Chapter - I

INTRODUCTION AND REVIEW OF LITERATURE
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"Doctrines are expounded enough
There are books by million
Oh! for an ounce of truth"

... VIVEKANANDA

1.1. INTRODUCTION & STATEMENT OF THE PROBLEM

Although the World economy is continuing to expand at a moderate pace, the persistence of large fiscal and external imbalances clouds the international economic outlook. No country remained untouched by the international economic events of the seventies. The collapse of the Bretton Woods system in 1971 and the switch over of major currencies of the world to managed float of currencies, the food crisis of 1972-74, the oil price shocks of the Organisation of Petroleum Exporting Countries (OPEC) in 1973 and 1979, the recession in industrial countries, once in 1974-75, and again in 1979-82, accelerated inflation and instability of exchange rates and interest rates had enormous impact on the world economy as a whole and on different countries in different degrees.

Come the 1980s, the balance of payments problem had assumed alarming proportions and the world is now left with a horrendous problem that seems to defy any amicable solution. Most of the developing countries are having huge trade deficits

which result in huge current account deficits. To bridge the gap in the current account the governments have no alternative but to go for loans from IMF, The World Bank and other agencies. As a result debt overhang has become a serious problem. The governments are paying large amounts towards the interest on the past debts. For this, again, they are going for fresh loans, and falling prey to debt trap. Subsequently, their foreign exchange reserves are depleting significantly which itself is a matter of great concern. In most of the developing countries monetary growth and inflation have accelerated sharply and fiscal deficits have remained high. As a result of all these problems achieving equilibrium in balance of payments has become an impossible task.

1.2 DEFINITIONS OF BALANCE OF PAYMENTS

What is this balance of payments about which so much concern is expressed and worried about? Put simply, a country's balance of payments is the final result of all economic transactions between the residents of that country and the rest of the world over a given period, usually a year².

IMF's definition of the balance of payments is said to be more comprehensive which says, "The balance of payments is a statistical statement for a given period showing (a) transactions in goods, services, and income between an economy and the rest of the world; (b) Changes of ownership and other changes in that economy's monetary gold, Special Drawing Rights (SDRs), and claims on and liabilities to the rest of the world; and (c) unrequited transfer and counter part entries that are needed to balance, in the accounting sense, any entries for the foregoing transactions and changes which are not mutually off setting".

The US department of commerce defined balance of payments in a statistical sense as an itemised account of transactions involving receipts from the foreigners on the one hand and payments to foreigners on the other. Since the former relates to the international income of a country, they are called "Credits" and the latter relates to international out goes, they are called "Debits".

Balance of payments policy is essentially a matter of means and ends. A nation's balance of payments is of interest

to economists and policy makers because it provides much useful information about the nation's international economic position and its relationship with the rest of the world. An examination of the balance of payments over a period of time should enable us to determine whether a nation is approximately in external balance, or whether it suffers from a disequilibrium in its balance of payments. Much of international monetary economics is concerned with diagnosis of "DEFICITS" or "SURPLUSES" in balance of payments, and especially with analysis of the mechanisms or processes through which such disequilibria may be corrected or removed. In view of the growing deficits in balance of payments, it is of some interest to work in this area.

1.3 NEED OF THE PRESENT WORK

Much like the monetary disturbances following the Napoleonic wars, the severe balance of payments crisis during the inflation period after World War-I, and those caused by the "GREAT DEPRESSION" of 1929-32 have all done much to stimulate theoretical thinking in this area. After World War-II,

prolonged balance of payments difficulties of most countries, excepting the United States, Switzerland and a few others - the so-called "STRUCTURAL DOLLAR SHORTAGE", which according to many writers had really started long before the War-have again given a strong impetus to further theoretical and empirical research in the mechanism of adjustment of the balance of payments. Any how, without exaggeration, it can be said that during the last thirty years the theory has advanced as much as during all of the 200 years which preceded them. Of late, several theories were developed viz., the absorption approach, the monetary approach and the Mundell's model. But, as of now no entirely satisfactory solution has been found to this problem, eventhough some of the finest minds are at it. Hence, the present study is undertaken to throw some light on various facets of the problem. For this purpose among so many problems of balance of payments four problems are identified which are very serious in nature and have a close link. These are : (a) Trade balance, (b) Overall balance, (c) Debt overhang and (d) Foreign exchange reserves. A brief overview of the problem is presented here.

6. HABERLER GOTTFRIED A survey of International trade theory, Princeton University, 1961, special papers in International econmics.
1.4 OVERVIEW

The past fifteen years have proved to be a period of considerable stress for the developing countries. Throughout most of the 1970s a combination of events caused the international economic environment to become less conducive to their stability and growth and aggravate their problems of economic management in general and balance of payments adjustment in particular. External developments, including substantial fluctuations in the world market prices of primary commodities, sharp increases in the price of energy products, the slow down of economic activity in the industrial countries, and sharp increases in real interest rates in the international capital markets, were all major contributors to a serious deterioration in the current account positions of most of the developing countries. At the same time, domestic developments in a number of economies also played a significant role in exacerbating payments disequilibrium, as inflationary demand management policies - combined with rigid exchange rate policies and restrictions on trade and payments - created domestic demand pressures and led to a cumulative loss of international competitiveness and to current account and overall balance of payments difficulties.
The factors that are typically identified as the major determinants of current account developments are (1) deterioration in the terms of trade, (2) the slow down of economic activity in the industrial countries, (3) the sharp increase in the level of real interest rates in global credit markets; (4) inadequate or insufficient domestic adjustment signalled by rising fiscal deficits and an appreciation of real effective exchange rates and (5) debt servicing burden. The list covers most of the more important causes even though it's not exhaustive certainly.

