, which has the highest quota has control over 17% of the votes. India has 1.92% of the votes.

Size of the Fund equals the sum of the subscriptions by its members, which was estimated to be equal to SDRs 213 billion (about \$308 billion) in 2006. The IMF's resource mainly comes from capital subscriptions by its member countries. The subscription up to 25% must be made in gold (or later in SDRs), and the remaining 75% in the country's own currency. Apart from this, the Fund can also acquire currencies for lending via sale of gold to members and by borrowing.

9.2.3 Process and Pattern of Funding in the Fund

According to the Articles of Agreement, the Fund may give necessary assistance to its member countries to finance their balance of payments deficits on current account. Obviously the assistance will be in the form of loans. When a country is in demand for foreign currency, it has to purchase the required amount from the Fund in exchange of equivalent amount of its

domestic currency. In technical terms this is called “drawing” on the Fund. The total amount that a country is entitled to ‘draw’ is determined by the amount of its quota. There are certain rules that the IMF follows for providing loans. A member is entitled to draw an amount not exceeding 25 per cent of its quota. The first 25 per cent of its borrowing, or the 1st part of its drawing rights, also called the gold tranche or reserve tranche, can easily be drawn by the member countries, as it is regarded as the members’ owned reserves, and therefore no conditions are attached on it. Apart from this, there are *four* other credit tranches or drawing rights, called the first, second, third and fourth credit tranches which can be used by a country for further borrowing. But the IMF has the right to impose conditions, if a country uses these tranches. These conditions become more and more stringent as a country moves beyond first tranche. However, the Fund does not charge any interest rate for the first credit tranche. Normally, repayment period of a country, fixed by the IMF is three to five years, and at most, the maximum amount that can be borrowed by a country is 450 per cent of its quota. Of course, the rate of interest goes on increasing, as a country uses its drawing right beyond the gold tranche.

Regarding the lending pattern of the IMF, it can be said that at the beginning, rich industrial market oriented economies drew substantial resources from the IMF. However, from 1980 the Fund lending became more directed towards developing countries of Asia and Africa. After the severe debt crisis in the eighties, the Latin American countries also became major users of the Fund resources. Another major aspect of the Fund’s lending is the introduction of Structural Adjustment Facility (SAF) during 1986. SAF was introduced in order to benefit the low income member countries suffering from severe debt crisis. Under the SAF, credit was made available at much flexible terms for poor members. Credit facilities for economic reforms programmes were made available at a interest rate of only 0.5% (compared to the general rate of 6%) and repayment period was increased to 10 years with a grace period of five and half years. In 1999, the IMF introduced the Poverty Reduction and Growth Facility (PRGF) for low-income countries, with similar concessional terms and a greater focus on poverty.

9.2.4 Convertibility of the IMF Credit Facilities

In providing financial support to any member country, the IMF must be assured that the member is pursuing suitable policies that will help to eliminate its external payment problem and enable it to pay its debts. Use of the IMF resources must be made in accordance with the provision of the IMF articles and the policies adopted under them. Therefore, as a part of conditionality, the IMF resources should be used accordingly to the guidance or frameworks provided by the IMF, so that the member country could restore its balance of payments equilibrium and sustain economic growth, without resorting to restriction on trade and current account payments.

Conditionalities imposed by the IMF are of varying degrees depending upon the different credit tranches. Drawings on gold or reserve tranche are unconditional. Under first credit tranche the member country is not required to satisfy any performance criterion. However, for the next three credit tranches drawings are conditional upon the agreement of the member country to follow structural adjustment and stabilisation programmes in their domestic economies. These programmes normally include a mixture of monetary and

fiscal policies, along with various policies, which focus on exchange rate devaluation, liberalisation, privatisation and towards market determined economic order, where government participation is minimum. Since the budget deficit is considered as a major concern, therefore, various direct fiscal measures are recommended for reducing such deficit under the fiscal stabilisation programmes. Ultimately, the conditionalities generally focus on removal of various rigidities and barriers in the working of a market based economy, so that borrowing country follows the principle of 'laissez-faire', which according to the IMF will help the borrowing country to attain sustained economic growth and development.

9.2.5 Functions of the IMF

The main objectives, with which the IMF was created was to restrict competing devaluation and to create international resources to help its members come out of temporary balance of payments crisis. In accordance with this objective, the following functions are, in general, performed by the IMF:

1) Providing mechanism for improving short term balance of payment situation

One of the major aims of the IMF was to overcome the balance of payments crisis among its member countries. In order to fulfil the objective, the IMF allowed short-term flows of its resources to the member countries suffering from such crisis on conditional terms.

2) Serving as short-term credit institution

If any member country is in a temporary difficulty in liquidating an advance balance of payments situation, then the Fund may come to its rescue by providing short-term credit supplies. But this does not mean that the Fund would supply all the foreign exchange that a country may need. In fact, it only acts as a second line of defence to fight against an emergency situation. Further, the borrowing country has to pay its interests and return the amount in time in order to keep its quota intact.

3) Maintaining exchange stability

One of the major outcomes of the Bretton Woods Agreement was the Bretton Woods system or the "adjustable-peg" exchange rate system, about which you have learnt in the preceding Unit 8 in this block. The responsibility of maintaining the overall stability in this system was imposed on the IMF. Under the system any drastic change in the exchange rate by its member countries was not possible without the prior provision of the IMF. In fact, any change in the exchange rate above 10% of its original value would require IMF's prior permission except under situation when the country's balance of payments situation was really critical. Thus the IMF was responsible in maintaining a relatively stable economic order at least till 1970s.

