COURSE GUIDE

BFN 401
INTERNATIONAL FINANCE

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GUIDE INTRODUCTION

BFN401: International Finance is a one semester course work having three credit units. It is available to students on Undergraduate Programme in the School of Management Sciences at the National Open University of Nigeria.

The course is made up of 15 units covering essential topics in International Finance. Topics covered include: International trade, balance of payment, Adjustment of balance of payment, foreign exchange market, international financial institutions, international capital flow, debt financing portfolio, etc.

This course guide tells you what the course is all about, the relevant textbooks you should consult, and how to work through your course materials to get the best out of it. It also contains some guidelines on your tutor-marked assignments.

COURSE CONTENTS

The aim of this course is to introduce you to the subject of International Finance. The course contains core topics in international finance including functions of international finance, market covered by international finance, international trade, balance of payment, adjustment of balance of payment, foreign exchange market, international capital flow, debt financing portfolio among others.

The subject of international finance is very important in the economic life of any nation. No nation constitutes an island upon itself. So long as every nation interacts with other nations politically, socially and otherwise, international finance has a role to play. We carry out transactions using different currencies and calling for international exchange rates. International finance also concerns balance of payment and adjustment of balance of payment issues.

COURSE AIMS

The course aims to groom the student in the process of International finance foreign exchange market operations and features, instruments and performance of international finance performance analysis which prepares him for life journey in the field of international finance through investment and portfolio management. Sooner or later, the student, after his studies, will be involved in international financial activities of one kind or another and the making one international financial decision or another to make gains to sustain himself and his family. Also, knowledge of international finance operation and international trade and understanding of the intricacies of foreign exchange market will be useful to the student in other areas of human endeavour

COURSE OBJECTIVES

In order to achieve the full aims of the course, the study is divided into coherent units and each unit states, at the beginning, the objective it is out to achieve. You are therefore advised to read through the specific objectives before reading through the unit. However, the following represent some of the broad objectives of the course. That is to say, after studying the course as a whole, you should be able to understand:

* The introduction of international finance
* International trade
* Balance of payment
* Adjustment of balance of payment
* Foreign exchange market
* Efficiency of foreign exchange market
* Global Economic Environment
* International Finance Institutions
* Market covered by international finance
* Functions of international finance
* Features, instruments and performance of international finance
* Nature of capital
* International capital flow
* Internal and external debts
* Debt financing portfolio

WORKING THROUGH THIS COURSE

It is imperative that you read through the units carefully consulting the suggested texts and other relevant materials to broaden your understanding. Some of the units may contain self-assessment exercises and tutor-marked assignments to help you. Only when you have gone through all the study materials provided by the National Open University of Nigeria (NOUN) can you satisfy yourself that indeed you have completed the course. Note that at certain points in the course you are expected to submit assignments for assessment, especially the Tutor-Marked Assignment (TMAs). At the end of the course, there will be a final examination to test your general understanding of the course.

COURSE MATERIALS

Major components and study units in the study materials are:

Course Title: BFN401 International Finance and the study units. .

S Module 1

Unit 1	Introduction to International Finance
Unit 2	International Trade I
Unit 3	International Trade II
Unit 4	Balance of Payment
Unit 5	Exchange Rates
Unit 6	International Finance Institutions I
Unit 7	International Finance Institutions II
Unit 8	Global Economic Environment
Unit 9	Economic Cooperation
Unit 10	Finance and Management of Foreign Operations
Unit 11	Foreign Exchange Market
Unit 12	Efficiency of Foreign Exchange Market
Unit 13	Market Covered by International Finance
Unit 14	Nature of Capital
Unit 15	International Capital Flows
Unit 16	Features, Instruments and Performance of International Finance
Unit 17	Internal and External Debts
Unit 18	Debt Financing Portfolio
Unit 19	Theory and practice of devaluation
Unit 20	Foreign Direct Investment And Portfolio

ASSIGNMENT FILE

The assignment file will be made available to you (where applicable). There, you will find details of all the work you must submit to your tutor for marking. The marks you obtain from these assignments will count towards the final mark you will obtain to hit the required pass-mark for the course.

ASSESSMENT

Your performance on this course will be determined through two major approaches. The first is through your total score in the Tutor-Marked Assignments, and the second is through the final examination that will be conducted at the end of the course. Thus, your assessment in the course is made up of two components:

Tutor-market Assignment
30% Final Examination
70%

The self-assessment tests which may be provided under some units do not form part of your final assessment. They are meant to help you understand the course better. However, it is important that you complete work on them religiously so that they will help in building you strongly and serving you as mock-examination.