It's widely acknowledged that each of the above said factors played a significant role in the substantial deterioration of current account positions for the group of developing countries. Nevertheless, there is a difference of views about the relative contributions of each of these factors, both for individual countries and for the group as a whole. Empirical evidence yielded statistically significant results suggesting that the variables representing the terms of trade, fiscal deficits, real effective exchange rates, and the level of international interest rates in real terms had definite effects in the expected direction on the current account ratios of developing countries.
However, real effective exchange rates and the level of international interest rates are outside the purview of the present study.

Like most of the developing countries India also had faced pressures on the balance of payments from time to time either due to certain domestic compulsions or external factors. The decade 1970s presents a balance of payments scenario of ups and downs with years of surplus which were short lived and continuous years of growing deficit. Either the oil shock effected by the hike in oil prices or the Gulf Crisis which caused the oil shock are responsible for the bewildering series of balance of payments difficulties in the 1970s, 1980s and early 1990s.

Besides external problems, in domestic front also, the country is facing a severe fiscal crisis which is a matter of great concern. Increasing subsidies, increasing non-developmental expenditure, especially the defence expenditure, are contributing significantly to the increasing budget deficits. The interest payments on the debt is a factor responsible to the decline in foreign exchange reserves. Like this, the problems are related to one another.
1.5 REVIEW OF LITERATURE

There are many studies on foreign trade and balance of payments. In what follows it's proposed to undertake reviewing some of these studies in brief for a better understanding of the problem to study them in the present period. In this task, an attempt is made to present the literature in chronological order under the broad headings - studies on Foreign Trade and Economic Growth; Trade liberalisation aspects; Exchange rates and Balance of Payments and related issues.

1.5.1 STUDIES ON FOREIGN TRADE AND ECONOMIC GROWTH

In recent years, investigation on the relationship between export expansion and economic growth has received considerable attention. The findings though, support the argument that export expansion leads to higher economic growth thereby suggesting the overall superiority of an export-led growth strategy for development to one of import substitution. The theoretical argument maintained in these studies is that export expansion results in both more efficient use of resources and the adoption of latest technology which in turn raises total factor productivity leading to higher output growth.

Myrdal\textsuperscript{8} advocates that international trade not only widens international inequality but also robs developing countries of their old-established traditional small scale and handicraft industries, as has been experienced in the past. Trade operates with a fundamental bias in favour of richer and progressive regions and countries and against the developing countries.

Singer\textsuperscript{9} observed that "Foreign trade tends to be proportionately most important when incomes are lowest" and Higgins\textsuperscript{10} claims "underdeveloped countries outside the arid zones are unstable mainly because of their orientation towards exports". But these conclusions do not seem to be well supported by facts as seen from the correlation coefficient of 0.28 (significant at five per cent) between foreign trade and national income. Cross country analysis by Kuznets\textsuperscript{11} and

\begin{itemize}
  \item \textsuperscript{8} Myrdal, G., \textit{Economic Theory and Underdeveloped Regions}, vo and co., Bombay, 1958.
  \item \textsuperscript{9} Singer, Han, "The Distribution of Gains between Investing and Borrowing Countries", \textit{American Economic Review}, 1950, P.473.
  \item \textsuperscript{10} Higgins, Benjamin, \textit{Economic Development}, New York, w.w. Norton, 1959, p.155
\end{itemize}
Michaely\textsuperscript{12} indicate that trade forms higher proportion of GNP in poor than in rich countries. Kindleberger\textsuperscript{13} was in agreement with Wallich's thesis that the ratio of exports to national income is higher than for either investment or government expenditure to income. However, for Macbean exports relative to investment and government expenditure are significantly related to size of nations, whether they are developed or underdeveloped.

Kindleberger\textsuperscript{14}, organised his book not by countries but analytically and discussed two broad questions. (1) What determines the nature and amounts of the goods a country buys and sells in international trade? and (2) What is the impact of foreign trade on national economic life? Particular emphasis has been given to how trade changes in the course of economic growth and how such growth and other aspects of economic life react to the impact of foreign trade, under the varying circumstances presented by different countries with this infinite variety of resources and of economic and political institutions.

\begin{itemize}
\item \textsuperscript{12} Michaely, Michael, \textit{Concentration in International Trade}, Amsterdam, North Holland Publishing Co., 1962, P.17.
\end{itemize}
There is nowhere else available this combination of theoretical analysis and profuse illustration of concepts.

Trade brings gains to the trading partners. The gains from trade could be both static and dynamic. Static gains accrue to the trading nations once for all while the dynamic gains "generate benefits over time as a result of the stimulus to increased productivity and economic growth resulting from international trade".  