4) Reservoir of currencies

The Fund also provides a reservoir of currencies and enables members to borrow another member's currency.

5) As a machinery for institutional consultation

The IMF brings together representatives of the principal nations of the world, and provides an excellent opportunity for reconciling their conflicting claims and discussing matters of mutual interest regarding the international monetary system. Thus the Fund has provided a platform for international cooperation. It also exercises surveillance of members' economies and provides training to their officials, especially in the areas of fiscal and monetary policy and banking regulation.

9.2.6 Critical Evaluation of the IMF

The Fund can play a vital role in achieving economic stability and in promoting healthy international monetary relations among the nation. However, the IMF has not succeeded to achieve its objective fully in the early years of its operations. Some of the major shortcomings, which has been pointed out by its critics are as follows:

Firstly, for many years, the Fund was not able to achieve its fundamental objective of pulling down trade barriers.

Secondly, it has not been successful in restraining inflationary pressure in countries and maintaining monetary stability.

But the major criticism of the IMF has actually came from the Third World countries due to the stringent conditionalities, which were imposed on them along with the supply of Fund resources. In fact, the ideological bias of these conditionalities towards free market economy further raised doubts about IMF's actual motives, which was supposedly and significantly influenced by the developed countries. Excessive power of USA, having the largest quota and almost 18% voting rights, in controlling the functioning of the IMF was another criticism, against functioning of the IMF.

But in spite of all these shortcomings, the IMF has successfully achieved its goals in certain fronts.

- It has provided an excellent forum for solving conflicting issues in the international scenario.
- It has promoted to a certain extent the expansion of international trade for mutual benefits of countries.
- It has simplified the exchange rate system by promoting steady programmes towards the establishment of a multilateral system of payments in respect of current transactions.

9.2.7 Special Drawing Rights (SDRs)

Creation of SDRs can best be linked with the problem of international liquidity. The term international liquidity covers all those financial assets, which can be used to overcome any balance of payment crisis and via which a government can intervene in the forex market. During the period of Bretton Woods System, the reserve position of a country was determined by its holding of gold and foreign exchange. But, gold - which is a scarce natural resource, cannot be expanded when it was required for. As regards to foreign exchange,

most of it was held in dollars (as it was the only currency that could be converted to gold). But the huge trade deficits on USA in order to sustain the growth in world trade, was making dollar less reliable as a means of foreign exchange. Thus, to avoid any shortage in international liquidity either USA would have to run deficits, which would undermine confidence on dollar, or the cessations of the US deficits to strengthen dollars would create liquidity shortage.

One important feature of SDRs is that it is created as an accounting entry in books of the IMF, just as a normal account is created in a Bank, except for the fact that in this case no deposits are required for its creation. After the allocation of SDRs is made, a member country automatically receives its share corresponding to its quota. This allocation is made annually by a collective decision of the IMF participating members. Possession of SDRs by a country enables it to obtain a definite amount of other countries' currencies, so that it can be used to correct its debt obligations. Apart from this a country can hold SDRs in order to:

- i) repay old debts with the IMF,
- ii) acquire foreign exchange to cover deficits, and
- iii) repurchase its own currency from other countries.

A country that uses part of its SDRs allotment becomes a debtor at the IMF and thus, must pay interest on the difference between its original allocation and its present one. Similarly, a creditor country will receive interests on its surplus holding of SDRs.

Unlike gold, SDRs creations do not induce utilisation of any scarce resources, nor does it require any deficit to sustain its circulation. Further advantage of SDRs is that it is costless to produce and cannot be demonetised. Thus, SDRs can be used as an effective reserve currency and can be used to solve the liquidity problem in the long run.

Check Your Progress 1

- 1) What are the objectives of IMF?
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- 2) What is the pattern of funding of the Fund?
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- 3) What are the main functions of IMF?
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- 4) Critically evaluate the role of IMF in achieving economic stability.

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- 5) What are SDRs? Discuss their important features.

9.3 THE WORLD BANK

At the Bretton Woods Conference, along with the IMF, the International Bank for Reconstruction and Development (IBRD) was also established in 1944. This is also known as the World Bank. While the IMF was given the task to look after the balance of payments adjustment within the member countries, the World Bank was given the task to provide aid and support to rebuild the war-devastated Europe. With the advent of the US Marshall Plan, which acted as the main locomotive of the European re-construction, the World Bank shifted its focus towards the developing countries of the world. By 1949, it launched itself as the multilateral development Bank (MDB), and since then the IBRD came to be known as the World Bank. According to its charter, the head office of the Bank should be located in the country, which will be holding the highest number of shares. Thus, the headquarters of the World Bank is located at Washington D.C. as USA holds the maximum number of shares of the Bank.

9.3.1 Objectives and Policies of the Bank

The main objective of the Bank was to support the European nations to rebuild their economies from the ruins of the Second World War. But soon after, the Bank realised that the reconstruction activity was controlled more by US-Marshall plan and thus shifted its objective towards the long term development of erstwhile colonised countries most of which became independent from the colonial rule after the World War II. It provides long term development loan to the developing and less developed countries.