TUTOR-MARKED ASSIGNMENT

At the end of each unit, there is a Tutor-Market Assignment (TMA), which you are encouraged to do and submit accordingly. The study centre manager/ tutorial facilitator will guide you on the number of TMAs to be submitted for grading.

Each unit of this course has a TMA attached to it. You can only do this assignment after covering the materials and exercise in each unit. Normally, the TMAs are kept in a separate file. Currently, they are being administered on-line. When you answer the questions on-line, the system will automatically grade you. Always pay careful attention to the feedback and comments made by your tutor and use them to improve your subsequent assignments.

Do each assignment using materials from your study texts and other sources. Try to demonstrate evidence of proper understanding, and reading widely will help you to do this easily.The assignments are in most cases easy questions. If you have read the study texts provided by NOUN, you will be able to answer them. Cite examples from your own experience (where relevant) while answering the questions. You will impress your tutor and score higher marks if you are able to do this appropriately.

FINAL EXAMINATION AND GRADING

At the end of the course, you are expected to sit for a final examination. The final examination grade is 70% while the remaining 30% is taken from your scores in the TMAs. Naturally, the final examination questions will be taken from the materials you have already read and digested in the various study units. So, you need to do a proper revision and preparation to pass your final examination very well.

HOW TO GET THE BEST OUT OF THIS COURSE

The distance learning system of education is quite different from the traditional or conventional university system. Here, the prepared study texts replace the lecturers, thus providing you with a unique advantage. For instance, you can read and work through the specially designed study materials at your own pace and at a time and place you find suitable to you.

You should understand from the beginning that the contents of the course are to be worked on carefully and thoroughly understood. Step by step approach is recommended. You can read over a unit quickly y to see the general run of the contents and then return to it the second time more carefully. You should be prepared to spend a little more time on the units that prove more difficult. Always have a paper and pencil by you to make notes later on and this is why the use of pencil (not pen or biro) is recommended.

FACILTATORS/TUTORS AND TUTORIALS

Full information about learning support services or tutorial contact hours will be communicated to you in due course. You will also be notified of the dates, time and location of these tutorials, together with the name of your tutors. Your tutor will mark and comment on your assignments. Pay attention to the comments and corrections given by your tutor and implement the directives as you make progress.

USEFUL ADVICE

You should endeavour to attend tutorial classes since this is the only opportunity at your disposal to come face to face with your tutor/lecturer and to0 ask questions on any grey area you may have in your study texts. Before attending tutorial classes, you are advised to thoroughly go through the study texts and then prepare a list of questions you need to ask the tutor. This will afford you opportunity to actively participate in the class discussions.

SUMMARY

International Finance is at the heart of investors and business people because money is required for every project, programme or transaction the businessman wants to embark upon. Needless to say that the investor or businessman must calculate the expected profit against the cost of capital he is raising for the transaction.

UNIT 1 INTRODUCTION TO INTERNATIONAL FINANCE

CONTENTS

1.0 INTRODUCTION

The field of international finance concerns itself with studying global capital markets and might involve monitoring movements in foreign exchange rates, global investment flows and cross-border trade practices.

International finance involves dealing with monetary system which cuts across national borders. All the activities involved in international financing help organizations to engage in cross-border transactions especially transactions having to do with international payments.

2.0 OBJECTIVES

After reading this unit the student will be able to

- Understand the dynamics of international payment.
- Understand the advantages of international finance which include: consumption pattern of different nations
- Understand where and how to invest in different instruments and projects

3.0 MAIN CONTENT

3.1 Definition of International Finance

International Finance is a branch of economics which studies the dynamics of foreign exchange. It is a monetary system which transcends national borders. The activities involved in international finance helps organizations to engage in cross-border transactions.

International finance covers all procedures, techniques and tools that financial institutions, such as banks and insurance companies, provide to clients.

Advantages of International Finance: Due to the current changes brought about by globalization of industrial activities and liberalization of trade among nations, international finance has become useful in the following ways:

(i) It helps us to understand the consumption pattern of different economies
(ii) It aids our understanding of production pattern of different nations
(iii)It guides us to know where and how to invest.