The realisation of gains from trade by the developed countries was never disputed, while the significance of gains to the developing countries has always been a controversial subject. The gains are "unlikely to be significant among developing countries because they lack the responsiveness to the market opportunities and dynamic influences of international trade found in developed market economies.

There are two aspects of the relation between export and economic growth. On one side, economic growth and particularly growth of manufacturing industries can help expansion of exports. On the other side, exports can promote economic growth by increasing aggregate demand faced by the economy. This two

way relation has been studied in the development economics literature from various angles. Export cannot only promote national income growth (Michaely\textsuperscript{16}), it can also have scale effects and externalities (Tyler\textsuperscript{17}). Tyler examined the relationship in a sample of 55 middle income countries.

Further, Kavoussi\textsuperscript{18} studied the impact of export growth on total factor productivity. He investigated the relationship in a sample of seventy three countries using the data for the period 1960-78. He found that export expansion is associated with better economic performance for both groups: low as well as middle income countries. Balassa\textsuperscript{19} and Chow\textsuperscript{20} have explored empirically the relation between export growth and growth of manufacturing industries.


1.5.2 STUDIES RELATING TO TRADE LIBERALISATION ASPECTS

The role of foreign trade in industrialisation is a vital issue for several reasons. First, there is a close relationship between trade-policy and industrial development. Second, many fear that slow world growth and rising protection in industrial countries may cloud the prospects for developing countries exports. Third, continuing debt problems increase the developing countries need to raise their net earnings of foreign exchange to service debt and maintain adequate growth. Liberal, outward-looking trade policies can lead to a higher economic growth through efficient industrialisation of developing countries, only if they are accompanied by appropriate fiscal, monetary, and exchange rate policies.

The classical economists have discussed the gains from trade in their works and advocated the policy of "FREE TRADE". Mill discusses the gains that result from "FOREIGN COMMERCE" which he further classifies into "DIRECT" and "INDIRECT" gains. According to Mill, "..... commerce is virtually a mode of cheapening production and in all such cases the consumer is


the person ultimately benefited; the dealer, in the end, is sure to get his profit, whether the buyer obtains much or little for his money".

A vast literature of theoretical and empirical studies has emerged as a result of on-going research on issues related to trade - liberalisation since 1970s. Since the goal of liberalisation is to improve resource allocation, therefore, some broad principles can be derived: (1) domestic markets are to be deregulated to ensure that resources are reallocated in an efficient way; (2) foreign economic relations are to be liberalised. It is usually believed and argued that the current account of the balance of payments should be liberalised first, then the capital account. McKinnon, Frenkel, Krueger and Edwards have written much on this issue; and their arguments can be grouped into three broad categories; (a)


Macro economic stability and real exchange rate movements; (b) Welfare effects of alternative orderings; and (c) costs of the adjustment process.

Frenkel and Khan and Zahler have showed that the speed of adjustment of the capital account is faster than that of the current account. Liberalisation of the capital account could result in large capital flows with undesirable consequences for the real exchange rate.

The view that a liberal trade regime promotes economic growth and efficiency has won wide acceptance in recent years. The reason is simple. Many developing countries for a variety of reasons, and in a variety of different circumstances - have successfully moved from highly restrictive trade regimes toward policies that can fewer economic distortions. A recent study by the World Bank has shed some new light on these questions. It observed, that in most of the reforming countries, exports increased faster than imports and the foreign exchange reserves grew larger - not smaller, as feared by many policy makers - after the reforms were launched. Trade liberalisation, by

27. Demetrious Papageorgiou et al., Liberalising Foreign Trade in Developing Countries: The Lessons of Experience. The World Bank, Washington D.C.,
definition, erodes the protection enjoyed by certain domestic producers, generally with the deliberate aim of opening the economy to greater volume of imports. So, it is natural to fear at least a short-term deterioration in the balance of payments. But, in fact, the study found that this was rare. The study stresses the distinction between the balance of payments in the short term and in the medium term.

Bhagwati\textsuperscript{28} felt that the dispute between developed and developing countries over the inclusion of services in the Uruguay Round of trade negotiations reflects critical differences in perspective on substantive issues. In particular, these substantive divisions arise from the differences between services and goods in matters such as regulation and the requirement in many instances of freedom to move productive factors across national boundaries - for example, the "RIGHT TO ESTABLISH" that would permit the provider of services to get to the uses. Developing countries have possible export advantages in the service sector and have much to gain by joining actively in negotiating a services compact that permits them to exploit these advantages.

Ram in a most comprehensive study estimated two forms of production function growth equations for eighty eight countries for the periods 1960-72 and 1973-82. He also obtained time-series estimates for these countries for 1960-82. While he received mixed evidence from time series, his overall conclusion is that the cross-section evidence reinforces the time-series results about the importance of exports for economic growth in most cases.

Bhagwati states that the link between trade and income growth is certainly a two way relationship and it is plausible that liberalisation induced trade expansion, through its efficiency effects, led the post war growth of incomes. The evidence confirms that the effects of postwar liberalisation and income growth in the industrialised countries was indeed to increase intra-industry specialisation rather than inter-industry specialisation.