In the first twenty years of its establishment two third of the Bank's loans to the developing countries was directed towards building up of large scale infrastructural projects such as electricity and transport. The Bank's main policy at that time was to promote expansion of production via improvement in the infrastructural base of the member countries, leading to economic growth in these countries. The dominant philosophy at that time was that economic growth would automatically take care of poverty. But financing large projects was growth-enhancing but did not have any impact on poverty reduction. This is

because of various bottlenecks present within these countries, which prevented downward percolation of the benefits of the growth. Thus the World Bank changed its policy during the chairmanship of Robert McNamara in the late sixties, and it emphasised on taking direct measures to reduce poverty. Consequently, projects on rural developments, poverty eradication, and agriculture became the largest recipients of the World Bank loans. Above all, priority was given to development of the education level, health, birth control in the poorer countries. Later with the introduction of Structural Adjustment Lending (SAL) / Structural Adjustment Programme (SAP), another change in policy of the World Bank was noticed. Loans were disbursed in exchange of policy reform, such as liberalisation, privatisation of public sector, financial sector reform, labour market reforms etc. By late 90's the policy of the Bank has been focused towards development of the market oriented economic structure in the Bank loan receiving developing countries. More recently, the Bank has focused on NGOs, for developing the less developed areas of the Third World countries and for implementing various poverty eradication programmes, literacy projects, health and birth control related programmes etc.

9.3.2 The Organisation and Structure of the Bank

Being sister institution of the IMF, membership of the IMF is a prerequisite for membership of the World Bank. The organisational structure of the Bank was quite similar to that of the IMF. At the top all the powers are vested to the Board of Governors, which consists of one representative from each member country. The Board generally meets once in a year to take any important decision, jointly with the Fund's Board of Governors.

But the daily effective management is controlled by the Board of Executive Directors, which consists of 24 members. The five countries, which hold the largest shares in the Bank have five permanent appointed Executive Directors and the rest are elected by the governors representing other member countries. Voting rights are same for all the members. The Chairman of the Board of Executive is appointed for a period of five years. He also acts as the chief of the World Bank's operating staff.

The officers and staff of the World Bank is divided into six regional groups along with various other administrative sectors. Each country group is led by the Bank Vice President. In addition there are nine operational sections.

9.3.3 Lending Policies of the Bank

The World Bank grants loans to the developing countries almost nearly to an amount of \$20 billion a year. Generally, the duration of loans is for a period of 15 to 20 years as against the IMF loan of 3 to 5 years. But the lending rate for the World Bank is a bit higher than that of IMF lending rate since the Bank loans are long-term loans.

Before granting a loan to a member country, the World Bank is generally guided by the following principles:

1. It verifies the particular country's debt serving capacity.
2. Loans are given only for productive purpose and entirely on economic considerations.

3. The loans are granted only when the country seeking financial assistance cannot raise capital on reasonable terms from any other source.
4. The Bank normally gives loan to cover only foreign exchange component of the project.

Normally there are three provisions for distributing loans:

Project Loans

This is most traditional way of allocating loans to the developing countries. It has been estimated that over 50 years (1944-96) the loans provided by the World Bank is almost equal to \$ 250 billion distributed over 3500 projects.

Sectoral Loan

These loans are generally sector specific non-project oriented loans, meant to help the developing countries. Most part of the loans in this category is directed to support a policy change while the rest may be used to meet the cost of sector specific projects.

Structural Adjustment Loans

A loan under this category requires the borrowing country to make policy reforms, which will alter its production structure. The World Bank loans in this category are designed to support –

1. Market oriented principles in order to promote competition and flexibility in every sphere of economic activity.
2. Privatisation of public enterprises.
3. Liberalisation relating to industry and trade.
4. International Reforms.

9.3.4 Functions of the World Bank

IBRD was set up in 1944 with the objective to provide long-term capital to its member nations in an orderly manner to accomplish long term developments in these countries. Its main functions, which are generally attached with its objectives, are as follow:

- i) It provides financial and technical assistance to developing countries for their development projects.
- ii) It promotes international flows of private investments from capital surplus countries to capital deficit countries, thus providing an outlet for surplus resources of capital abundant countries, and helping to raise investment level in capital deficit countries.
- iii) It aims to sustain balanced growth of international trade that will improve welfare of the people throughout the world.
- iv) It serves as guarantor, thereby attracting private foreign investments towards the developing countries and hence stimulating foreign investment in those countries.

Countries suffering from acute balance of payment crisis can get structural loans from the Bank on easy instalments but generally these loans are

accompanied with stringent conditionalities based upon various market oriented policies, which must be followed by the borrowing country.

9.3.5 Affiliates of the World Bank

The World Bank has two financial affiliates- one is the International Development Agency (IDA), and the other is the International Finance Corporations (IFC). Both of these are separate legal entities of the World Bank.

The International Development Agency (IDA)

IDA was set up in 1960 with the aim of providing easy and commercial loans to the Less Developed Countries for their development purpose. The creation of IDA highlighted three important facts:

- i) It is a step to institutionalise commercial finance for development purposes.
- ii) It has made poverty and backwardness of the Less Developed Countries as a matter of concern for the developed countries.
- iii) By improving the economic capabilities of the LDCs it tries to enhance the multilateral trade and payments throughout the world.

Membership of the World Bank is a prerequisite for the membership of the IDA. It is usually referred to as the soft loan window of the World Bank due to the easy loans it provides to the LDCs. These loans are mainly aimed at reducing the burden of the borrowing to stabilise balance of payment positions of the poor member nations.

The International Finance Corporation (IFC)

The IFC was set up in 1956 with the aim of supplementing the activities of the World Bank. The membership of the World Bank is a prerequisite for the membership of the IFC. It assists financially the private productive enterprises in the LDCs. This role of the IFC is supposed to induce foreign fund flow to the LDCs. It provides assistance to the LDCs. It provides assistance to the private enterprises in three different ways:

- i) by direct investments;
- ii) by obtaining additional foreign and domestic capital; and,
- iii) by providing technical assistance.