3.1.1 The balance of Payments

A country's balance of payments is commonly defined as the record of transactions over a specified period of time between its residents and foreign residents. These transactions include exports and imports of goods and services, cash receipts and payments, gifts, loans and investments. Residents may include business firms, individuals, and government agencies.

The balance of payments helps business managers and government officials to analyze a country's competitive position and to forecast the direction of pressure on exchange rates. The ability of multinational firms to move money across national boundaries is critical. Multinational companies depend on this ability for exports, imports, payment of foreign debts, and dividend remittances. Many factors affect a firm's ability to move funds from one country to another. In particular, a country's balance of payments affects the value of its currency, its ability to obtain currencies of other countries, and its policy toward foreign investment.

3.1.2 Balance-of-Payment Accounts

The balance of payments identifies transactions along functional lines. We may classify balance-of-payments transactions into four major groups:

1. Current Account: Merchandise, services, and unilateral transfers.

2. Capital Account: Long-term capital and short-term capital.
3. Statistical discrepancy: Errors and omissions
4. Official reserve account: Official reserve assets and foreign official assets.

The Current Account

The current account includes merchandise exports and imports, earnings and expenditures for invisible trade items (services), and unilateral transfer items. Entries in this account are "current" in nature because they do not give rise to future claims. The balance of payments on the current account is the broadest measure of a country's international trade because it includes financial transactions as well as trade in goods and services. A surplus on the current account represents an inflow of funds, while a deficit represents an outflow of funds.

Balance of Merchandise Trade: The balance of merchandise trade refers to the balance between exports and imports of physical goods such as automobiles, machinery, and farm products. A favorable balance-of-merchandise trade (surplus) occurs when exports are greater in value than imports. An unfavorable balance-of-merchandise trade (deficit) occurs when imports exceed exports. Merchandise exports and imports are the largest single components of total international payments for most countries.

The Capital Account

Using America as an example, the U.S. residents and businesses may choose to invest in foreign countries. Of course, foreigners may engage in similar capital transactions, for example, they may bus real capital assets in the United States, or they may invest in US government securities. The capital account consists of loans, investments, other transfers of financial assets, and the creation of liabilities. Unlike current account entries, entries in the capital account indicate changes in future claims, for instance, loans and their interests should be paid, or dividends on investments should be paid. The capital account covers long-term capital and short-term capital.

Statistical Discrepancy: Errors and omissions

The balance of payments should always balance in theory because all debits are offset by credits and vice versa. But it rarely does balance in practice for a number of reasons. Balance-of-differently by individuals and agencies. Thus, the debits and credits may not balance at the end of the year. This is why the statistical discrepancy is treated as a "plug" item to keep the balance-of-payments accounts in balance. Although this item could be placed anywhere in the balance of payments, it is typically placed close to the short term capital account because more errors and omissions occur in that account than in other accounts.

The Official Reserve Account

Official reserves are government-owned assets. The official reserve account represents only purchases and sales by official monetary authorities, such as the Federal Reserve System of the United States or the Federal Reserve Account of the Federal Government of Nigeria. Changes in official Reserves are necessary to account for the deficit or surplus in the balance of payments.

The official reserve account consists of official reserve assets and foreign official assets. Official reserve assets are composed of gold, convertible foreign exchange, and Special Drawing Rights. The principal convertible currencies are the U.S dollar, the British pound, the Euro and the Japanese Yen for most countries. Special Drawing Rights, sometimes called "paper gold," are rights to draw on the International Monetary Fund.

The official reserve account of a country also includes its liabilities to foreign official holders, such as foreign central banks, refer to foreign official deposits with U.S banks and official holdings of U.S. Treasury Securities. Foreign governments frequently wish to hold such assets in the United States because of their interest earnings.

The official reserve account presents a great difficulty when trying to classify its transactions either as debits or credits. On the one hand, an increase in any of the reserve assets represents a use of funds on a debit entry in the balance of payments. On the other hand, a decrease in any reserve asset indicates a source of funds on the credit entry. By the same token, a decrease in any official liability is entered as a debit, and an increase in any official liability is recorded as a credit.

3.1.3 Measuring the Surplus or Deficit

The operational definition of surplus or deficit is the sum of the above-the-line transactions or autonomous transactions. Surely, a nation's surplus or deficit will vary according to the definition of autonomous transactions. The balance of merchandise trade designates only exports and imports of merchandise as autonomous transactions. Balance of goods and services covers merchandise trade items and services as autonomous items. Balance of current account considers goods, services, and unilateral transfers as autonomous items. Balance on capital account treats current account items and capital flows as autonomous items. A clear definition of autonomous transactions is thus essential if one is to isolate the moist probable causes of imbalances before determining what actions government officials should take to remedy these imbalances.