At the end of 1970s, the use of export subsidies got widespread as a means to protect national producers. But according to the classical analysis of trade policies, they are


not efficient policy tools to reduce the external constraint. Nevertheless, this analysis relies upon three hypotheses: (1) two goods model (2) full employment and (3) Perfect competition. The authors discussed here whether questions of these hypothesis enables to justify export subsidies.

Most of the studies that measure directly the effect to trade policy on productivity conclude that outward orientation leads to productivity gains, though the results are not always consistent. Havrylyshyn in a review of several studies reached four conclusions: eight of nine studies found that liberalisation leads to efficiency gains; studies using the efficiency frontier methodology tend to yield much stronger results, while country-specific analysis is superior to cross-country comparisons; the design of research studies must consider the mechanism through which liberalisation affects productivity; and protection can and does generate some benefits to an economy.

Culbertson, believed that the interconnections of international trade must result in gainer and loser economies.


and thus will not create a framework for mutual benefit or yield a global harmony of interests. Domestically, he argued for an intimate two-way connection between trade expansion and visible hand domestic development strategy. Finally, as with the writings of the individual mercantilists, a few important insights are mingled with a much greater mass of rambling, incoherent, normative, repetitive and opinionated balderdash.

1.5.3 STUDIES ON TERMS OF TRADE AND RELATED ASPECTS

The long run movement of the terms of trade has continued to be a controversial area in the literature. The classical economists believed that the terms of trade would move in favour of the developing countries, whereas the modern economists disproved this and claimed that terms of trade would deteriorate for developing countries.

According to Lewis, Singer, Myrdal and Prebisch international trade is bound to lead to a "SECULAR DETERIORATION" in the terms of trade of developing countries.


which are mainly producers and exporters of primary commodities. This has been due to the fact that prices of primary products have been exhibiting slower growth than the prices of manufactured commodities. This slower rate of growth in the prices of primary commodities compared to the prices of manufactured goods is explained by the relatively inelastic world demand for primary commodities than manufactured products.

Edwards\textsuperscript{37} used a three-goods model viz., importables, exportables and nontradables to analyse labour market adjustment to changes in the terms of trade and import tariffs for a small, open economy. In the first section a three goods trade model was developed to investigate how sectoral labour allocations and wages react to shocks in the terms of trade. It was shown that, under the assumption of flexible wages labour will move to a particular sector in the short run, only to move out of it in the longer run. Section two introduced wage rigidities in the form of an economy wide minimum wage and a sector specific minimum wage. Here, it was shown that even

when importables are capital intensive, and the minimum wage is expressed in terms of the exportable good, a positive terms of trade shock will generate unemployment in the short run.

Ostry\textsuperscript{38} used an inter temporal optimizing model of a small open economy to analyse how terms of trade changes affect real exchange rates and the trade balance. Temporary current, (expected) future, and permanent changes in the terms of trade are considered. The results suggest that the relationship between the terms of trade and the current account is sensitive to whether the model incorporates nontradable goods. Thus, the real exchange rate may be an important variable through which terms of trade shocks are transmitted to the current account.

Copeland\textsuperscript{39}, examined the equilibrium level of trade barriers in a two-countries world when both tariffs and quotas are available as instruments of protection. It is shown that the set of efficient equilibria is the same when either tariffs or quotas, but not both may be negotiated. Furthermore, it is shown that a trade eliminating quota war will not occur unless bargaining over tariffs is inefficient.


In a paper on "Incremental Protection and Efficient political choice between tariffs and Quotas", Kaempfer et al. offered a new political economy explanation for the increasing use in recent years of quotas instead of, or in combination with, tariffs as a form of trade protection. The authors showed that, under domestic monopoly, the comparative efficiencies of tariffs and quotas in achieving political objectives will vary depending on the nature of the market and the level of protection. At high levels of protection, quotas can become more politically efficient than tariffs. They also showed that at low levels of protection, a price equivalent quota may not exist.

Sawyer W. Charles et al., analysed the properties of two models commonly used to estimate "exante" trade creation and diversion. The analysis indicates that both models produce identical estimates of trade creation. However, due to slightly different assumptions concerning the degree of substitutability between imports from preferred and non-preferred countries, estimates of trade diversion may differ depending on which model is used. These differences are then examined using an empirical example.


Lahiri Sajal and Ono Yoshiyasu developed a necessary and a sufficient condition for an improvement in terms of trade to reduce welfare under a general setting, which can accommodate various types of market structures and trade distortions. They also applied the conditions to two specific cases, viz., export subsidies and the existence of monopoly in a non-tradeable sector. It is found that a rise in price for an exportable commodity that is subsidised may well reduce welfare. Also, improvements in terms of trade may well harm the economy if there is a non-tradeable monopoly sector.