It sometimes also invests in the private enterprises where the public sector has joint holdings.

9.3.6 Critical Evaluation of the World Bank

Of late, like the IMF the workings of the World Bank are also under severe criticism. These criticisms are mainly concerned with the World Bank's structural adjustment packages, which call for dismantling of state-control in every sphere of economic life in the developing and least developed countries in an attempt to restructure these economies along the market-based principles. As a result, in many of these countries subsidies aimed at the poorer sections of the population, development spending directly affecting the poor and marginalised sections have been withdrawn. In many countries, Bank

conditionality-based lending has led to a process of growth, known as job-less growth. The latter implies economic growth with rising unemployment and underemployment. All these actually increased the sufferings of the poor and the vulnerable sections of the population. With increasing integration of the world economy, as the structural adjustment programme unleashed by the Bank's lending policy, in many of these developing countries the domestic economies became adversely affected with the transmission of international shocks (in the form of financial crisis, output shocks, exchange rate volatility etc). With all these the basic purpose of the Bank lending i.e. removal of poverty and raising standard of living of the common people in the developing and least developed world seems to be defeated.

9.4 ASIAN DEVELOPMENT BANK (ADB)

Asian Development Bank (ADB) is a multilateral development finance institution dedicated to reducing poverty in Asia and the Pacific. It is one of the regional development banks set up in 1966 almost in line with the World Bank to cater to the financial needs of development in the Asia Pacific region. It is owned by 64 members, mostly from the region. Its headquarters is in Manila.

Much like the organisational structure of the World Bank, the ADB is managed by a Board of Governors, a Board of Directors, a President, four Vice-Presidents, and the Heads of departments and offices. Each member country nominates one Governor and an Alternate Governor to vote on its behalf. The Board of Governors elects the 12 Directors (each with an alternate)—eight representing countries within the Asia-Pacific region and four representing countries outside the region. The Board of Governors also elects the President for a term of five years, with the possibility of re-election. The President chairs the Board of Directors and follows its directions in conducting the business of ADB.

The major functions of the Asian Development Bank are the following:

- extending loans and equity investments to its developing member countries (DMCs) for their economic and social development
- providing technical assistance for the planning and execution of development projects and programs and for advisory services
- promoting and facilitating investment of public and private capital for development, and
- responding to requests for assistance in coordinating development policies and plans of its developing member countries.

ADB's projects and programs, whether poverty interventions or otherwise, emphasise one or more of the following priorities - economic growth, human development, gender and development, good governance, environmental protection, private sector development and regional cooperation. Each priority is related directly to the three pillars of the poverty reduction strategy:

- pro-poor, sustainable economic growth
- inclusive social development, and
- good governance

Other crosscutting priorities are law and policy reform and social dimensions

of development.

ADB's operations are diverse, covering

- agriculture and natural resources
- education
- energy
- finance
- health, nutrition, and social protection
- industry and trade
- law, economic management, and public policy
- transport and communications
- water supply, sanitation, and waste management
- activities involving multiple sectors

ADB lends to governments and to public and private enterprises in its developing member countries. ADB's principal tools are loans and technical assistance, which are provided to governments for specific, high-priority development projects and programs. ADB's lending both supports and promotes investment for development based on a country's priorities.

In 2004, ADB approved loans worth \$5.3 billion for 64 projects, most of which went to the public sector. People's Republic of China was the largest borrower, followed by India, Pakistan, Philippines, and Vietnam. Grants worth US\$99.4 million were provided and technical assistance, which is used to prepare projects and support advisory activities, amounted to \$197 million.

Check Your Progress 2

- 1) Explain the organisational structure of the World Bank.

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- 2) Discuss the World Bank provisions for distributing loans.

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- 3) Critically evaluate the role of the World Bank.

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4) What are the main functions of ADB?

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9.5 LET US SUM UP

The Unit explains to you the objectives, functions and structure of the main International financial Institutions IMF, The World Bank and Asian Development Bank. It also discusses the conditionalities of the IMF credit facilities and the lending policies of the World Bank. The Unit also discusses Special Drawing Rights (SDRs). It exposes the learner to the critical evaluation of each of these financial Institutions.

9.6 KEY WORDS

Bretton Woods: A town in New Hampshire at which in 1944 a conference launched the IMF and the World Bank. These, along with the GATT/WTO became known as the Bretton Woods Institutions. All the three institutions together comprise the Bretton Woods System.

Forex Market: This is also called foreign exchange market. It is defined as a market where buyers and sellers conduct foreign exchange transactions.

Poverty Reduction and Growth Facility: The low-interest lending facility of IMF for poor countries, established in 1999. This facility is intended to be more favourable to reducing poverty and promoting growth as compared to its previous policies.

Special Drawing Rights (SDRs): Special Drawing Rights were originally intended within the IMF as a sort of international money for use among central banks pegging their exchange rates. These rights are defined in terms of a basket of currencies, as they play the role in that form of a unit of international account. These rights are transferable and can be used to acquire another country's currency.

Structural Adjustment Program: The list of budgetary and policy changes required by the IMF and World Bank in order for a developing country to qualify for a loan. This "conditionality" typically includes reducing barriers to trade and capital flows, tax increases, and cuts in government spending.