A change in the official reserve account measures a nation's surplus or deficit on its current and capital account transactions by netting official liabilities from official reserve assets. Normally, a surplus will lead to an increase in official reserve assets, while a deficit will cause a reduction in these assets. The only question that might arise is how to treat private holdings of foreign exchange on both sides. Few private citizens of other counties hold Spanish pesetas, Mexican pesos, or Indian rupees. If they receive foreign currency, the foreign currency will be exchanged quickly for their own currency at a commercial bank. The commercial banks, in turn, exchange the foreign currency at the Central Bank. At this point, the transaction shows up in the official reserve account.

3.2 The Actual Balance of Payments

The balance of payments statement has many formats, because many different organizations collect and present balance of payments statistics. A number of international organizations such as the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade

(GATT) compile balance of payments data for their member countries and present them in their yearbooks. The U.S Department of Commerce compiles U.S. balance of payments statistics and publishes them in its "Survey of Current Business.

3.2.1 The World Balance of Payments

The value of world merchandise trade reached a new record of $3.5 trillion in 1990. In its review of the 1980s, the GATT report observed that the volume of world trade increased by 50 percent during the decade, while the value of trade rose by 75 percent. The expansion of world trade averaged six percent annually, while the growth of global output averaged four percent a year. Hence, the share of production traded increased substantially during the 1980s; this reflects the relative openness of markets and the on-going integration of the global economy.

3.2.2 The U.S. Balance of Payments

Merchandise Trade: In 1990, the world's second largest trading nation, the United States, exported $389 billion worth of goods and imported $498 billion worth of goods. Both figures represent about 15 percent of the world's total. In 1990, the United States lost its position as the world's largest merchandize exporter to Germany, due to a 16.5 percent increase in the value of the German Mark (Euro Currency) and the unification of the East and West Regions.

The U.S. balance on merchandise trade was in surplus during the early 1960s to the early 1970s, the U.S. merchandise trade balance moved gradually from surplus to deficit. This movement was interrupted, however, during the world-wide recession of 1974-75. During this time of recession, the United States suffered more economic contraction than most other major trading nations. Thus, the U.S. merchandise trade balance swung into surplus in 1975, even though there was a sizeable increase in U.S outlays for imported oil. The surplus proved short-lived because the U.S. balance of payments deficit for merchandise trade rose sharply from 1976 through 1987

Three factors had been singled out as leading causes of this six-fold rise in the U.S. deficit for merchandise trade from 1980 to 1987; the strong U.S. dollar reduced U.S. exports to heavily indebted developing countries, and faster economic growth in the United States than in its major trading partners. This is why there have been many calls for trade protection and why the United States became a net debtor nation in 1986.

3.2.3 U.S. International Investment Position

Balance of payments is a flow concept because it measures the economic activities of a country over a one year period. International investment position is a stock concept because it summarizes a country's assets and liabilities on a given date. Table 1 below shows the international investment position of the United States from 1982 to 1990. The U.S. net overseas investment evolved steadily from $6 billion in 1919 to $141 billion in 1981. This long-term increase in the U.S. net investment position has decreased dramatically since 1982.

In 1982, the United States became a net debtor nation for the first time since World War I. Its foreign debt reached $412 billion in 1990. This is about one-third the combined total debt of some 110 developing counties. Huge trade and budget deficits, caused by major shifts in macroeconomic policy in the first half of the 1980s, turned the United States from creditor to debtor.

TABLE 1

International Investment Position of the United States
(in billions of dollars)

Type of Investment	1982	1983	1984	1985	1986	1987	1988	1989	1990
U.S. Assets Abroad	1100	1114	1105	1174	1319	1463	1534	1673	1764
Govt. Assets	217	203	190	206	229	251	230	253	256
Private Assets	883	911	915	968	1090	1212	1304	1420	1508
Foreign Assets in U.S.	737	829	941	1109	1393	1598	1840	2112	2176
Govt. Assets	189	194	200	2002	242	283	322	337	367
Private Assets	548	635	741	907	242	1315	1518	1775	1809
Net position	363	285	164	65	-74	-135	-306	-439	-412

Note: Portfolio investment position at market value and direct investment position at current cost
Source: The U.S. Department of Commerce, Survey of Current Business, June 1991, p.26

Net international investment positions themselves are not particularly meaningful. This is why many economists look at four broad categories of international investment position: short-term position, long-term position, government sector, and private sector. In other words, analysts break down international investment holdings into several categories so that they can draw policy implications from each category about the liquidity status of a country.