1.5.4. EXCHANGE RATE RELATED STUDIES

According to the theory of unequal exchange developed by Emmanuel, a noted French economist, using the theoretical discussions of Rosa Luxemberge and Evenly Preobruzhensky, within the framework of Marxian theory of value and prices - operation of international forces facilitate unequal exchange and thereby unequal trade and ultimately unequal rates of growth in developed and developing countries. This model was later


extended by David Evans, Oscar Brown, Samir Amin, Saigal and Ranjit. According to them developed countries exercise their monopoly power over world markets and bring down prices of goods exported by them, which facilitate unequal pricing and unequal exchange between developed and developing countries.

Claessens Stijn extended the literature on balance of payments crises by treating the issue in a generalised equilibrium framework. Investors maximise a non-separable utility function, defined over consumption and real money balances, under the threat of a future collapse of the fixed exchange rate regime. The paper obtains real effects, in the


form of current account adjustments, when agents realise that the fixed regime is not indefinitely viable. New information regarding official foreign lending can cause attacks at the central bank in the form of sudden shifts by investors out of domestic money into foreign bonds.

Himarios Daniel reexamined the effectiveness of devaluation in trade balance adjustment. The question is addressed in a framework that improves the previous empirical literature in several respects. The evidence indicates that devaluations have been a successful tool in inducing trade balance adjustment. In particular, nominal devaluations are found to result in significant real devaluations that last for at-least three years, and the real devaluation induces significant trade flows that are distributed over a two-to three-year period. The evidence comes from two different samples, 1953-73 and 1975-84, involves twenty seven countries and sixty devaluation episodes.

The growing literature on whether devaluation has contractionary effects on output in developing countries is evaluated in a paper by Lizondo and Montiel. The paper explored links between the exchange rate and real output within a unified, fairly general analytical framework that incorporates several of the developing country features cited in the literature. The analysis suggests that many of the arguments on both sides of the debate about contractionary devaluation require modification, that some potential effects have been ignored, and that the direction of the impact effects of devaluation on real output is ambiguous, on analytical grounds.

An optimising model with overlapping generations and finance constraints is used to develop microfoundations for the monetary adjustment process under fixed exchange rates. The results are broadly consistent with those of the monetary approach to the balance of payments. However, it is shown that, although the model exhibits movements of money, interest rate, and income that seem consistent with an aggregate money demand function, aggregate relation is not structural.


Joyce presented a model of monetary policy in developing economies which is estimated for Mexico, Korea, India and Zambia. The model is designed to identify both the goals and patterns of policy in these economies. The results demonstrate that the authorities in these economies respond to foreign reserve flows, partially sterilising their impact in three countries. They also respond to domestic variables accommodating seasonal variation and growth or price changes.

Most of the studies have postulated that there exists a positive relationship between the rate of inflation and its variability. They have shown that a high inflation rate contributes to inflation variability. Bahmani-Oskooee argued that with the current floating exchange rate system exchange rate variability is another factor contributing to inflation variability. After incorporating a measure of exchange rate variability into a simple model used by previous authors, they estimated a model using cross country data from 20 developed and 76 less developed countries and the cross-sectional regression results support their conjecture.


1.5.5. STUDIES PERTAINING TO BALANCE OF PAYMENTS AND RELATED ISSUES

Michaely Michael, attempted a study which is confined to an analysis of the responsiveness of the major monetary and fiscal policy variables operating on aggregate demand. It observed that, "While sporadic studies of this issue may be found, particularly for individual countries, there is a noticeable lack of comparative studies of the pivotal countries permitting inferences to be drawn for the system as a whole. The study, through observation of actual movements of these policy instruments and of their relation to the balance of payments position made an attempt to establish patterns of policy conduct in each of nine major industrial countries: Belgium, France, Germany, Italy, Japan, the Netherlands Sweden, the United States, and the United Kingdom. It is found that in six of the country's studies - Japan, the United Kingdom, Belgium, France, Italy and the Netherlands - monetary policy as a rule has been responsive, at least in direction, to the indications provided by the country's external position.

It is also found that, with the notable exception of the United States, Countries tend to respond more consistently to balance of payments deficits than to surpluses.

Unlike monetary policy, it seems that fiscal policy usually has not responded to the countries' external positions. Neither, it may be added, does fiscal policy seem to have been used very often to achieve other major economic targets. Thus, the study observed that, the widely advertised "POLICY MIX" in which Monetary policy is assigned to the balance of payments and fiscal policy to the fulfillment of domestic targets, rarely seems to have been adopted in practice.

Kyle\textsuperscript{56} has developed a model in his study which explicitly includes a production sector and a complete monetary sector to reconcile relative price and income approaches with balance of payments analysis. He demonstrates the inadequacy of the traditional method of extending macro-economic models to deal with trade problems and proceeds to develop a property specified open economy model adequate to the task. His theory of balance of payments takes into account both important

monetary and aggregate demand features of macro economics and the relative prices and interdependencies of general equilibrium theory. This is an important contribution to the theory of balance of payments. It assesses and integrates an enormous literature and focuses attention on the principle analytical issues.

Bhavangri advocates that countries should relax restrictive monetary and fiscal measures, while, at present a tight monetary policy and more restrictive fiscal policy is the need of the hour. However, the period she covered is too old to predict anything now from those findings.