9.7 SOME USEFUL REFERENCES

[http:// www.imf.org](http://www.imf.org)

[http:// www.worldbank.org](http://www.worldbank.org)

[http:// www.adb.org](http://www.adb.org)

9.8 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Read Sub-section 9.2.1
- 2) Read Sub-section 9.2.3
- 3) Read Sub-section 9.2.5
- 4) Read Sub-section 9.2.6
- 5) Read Sub-section 9.2.7

Check Your Progress 2

- 1) Read Sub-section 9.3.2
- 2) Read Sub-section 9.3.3
- 3) Read Sub-section 9.3.6
- 4) Read Section 9.4

UNIT 10 INTERNATIONAL DEBT AND THE ROLE OF THE FINANCIAL INSTITUTIONS

Structure

- 10.0 Objectives
- 10.1 Introduction
- 10.2 International Financial Markets & the External Debt of Developing Countries
- 10.3 Roles and Functions of External Debt in Developing Countries
- 10.4 Budget Deficits and Public External Debt
- 10.5 The International Monetary Fund and its Role
- 10.6 Let Us Sum Up
- 10.7 Key Words
- 10.8 Some Useful References
- 10.9 Answers / Hints to Check Your Progress Exercises

10.0 OBJECTIVES

This Unit deals with the international or external debt and the role of the financial institutions. This Unit will enable you to:

- learn the external debt process of the developing countries during 1970s and 1980s;
- explain analytically the debt accumulation process in a debtor country;
- describe the debt crisis experience of the developing world during the eighties;
- know the role of public debt and budget deficits in the developing country debt crisis of the 1980s; and
- explain the role of the International Monetary Fund (IMF) in mitigating the debt crisis of the developing countries.

10.1 INTRODUCTION

This Unit deals with the upsurge of developing country debt crisis during the decade of eighties. The external debt process began in 1973 with the first oil-price shock. Non-oil importing developing countries started borrowing heavily from the international banks, located in the United States, Western Europe and Japan. These banks were afloat with petro-dollar surpluses of the oil exporting countries like Saudi Arab, Libya etc. These bank loans financed the soaring current account deficits of the developing countries and the rising budget deficits. In the beginning of the eighties it became clear that many of the developing countries were not in a position to meet their debt obligations. Hence, the international banks' loan exposures in the developing countries culminated into debt crisis. This gave a severe blow to the international financial system, which encountered the spectre of sudden collapse. The IMF came forward with its rescue package. It extended loans to the debt-ridden countries with conditions. The Fund-led conditionalities led to restrictive economic policies in the debtor countries, which adversely affected the well-being of the common people in these countries. Therefore, the IMF loan packages became politically unpalatable to the debtor governments. Yet, they resorted to it

because it was found that the cost of Fund conditionalities is less than the costs of default in the international financial market. The Fund also forced the banks to come forward with additional lending to the debt-ridden countries.

10.2 INTERNATIONAL FINANCIAL MARKETS AND THE EXTERNAL DEBT OF DEVELOPING COUNTRIES

One of the most important developments in international financial markets during the seventies was the drastic increase in the participation of developing countries in these markets. The increased participation originated during the late sixties and boomed after the 1973 quadrupling of oil prices. Two groups of Third World countries have been particularly involved: the oil-exporting countries and the so-called middle-income developing countries, with GNP per capita above \$400. The richer oil-exporting countries, such as Saudi Arabia, Kuwait, and Libya, have become heavy lenders as a result of their huge oil revenues. For instance, by the end of 1980, the external assets of the oil-exporting lending countries were equal to \$300 billion, most of which was invested in time deposits, equities, government securities, and other financial instruments in industrial countries. The middle-income developing countries, such as Argentina, Mexico, and South Korea, on the other hand, have borrowed heavily in international financial markets. The increased relative importance of commercial loans as a source of international finance for the middle-income developing countries stands out above anything else. We should also mention that, for the low-income developing countries, access to international financial markets has remained quite limited, with official development assistance through loans and grants from governments and official organisations in industrial countries remaining the most important source of external capital.

The rising overall participation of non-oil developing countries in international financial markets has been accompanied by a sharp increase in their external debt. External debt refers to all the fixed-income foreign claims to which a debtor country is subject. For most developing countries, however, external debt is essentially bank debt. Bond indebtedness is rarely used as a source of financing in developing countries. The eight countries - Argentina, Brazil, Chile, Mexico, Peru, Philippines, South Korea, and Thailand - account for more than 75% of the external bank debt of all non-oil developing countries.

The spiralling external debt of the developing countries has raised serious concerns about the possibility of a default on these debts and of the ability of the heavily indebted countries to finance even the scheduled interest payments on their debts. So a fear developed in the minds of the creditor institutions and the developed countries about a possible debt default by the major LDC debtors and a consequent worldwide financial collapse.

Ultimately, in August 1982 Mexico announced moratorium (short-term deferring of debt repayment) and within quick span other severely indebted countries came almost on the brink of default. So, the debt crisis came into the surface raising the alarm for an impending collapse. The entire decade of the eighties starting with the Mexican moratorium in August 1982 is termed as the developing countries debt crisis decade. It was a lost decade for many of the severely indebted countries and the international lending banks were in deep

trouble due to their huge developing country loan exposures. Fear of collapse of these banks due to their huge bad debts led to the fear of impending collapse of the international financial system, as the international commercial banks are considered to be one of the major pillars of the international financial system.