Short-term foreign assets in the United States such as bank deposits and government securities are meaningful because foreigners can withdraw these holding at very short notice. If they fear capital losses from further depreciation of the dollar or if interest rates decline, foreign investors may turn away from dollar-dominated short-term assets. Such actions by foreign investors can endanger the stability of the U.S. financial system. Foreign official assets in the U.S. are also significant. If foreign monetary authorities decide to liquidate their holdings of U.S. government securities, the financial strength of the dollar will fall. Long-term investments such as long-term corporate securities and direct investment are less important because they respond to basic economic trends and are not subject to erratic withdrawals.

Increased Economic Interdependence

The growing economic interdependence of the United States and other countries is reflected in expanding international trade and capital flows. U.S. imports of goods and services increased from less than 5 percent of total demand on average in the 1960s to more than 11 percent on average in the 1980s. U.S. exports of goods and services increased from just 6 percent of domestic production on average during the 1960s to nearly 11 percent on average during the 1980s.

International financial markets have also growndramaticall6 over the past decade. Capital flows abroad helped to finance economic investment expenditures in the United States. These flows respond quickly in 24 hours financial markets to differences in short-term interest rates and other developments across countries. Because capital movements are sensitive to differences in policy, the globalization of financial markets has increased the interdependence of national economic policies.

The globalization, innovation, and deregulation of financial markets have reduced the cost of financial transactions and improved the allocation of investment internationally. But these same forces have also increased volatility in financial markets and introduced highly complex elements of risk.

3.3 How to Restore International Equilibrium

Some countries, such as the United States, have had deficits for many years. But their compensating transactions cannot be maintained indefinitely. Hence, some adjustments must be made to correct the balance of payments deficit. International equilibrium may be restored in three ways: price mechanism, income mechanism, and public controls.

3.3.1 Price Mechanism

In international finance, price mechanism refers to exchange rates. Exports and imports between countries with different units of money introduce a new economic factor called the foreign exchange rate. The foreign exchange rate is the rate of exchange between a country's currency and a foreign currency. An equilibrium exchange rate occurs at the point where demand equals the supply for foreign exchange. At the equilibrium exchange rate, there would be no tendency for the exchange rate to rise or to fall. Debit and credit items in the balance of payments cause demand and supply for foreign exchange. Thus, equilibrium for a foreign exchange rate also implies some form of equilibrium in the balance of payments.

The exchange rate is a special price because it is the relationship between all domestic prices and all foreign prices. Consider the exchange rate between the U.S. dollar and the Japanese yen. A change in the interest rate would alter the prices for all American products for Japanese people and the prices of all Japanese products for Americans. Such changes in an exchange rate could cause the relative attractiveness of American exports and imports to change in such a way that it would restore equilibrium in the U.S. balance of payments.

The price mechanism restores international equilibrium through changes in interest rates and commodity prices. Assume that the United States is the deficit country and Japan is the surplus country. In this case, money tends to move from the United States to Japan in order to finance the U.S. deficit. Unless the Federal Reserve System of the United States counteracts these flows, money supply in the United States will decrease. A decrease in the U.S. money supply will push U.S. interest rates up. In Japan, the money supply will increase. Such an increase in money supply will push Japanese interest rates down. The new relative yield will encourage capital flows from the surplus country (Japan) to the deficit country (the United States). Such a reverse movement of money will help to bring the U.S. payments into balance.

3.3.2 Income Mechanism

The equilibrium level of income exists where the aggregate quantity demanded (spending) equals the aggregate quantity supplied (income). In an open economy (free market economy), the equilibrium condition is explained simply in the **Equilibrium Equation** stated below

$$\mathbf{C + I + G = C + S + T + (Ex - Im)}$$

Where:

C	=	Consumption
I	=	Investment
G	=	Government purchases of goods and services
S	=	Savings
T	=	Taxes
Ex	=	Exports
Im	=	Imports

It is important to recognize that the left-hand side of the Equilibrium Equation stated above represents an aggregate spending, and its right-hand side represents an aggregate income. If exports exceed imports, domestic spending is smaller than domestic income. If imports exceed exports, domestic spending is larger than domestic income. When the excess of imports over exports is extremely large or continues too long, the obvious remedies would be an increase in income or a reduction in spending.