Kalipada Deb has taken much pains in collecting the statistics of different aspects of external resources required for economic development in India. As a matter of fact the subject is extremely important for almost every developing country and any worthwhile study on this subject should be greatly welcome. He observed that Indian exports during the last few decades have been increasing in an important way. But by


attributing various estimated cost of receiving assistance and or export promotion measures, he has come to a conclusion that much of the gain has been illusory.

Neela Mukherjee⁵⁹ observed that external borrowing for India has proved to be doubly advantageous. Not only the price of loans has softened over time, the amount of debt burden has also depreciated, reducing the extent of real external indebtedness. But the growing uncertainty in the international market and the indispensability of external borrowing affect its prospects in the coming decades.

Rambabu⁶⁰ observed that the existing international economic order and institutional arrangements have only catered to the requirements of the advanced countries but failed to help the developing economies to overcome their problems. Export instability in developing countries appears to be influenced by commodity concentration, lack of market diversification and excessive dependence on primary product exports. The unfavourable gains from trade led to a deficit in trade balance of both developed and developing countries and favourable


gains from trade led to accumulation of surplus in case of the oil exporting countries. Fluctuations in primary markets and secular movements in terms of trade have resulted in the accumulation of huge deficits in the current account of the developing countries balance of payments. Commodity problem will continue to be an important issue throughout the 1980s. It is at the centre of all trade and payments problems.

Graham Bird examined the relationship between the international monetary system and the less developed countries. Chapters 3, 4, 5 and 6 look at some of the international monetary problems faced by LDCs as regards balance of payments instability, inadequacy of reserves and choice of adjustment strategy, Chapter 7, 8 and 9 examines the major channels of balance of payments financing available to LDCs, while the final chapters 10, 11 and 12 investigate various policy alternatives. The study observed that the commodities problem has significant implications for LDCs, being major determinant of many of the balance of payments difficulties which they experience.

International financial developments have had an important impact upon the developing countries in 1980s. Events in the developing countries have also created unprecedented concern in international financial circles. The high profile of the commercial banks and the International Monetary Fund in discussions of current economic performance in the Third World suggest that an analytical account of recent developments and current issues could be extremely useful. While attempting to fill an evident vacumm in the literature by providing a survey, Graham Bird\textsuperscript{62} consciously aspired to policy relevance and addresses a number of policy questions relating to IMF behaviour, debt and stabilisation. He devoted six chapters to IMF Policies, three to commercial Bank lending to developing countries and the remaining seven chapters raise related questions such as commodity price stabilisation, cooperation among developing countries and the like.

Neela Mukherjee\textsuperscript{63} in her study observed that the balance of payments position of the South-Asian Economies shows that their earnings from exports were inelastic whereas, their


\textsuperscript{63} Neela Mukherjee, \textit{Op.Cit.}
imports were increasing inspite of import substitution efforts. In some years unrequited transfer receipts helped them in financing substantial portion of their trade gaps. In other years net inflow of long term official capital came to their rescue. The author felt that, the problems can be lessened to a greater extent by regional economic cooperation in South Asia. Such cooperation, goodwill and mutual trust would increase trade within the South-Africa economies and would in all probability reduce unproductive expenditure like defence. The study is a well organised one and it covers the salient features of South-Asian countries, their domestic conditions and the international economic crises, international payments position of the four South-Asian economies, the impact of external stocks on balance of payments and examines the balance of payments adjustment process of South-Asian countries.

Anjaria in his article suggests that there is a need to pay much attention to the balance of payments provisions of the General Agreement on Tariffs and Trade (GATT) which directly influence the trade policies of the developing countries and to reconsider these provisions in the context of the ongoing Uruguay Round of multilateral trade negotiations. The article

traces to historical evolution of GATT practices on trade restrictions for balance of payments purposes. It felt that recent theoretical and empirical work has demonstrated that neutral or export promoting trade strategies are more effective for development than the import substitution frequently advocated by economists in the 1950s and 1960s. The current debt problems of developing countries strengthen the argument for a relatively open trade and payments regime to attain balance of payments viability. It suggests that stronger international discipline over trade restrictions for balance of payments purposes would contribute to and presuppose other necessary improvements in the multilateral trading system.

Laird and Nogues 65 analysed the influence of the trade policies of the highly indebted countries and the industrial creditor countries on the highly indebted countries debt problem. Many of the highly indebted countries, after increasing their import barriers in the early 1980s, have liberalised their import regimes and achieved devaluation of their real exchange rates. They examined the use of tariff and non tariff barriers by the main industrial creditor countries in

relation to the effects on the highly indebted countries and on other groups of countries. Highly indebted countries exports to these countries could be increased by $16.5 billion a year and help alleviate the debt problem if some of these trade barriers were removed.

Greenaway and Milner argued that developing countries can gain more from multilateral expansion of trade than from efforts directed at a narrow liberalisation. In the past decade the dominant view of the most appropriate trade strategy for developing countries has shifted. The high economic costs of trade substitution with the disappointing performance of the most inward-oriented economies and the impressive gains of the outward oriented economies have shifted opinion. Outward orientation has moved toward discriminatory export promotion, where intervention would reduce "NORTH-SOUTH" trade in favour of "SOUTH-SOUTH" trade.