10.3 ROLES AND FUNCTIONS OF EXTERNAL DEBT IN DEVELOPING COUNTRIES

Let us now understand the role and functions of external debt in the context of a typical developing country. We can write from balance of payments accounts of a country:

Current Account (CAB) deficit = total capital inflows + reduction in international reserves (IR) (1)

The above relation states that a current account (CAB) deficit can be financed through capital inflows and/or through losses of international reserves (gold, SDRs and foreign exchange reserves). Given a certain CAB deficit, external borrowing can provide the capital in-flows required to finance that deficit without the Central Bank's level of international reserves declining. In a certain sense, capital inflows and losses in reserves are substitutes for each other. The increased access of non-oil developing countries to world financial markets allowed them to sustain large current account deficits, while at the same time increasing (or preventing huge decreases of) their overall level of international reserves. Actually, the oil shocks of 1973 to 1974 and of 1979 to 1980 both led to sudden huge increases in the current account deficits of these countries, deficits that were not able to be completely financed immediately through increased debt and other capital inflows. As a result, in the year immediately following the oil shocks, overall losses of international reserves were clearly observed. In the ensuing years, however, one finds increased reliance on indebtedness and a replenishing of the lost reserves. For example, in 1975, right after the oil shock of 1973 to 1974, the overall current account deficits of oil-importing developing countries were more than triple the amount they were in 1973 (in constant 1978 dollars). There were also overall losses of international reserves. During the period of 1976 to 1978, however, the current account deficits declined while indebtedness continued to increase. In 1978 there was a net accumulation of reserves equal to \$21.2 billion.

In conclusion, during the 1970s external indebtedness increasingly financed the current account deficits of the developing countries. For these countries, the predominant item on the right-hand side of equation (1) became private financial capital inflows, rather than official capital inflows or losses of international reserves. How were the funds available from this borrowing used exactly? In other words, what particular items made up the current account balance deficit of the developing countries during the seventies? Was it increasing bills on the consumption of imported oil, or was it increased investment spending, arising perhaps from private and public capital accumulation projects, or what? Clearly, this is one of the major questions regarding the role of external debt in the developing countries as well as the issue of repayment of the debt.

A current account deficit is associated with an excess of domestic spending over national income, namely

$$CAB \text{ deficit} = (I_N + C_N + G_N) - Y_N \quad \dots\dots\dots(2)$$

where *CAB* is our symbol for current account balance, I_N represents private domestic investment, C_N refers to private consumption expenditures, G_N is equal to total government spending, and Y_N is gross national product. (Notice that this is basically the same as equation (3) in Unit 8.) Now, breaking down government expenditures into public investment spending, I_N^G (which includes such expenditures as the public construction of roads or oil wells), and public consumption expenditures, C_N^G (which includes expenses on public health, education, and other services), we can modify equation (2) to yield:

$$\begin{aligned} CAB \text{ deficit} &= (I_N + I_N^G) + [(C_N + C_N^G) - Y_N] \\ &= \text{total domestic investment} - \text{total domestic savings} \quad \dots\dots\dots(2a) \end{aligned}$$

where total domestic investment includes both private and public domestic investment, and total domestic savings is the difference between GNP and the aggregate of private and public consumption.

What equation (2) says is the increased indebtedness financing CAB deficits can be associated with an excess of domestic investments over savings. Consequently, the increased external borrowing of developing countries is associated with a persistent and growing shortfall of domestic savings below investment in these countries. This gap may have arisen through two main routes: through sustained and increasing expenditures with relatively fixed savings, or through decreased savings (increasing consumption relative to income) with relatively fixed investment spending. The first possibility implies that countries borrow in order to accumulate capital with which to increase future income, while the second possibility implies that countries borrow to finance current consumption expenditures that have no clear-cut effect on economic growth or future income. Accordingly, the first possibility seems less likely to give rise to problems involving the repayment of the debt. As long as the investment projects undertaken are profitable, increased future income streams should provide enough funds for repayment of the principal plus interest. Borrowing for consumption purposes, however, does not provide such a clear-cut future repayment potential and seems likely to require a reduction of consumption some time in the future by means of which funds can be obtained to pay the debt without crippling reductions in domestic wealth.

What evidence exists on the links between spending and external borrowing in developing countries? The overall behaviour of gross domestic savings, gross domestic investment, and the current account balance (all as fractions of GNP) for groups of developing and developed countries is presented in Table 10.1.

Table 10.1
The Current Account, Savings and Investment, 1965-79

(in per cent)

Item (Average over Period)	1965-1973	1974-1979
<i>Selected Debt-ridden developing countries</i>		
Investment/GNP	20.4	22.6
Savings/GNP	20.6	21.9
CAB/GNP	-1.8	-3.1
<i>Selected Developed Countries</i>		
Investment/GNP		
Savings/GNP	21.6	21.3
CAB/GNP	23.1	22.0

Source: Jeffrey Sachs, "The Current Account and Macroeconomic Adjustment in the 1970s", *Brookings Papers on Economic Activity* (1981).

Note: The selected debt-ridden developing countries include Brazil, Chile, Colombia, Mexico, Peru, Philippines, South Korea, Taiwan and Thailand. The selected developed countries include United States, United Kingdom, Austria, Belgium, Denmark, France, Italy, Norway, Sweden, Canada, Japan, Finland, Australia, and Netherlands.

The breakdown of the current account balance into its components varies from country to country and on the specific years considered. Still, some trends can be discerned. First of all, for the developing countries considered, the increased current account balance deficits of the 1970s were associated with rising investment (as a fraction of GNP) combined with relatively stable (or slightly rising) saving rates. The matter is very different for the developed countries, whose current account deficits during the 1970s have been associated with declines in savings (as a fraction of GNP) combined with relatively stable (or slightly falling) investment rates. Of course, these generalisations cannot be applied without qualification to every country.

As shown in Table 10.1 there was the marked shift of investment spending from the (non-oil) developed countries to the developing countries. What factors can account for this shift? One cause has been attributed to the general worsening of investment opportunities in the developed countries during the seventies attributable to widespread recession and declining productivity coupled with growth of real wage rates, all of which combined to cause a sharp squeeze on profits. Another factor involved the increased receptiveness to foreign investment in many developing countries and the heightened attractiveness offered by investments in raw materials and manufactured industries in these countries.

With widely available funds represented by the capital account surpluses of OPEC countries (especially through the Euro banks), the world financial markets turned to the developing countries for their investments during the seventies. Offering low real interest rates (often negative, depending on the measure of inflation used), external borrowing became in effect an irresistible bargain. The subsequent explosion of the external debt of the developing countries is now history. The resulting uncertainty and the rising fear of default led to significant tightening of the lending offered to developing countries by the international financial markets. The extensive long-term lending of the seventies gave way to a shift toward short-term lending at high interest rates and, more recently, to set credit constraints on all lending. In addition, real interest rates rose to levels much higher than in the seventies. The terms of external borrowing thus became more stringent.

One apparent conclusion from our discussion relating to Table 10.1 is that the external debt of developing countries has been associated with increased investment rather than increased consumption. This tends to suggest a rather optimistic view regarding the repayment of the debt.

A main problem of analysing external borrowing by focusing on the aggregate investment and savings behaviour of the economy is that it ignores the issues relating to the composition of these aggregates into their public and private components. An alternative expression for a current account deficit is:

$$\text{CAB deficit} = (I_N - S_N) + (G_N - TX_N) \quad \dots\dots\dots(3)$$

where TX refers to tax revenues so that $(G - TX)$ is the government budget

deficit. This means that when external indebtedness finances a current account balance deficit, it is financing that part of domestic investment which is not accounted for by domestic savings and/or by that part of government expenditures which is not financed by government revenues.

The measured size of budget deficits is clearly dependent on the particular country and time period considered and is complicated by the intricacies of the various government and public enterprise accounts (and governments statistics on the matter) and by the general problems of measuring public sector deficits. Generally, however, budget deficits in the debt-ridden developing countries were relatively high during the seventies. In Argentina, for instance, the fiscal deficit in 1975 reached more than 12% of GNP and revenue less than 25% of government expenditure; in Mexico the government deficit gradually increased over the early seventies reaching close to 10% of GDP by 1976. A large fraction of these deficits has been financed by borrowing from the local financial community or from the Central Bank (by printing money), but a substantial fraction has been associated with external public borrowing. The next section examines and documents the importance of the growth of the public external debt of the external debt of the developing countries.

Check Your Progress 1

- 1) Briefly define the role and functions of external debt in the case of a developing economy.

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- 2) What are the factors that led to the shift of investment spending from the developed to the developing Countries?

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- 3) What are the different approaches to define current account deficit?

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- 4) What is the role of International financial markets in the external debt of the developing Countries?

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10.4 BUDGET DEFICITS AND PUBLIC EXTERNAL DEBT

Public external borrowing has been an increasingly important source of revenue for the governments of the developing countries and has consistently comprised a major part of their external borrowing. This growth continued unabated until 1982, keeping pace with the growth of the overall debt of (non-oil) developing countries of more than 30% from 1980 to 1982. After 1982, new lending to these countries has been sharply curtailed.

The rise of public external borrowing as a means of financing budget deficits during the 1970s was directly connected to the relatively low real interest rates and easy terms widely available in international financial markets at the time.

It was also due to the relative attractiveness of external borrowing offered to the governments of developing countries at the time. In contrast to raising taxes and printing money, external debt does not immediately generate outrage of taxpayers. As a matter of fact, the immediate effect of external borrowing is to generate capital inflows and avoid losses of international reserves. Consequently, developing countries relied more and more heavily on external borrowing to finance their huge deficit expenditures on investment projects and other consumption and subsidy programs.

The apparent short-run attractiveness of external borrowing, however, hides the potential longer-term problems associated with persistent borrowing. First of all, borrowing usually involves interest payments. As a result, accumulating debt will give rise to accumulating *interest payments*. In addition, even though much of the external borrowing of the 1970s involved long-term debt, borrowing is borrowing and, even if slowly, the debt principal has to be repaid. Accumulating debt means accumulation of these *amortisation payments*. The addition of interest and amortisation payments is what is called the *debt service*, which involves a negative item on the balance of payments and, thus, losses of international reserves. Consequently, accumulating debt will eventually generate balance of payments deficits intended to finance growth-including expenditures that can raise future revenues (such as capital accumulation, oil-reserves exploration, or research and development), future taxes will have to finance government debt engaged today. Growing debt thus implies higher future taxes to service it. This is the so-called *burden of the debt*. When the external public debt of the economy is important, this burden falls on domestic tax payers paying foreign banks, and it can become a sticky international problem. Since the burden of the debt may not be politically (if economically) possible to exert effectively after the debt has accumulated to a certain point, the government may be forced to roll it over and borrow even more to pay for debt servicing. Accumulating debt-service payments, however, may impose a heavy burden on the public sector. When external debt service payments reach 64.1% and 34.6% of the exports of a country, as in Mexico and Brazil in 1979, the government starts playing with default and bankruptcy.