A report on debt reduction examined the behaviour of debtors, creditors, and the international financial community during the world debt crisis of the 1980s. It is the first publication to analyse at length the "BRADY INITIATIVE" on


debt and debt-service reduction for the highly indebted countries. The papers in the volume emphasised the relationship among indebtedness, macro economic management, and growth. Topics include the constraints on and the scope for action, the merits of the diverse debt reduction mechanisms, and the ways to strengthen debt reduction.

Da Costa Genaro C., examined the various facets of India's balance of payments, the trends in India's external trade and the net barter terms of trade during the period 1970-71 to 1985-86.

In this work, the author looked at the problem in the context of the development in both the domestic and the external economies. In particular, he has sought to identify, over the turbulent period of the seventies and the early eighties, the forces which have been at work and which have created, and in deed, have increased the trade imbalances over the years. These imbalances are at the core of the external payments problem of the country. It recommends to reduce these imbalances and improve the external payments situation of the country.

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Holla K.R., made an indepth analysis on India's balance of payments which is the first of its kind and it discusses all the factors that are responsible for balance of payments deficit in India. It gives a bird's-eye-view of the entire situation from the First Five Year Plan to the Seventh Five Year Plan.

Bird Graham has attempted to demonstrate how changes in both the international financial regime and the conduct of global macroeconomic policy are required in the problems which faced the world economy in the 1980s are to be avoided in the 1990s. The world economy in the 1980s was dominated by problems of international debt, balance of payments and fiscal deficits. Recognising the bureaucratic and political constraints on far-reaching reform, Bird Spelt out a number of less ambitious options which could, nonetheless, have a beneficial effect on the world economy. An implication of all the reforms discussed, touching on both financing and adjustment, is an increase in the relative importance of the official sector, in the form of the International Monetary Fund (IMF) and the World Bank, as compared with the Private Sector, in the form of the International Commercial Banks.


Sahadevan and Kamaiah\textsuperscript{71} attempted to test the bivariate causal relationship among income, absorption and trade balance using Granger, Sims and multiple rank F-tests. The evidence from both the Granger and Sims tests rejects the basic contention of the absorption approach - a unidirectional causal relationship running from absorption to income may be justified from the Keynesian line of argument wherein absorption causes via a multiplier, a change in income with a chain of further effects, depending on the magnitude of propensity to spend, which are neglected by the absorption approach.

A major link in the scheme of causation underlying Alexander's analysis is the unidirectional causation running from absorption to trade balance which has been empirically supported by this study. The implication of this finding is that an excess of absorption over income, leads to a balance of trade deficit. Hence, a cut in domestic expenditure is suggested to improve the external position of a country.

Agenor et. al\textsuperscript{72} reviewed recent developments in the


theoretical and empirical analysis of balance of payments crises. A simple analytical model highlighting the process leading to such crises is first developed. The basic framework is then extended to deal with a variety of issues, including alternative post-collapse regimes, uncertainty, real sector effects, external borrowing and capital controls, imperfect asset substitutability, sticky prices and endogenous policy switches.

Bimal Jalan\textsuperscript{73} has suggested the policies to be followed and action to be taken in ten broad areas of the Indian economy. They are foreign exchange, public debt, fiscal deficit, public sector, competition, controls, decentralisation, literacy, food and poverty and administration. Though the balance of payments situation is quite grim, the author says that there is no need to sink into panic. "By international stands the size of balance of payments required in India is relatively modest - between one and 1.5 per cent of GDP under normal circumstances. A programme of shifting the structure of production in favour of exports alongwith other administrative and policy reforms should be able to accomplish this task within two to three years without imposing intolerable social and political costs".

The other recommendations relate to the imposition of a ceiling on government borrowing and the revamping of the public sector.

Rajgopala Reddy tried to express upon the necessity of greater aid to developing countries by restructuring of debt relief, SDR reallocation, change in the policy of Gold reserve and accounting priorities. He observed that the balance of payments problem of developing countries could be improved through substantial aid restructuring which could give industrial diversification with access to markets of developed countries. SDR link is intended to expand the amount of aid going to the developing countries and this could be pushed forward.

1.6 HOW THE PRESENT STUDY IS DIFFERENT FROM EARLIER STUDIES?

Most of the above mentioned studies have been made during 1970s and mid 1980s and hence may not be relevant to present day context. The dynamic nature of international economic sphere and India's sources of foreign exchange

earnings of late 1980s and oil shock of early 1990s have not been taken into account. Secondly, most of the available studies have covered the broad spectrum of foreign trade and the problem of Balance of payments in general and not the Pros and Cons of various corrective measures in particular. Thirdly, no study was available on whether there is a nexus between fiscal deficit and Balance of Payments deficit. And finally, the available studies analysed the trends in the Balance of Payments of one country or a group of countries only and not different groups of countries.

The proposed work attempts to bridge some of the above gaps, especially it focussed on analysing the balance of payments problems of developing countries divided into five regions with emphasis on the balance of payments problems of India.

1.7 RESEARCH QUESTIONS

Based on the research gaps stated before, the following research questions have been raised:
1. What are the trends in balance of payments position?