The general conclusion of this section is the importance government finances have had on the so-called external debt crisis of the developing countries. Government budget deficits are closely related to the problem, and any sort of

solution would certainly involve some belt tightening; public enterprise pricing may play a major role in this process. This is, of course, one of the primary conditions imposed by the IMF on the granting of loans to countries with major debt problems. Actually, the role of the IMF, both through its function as international lender of last resort and through intermediating activities between international lenders and borrowers, must be extremely important if the existing external debt mess is to be resolved without a major shake-up of the international financial system. The next section examines the functions and role of the IMF in the current world economic juncture.

10.5 THE INTERNATIONAL MONETARY FUND AND ITS ROLE

As you learned in the preceding Unit, the IMF provides last-resort financing to those countries with short-term balance of payments difficulties. In doing so, it contributes towards speeding up the balance of payments adjustment process in these countries and prevents disruptive monetary crises. The loans usually serve to finance directly the replenishing of international reserves, external debt repayments, and so on. Most Fund lending is made on a conditional basis; that is, the Fund imposes conditions on the countries to which it lends. These include restrictions on economic policies, like reductions in government budget deficits or monetary contraction, that are deemed by many to be undue foreign intervention in the countries involved, particularly in the LDCs, which represent a substantial portion of the Fund's clientele. The issue of conditionality has strong political connotations, especially in light of the fact that the Fund is effectively controlled by a small number of large industrial countries. The restrictions on economic policies imposed by the IMF conditions are themselves the subject of controversy as they have unleashed a process of GDP-compression-led growth process in several debt-ridden developing countries. The IMF conditionalities are imposed on a developing country seeking the IMF loan. They come as a package and constrain the growth process in these countries.

The role of the IMF in the international monetary system has come to the forefront lately when the IMF emerged as a main negotiator, collaborator, and intermediary in the negotiations between creditor and debtor countries during the debt crisis of the 1980s. Its coordinator's role in this respect is generally considered as having been crucial in the successful completion of many negotiations.

IMF lending and conditionality have been more visible during the debt crisis than ever before. IMF conditionality is the close economic surveillance a country's policymakers may have to accept as a condition for borrowing Fund resources. Countries rescheduling debts have also borrowed from the IMF and had to agree to the IMF-designed stabilisation programmes aimed at reducing current account deficits. This stabilisation aimed at reducing the government fiscal deficits in the borrower countries. Even though the amounts lent by the Fund have been small relative to the debtor's financing needs, the Fund's involvement has been crucial. When a debtor agrees to an IMF stabilisation programme, banks are reassured that the debtor is taking measures that will eventually allow it to resume normal debt servicing.

In addition, IMF involvement remained politically unpalatable for a debtor government. To reduce current-account deficits to the levels that can be financed, debtor governments have been forced to reduce public-sector deficits by removing subsidies, cutting wages in publicly owned industries, and raising the prices of goods and services provided by the government. An expenditure-switching devaluation is often necessary as well. These measures have naturally been unpopular with the sectors of the population that are directly affected. Debtor governments in order to borrow from the Fund had to abide by the Fund guidelines regarding its stabilisation and economic reform programmes and had to encounter the wrath of their citizens, particularly those sections of the population who are vulnerable to reduction in subsidies, cutting wages and raising prices of publicly provided goods and services. In reality, debtor governments that entered the IMF-guided GDP-compression growth process in the domestic economies viewed the costs of co-operation as outweighing the costs of default.

The IMF has also played a key role in coordinating bank lending to debt-ridden LDCs. In the Mexican case, the IMF loan package to Mexico was made conditional to the additional bank-lending to Mexico in 1982. This tactic of forced lending by banks became the norm in other cases. By making continued bank lending the price of IMF involvement, the Fund has helped discourage smaller banks from free riding on its own lending or that of the larger banks.

Check Your Progress 2

- 1) Briefly define the relation of budget deficits and Public external debt.

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- 2) What is the role of IMF in the management of External debt?

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10.6 LET US SUM UP

This Unit has explained to you the evolution and position of the external debt of developing countries and the role of International financial institutions. It explains the role of International Financial Markets and the external debt of developing countries. Learners get to know the external debt process of the developing countries during 1970s and 1980s. The Unit discusses analytically the debt accumulation process in a debtor country and describes the debt crisis experience of the developing world during the eighties. The Unit exposes you to the role of public debt and budget deficits in the developing country debt crisis of the 1980s. The role of the International Monetary Fund (IMF) in mitigating the debt crisis of the developing countries has also been discussed in this Unit.

10.7 KEY WORDS

Amortisation: The repayment of a debt in installments over a period of time, rather than all at once.

Budget Deficit: Budget deficit the excess of expenditure over income. This is the negative of the budget surplus; which is in general an excess of income over expenditure, but usually refers specifically to the government budget, where it is the excess of tax revenue over expenditure (including transfer and interest payments).

Conditionality: The requirements imposed by the IMF and World Bank on borrowing countries to qualify for a loan, typically including a long list of budgetary and policy changes comprising a structural adjustment program.

10.8 SOME USEFUL REFERENCES

Krugman, P. and M. Obstfeld. 2000. *International Economics : Theory and Policy*, Addison Wesley Longman : Singapore.

10.9 ANSWERS /HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Read Section 10.3
- 2) Read Section 10.3
- 3) Read Section 10.3
- 4) Read Section 10.2

Check Your Progress 2

- 1) Read Section 10.4
- 2) Read Section 10.4

THE END