2. What are the factors responsible for rising deficits in balance of payments and what is the contribution of each of these to the deficits in balance of payments?

3. What are the measures adopted by the government to restore equilibrium in the balance of payments and to what extent each of these measures proved to be successful?

4. What are the alternative ways of bridging the gap in the balance of payments?

1.8 OBJECTIVES

In view of the growing importance of the problem of balance of payments the present study attempts to examine the nature and causes of the deficits in balance of payments. The specific objectives are:

1. To describe the trends in trade and current account balances of different groups of developing countries over
a period of two decades, 1971-90.

2. To examine the situation in regard to capital transactions and balances during the period 1970-91 for different groups of developing countries.

3. To trace the overall balance of payments situation of different groups of developing countries in the study period of two decades.

4. To analyse India's position with regard to current and capital accounts and to explain the emerging trends during the two decade period.

1.9 HYPOTHESES

As a corollary to the objectives stated the following hypotheses have been formulated:

1. There is no significant difference in the growth rates of trade and current account balances of different groups of developing countries over a period of two decades 1971-90.
2. There is no significant change in the debt overhang and the foreign exchange reserves of different groups of developing countries during the period under study.

3. The disequilibrium in the balance of payments of different groups of developing countries is a transitory one.

4. There is no interconnection between fiscal and balance of payments disequilibrium in the Indian economy during the period.

1.10 DATA REQUIREMENT AND DATA BASE

To test these hypotheses the data pertaining to these aspects are required; Trends relating to imports and exports, direction and sources of exports and of imports, policy measures adopted by Government of India; Figures related to Government debt servicing, foreign exchange reserves and balance of payments. The very nature of the present study calls for reliance on secondary sources. The data for the developing countries are culled out mainly from the publications of the international organisations like UNCTAD, The World Bank and IMF, namely, UNCTAD Bulletins, World Development Reports,

1.11 SCOPE OF THE STUDY

This study on "Balance of Payments problems of Developing Countries with special reference to India" covers the two decade period from 1970-71 to 1990-91. During this period several significant changes have taken place in different aspects of the balance of payments. Due to consecutive oil shocks of 1973, 1979 and 1990 the direction and composition of balance of payments account have undergone significant changes. Severe droughts and floods in various parts of India and increasing subsidies led to huge budget deficits. Analysing the factors which are responsible for these problems and the steps taken by the Government to cope with them form the mainstay of the present study.
1.12 TOOLS OF ANALYSIS

The data drawn from various sources are subjected to statistical treatment as modern economic investigation involves greater precision in measurement of economic phenomena and its relationship thereof. The various tools that are used are detailed below:

Linear and Compound Growth Rates are calculated for exports, imports, current and capital account balances and overall balances in order to explain the nature and magnitude of these deficits. These growth rates are calculated for the time series data. However, for the data in which both deficits and surpluses exist only linear growth rates are calculated. Regression analysis is employed to find the nexus between fiscal deficit and balance of payments deficit under the theoretical framework of absorption approach.

Using Regression the cause and effect relationship and degree of relation between terms of trade and trade balance are tested. Based on the results arrived at, conclusions are drawn as how terms of trade affect the trade balance, which in turn, affect the overall balance.
1.13 LIMITATIONS OF THE STUDY

A doctoral thesis is too fragile an instrument to tackle the multifarious facets in the management of balance of payments in a growing economy. The confidence that one may repose in the conclusions of any investigation depends upon the quality and reliability of the statistical data and appropriateness of the tools used. The conclusions, therefore, are as reliable as the data mostly drawn from the Blue Books. Cross references and continuous efforts have resulted in making the presentation of facts as complete as possible. The period is confined to 1970 to 1990, however, as the data differs in the publications of the IMF from year to year to have uniformity its latest issues are consulted and hence twenty year period could not be covered in certain cases. Balance of payments problems of different groups of developing countries are analysed. Since no two countries are alike, it is not easy to classify groups of countries with respect to their balance of payments problems. Nevertheless, following IMF Classification these countries have been classified regionwise into five viz., Africa, Asia, Europe, Middle East and Western Hemisphere. The tools of analysis are also the most familiar ones, and the sophisticated economic tools are not attempted due to the
researcher's own limitations in that field. There may be some lapses in terms of idiom and style which confront any student whose mother tongue is not English.

1.14 PLAN OF THE STUDY

The thesis is organised into six chapters as detailed below:

With the aforesaid background, the present chapter outlined the balance of payments problems in the last two decades. The latest literature on the problem is also presented besides explaining the methodology that is adopted.

The trends in external trade and terms of trade of developing countries since 1970-71 form the subject matter of the second chapter.

Whereas the Third chapter dealt with the Trends, in current account balances, the factors responsible for the growing deficits in the current account.
The situation in regard to capital transactions and balances is outlined in chapter Four. The problems of debt overhang, trends in foreign exchange reserves and overall balances are also examined.

The penultimate chapter examined India's position with regard to current and capital accounts and the relationship between internal and external balances.

The last chapter consists of the summary of basic arguments relating to the balance of payments problems, their constraints and specific policy measures arising out of the present investigation.