Income changes in one country affect other countries. An increase in U.S. imports means more export sales for Japan. This has an expansionary effect in the Japanese economy; thus, Japan wil increase its imports. If Japan buys more goods and services from the United States as a result of its increased income, the United States will find its exports increasing. An increase in U.S. exports will eliminate part of its original deficit caused by rising imports. At the same time, increased exports by Japan, means more imports by the United States. Such an increase in the U.S. imports means a reduction in U.S. income. After a time, the U.S. will reduce its consumption and imports because of her reduced income. Reduced imports by the U.S. will eliminate part of the original increase in Japanese exports. When these two forces are combined – the increase in exports by the deficit country (the United States) and the decrease in exports by the surplus country (Japan) – international equilibrium will be restored between the two nations.

Income changes also tend to restore international equilibrium because they affect interest rates on domestic investment in capital assets. Investment in capital assets, such as plants and equipment, tends to increase as interest rates fall. Because capital flows from the deficit country to the surplus country, interest rates in the United States start to increase. An increase in the U.S. interest rates reduces U.S. investment in assets. As a result of its reduced investment in capital assets, the United States will find its national income and imports falling. The reverse is the case in Japan where declining interest rates will raise investment in capital assets. An increased investment in assets will, in turn, push Japanese income and its imports to rise. This mechanism operates as long as there is a surplus or a deficit. It could eventually eliminate international disequilibrium.

The income mechanism, like the price mechanism, is supposed to correct the U.S. balance of payments deficit automatically. But it is also possible that a fluctuation of income may be insufficient to correct an original deficit. In a fashion similar to price elasticity, income elasticity measures the relative change in quantity demanded for a given percentage change in income. If the income elasticity for traded products are high, an income mechanism will restore the balance of payments disequilibrium automatically. Because, income elasticity for certain products are low, an income mechanism may be insufficient to correct the balance o0f payments imbalances.

3.3.3 Public control

Most leading economists and leaders of commercial nations have applauded pleas for liberal trade and automatic adjustment policies. Nevertheless, free trade among nations and automatic adjustment mechanisms have recently faced their most serious challenges. Governments have two major reasons for their balance of payments controls. First, they may find their international reserves inadequate to finance their deficits. Second, the free fluctuation of exchange rates may be insufficient to eliminate international disequilibrium completely.

In general, there are two types of public controls: foreign exchange controls and trade controls: Think, for a moment, of a case in which increased Mexican imports create a shortage in its foreign exchange. Under exchange controls, the Mexican government would force its exporters and other recipients to sell their foreign exchange to the government or to designated banks. Then, the government would allocate this foreign exchange among the various users of foreign exchange. In this way, the Mexican government restricts Mexican imports to an amount of foreign exchange earned by Mexican exports. Thus, imports under exchange controls are less than they would be under free market conditions.

When governments are faced with a serious payment deficit, they may manipulate exports and imports through tariffs, quotas, and subsidies. High tariffs on imported goods and import quotas by Mexico would reduce Mexican imports. On the other hand, the Mexican government may subsidize certain Mexican exports to make them competitive in world markets and to increase the volume of Mexican exports. Special taxes

4.0 CONCLUSION

As discussed in the text, the balance of payments summarizes all international transactions between residents of a country and residents of foreign countries during a specified period. The systematic recording of these international transactions requires pre-established principles. These principles include rules or procedures, such as the double-entry accounting rule, and definitions of terminology, such as the current account.

We noted that the balance of payments deficit can be corrected by means of freely fluctuating exchange rates, changes in income, and government controls. Government controls, such as exchange and trade controls, can be used to alleviate or control the balance of payments deficit.

5.0 SUMMARY

In this unit, we noted that the balance of payments identifies transactions according to functional lines. For this reason, balance of payments transactions can be classified into four broad groups. The current account mainly includes merchandize exports and imports, earnings and expenditures for invisible trade items and services. In the next unit, we shall be looking at Foreign Exchange Market.

6.0 TUTOR-MARKED ASSIGNMENT

* Explain the four major groups into which balance of payment can be classified.
* Why is balance of payments regarded as a flow concept?

7.0 REFERENCE/FURTHER READING

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UNIT 2 INTERNATIONAL TRADE I

CONTENTS

1.0 INTRODUCTION

International trade and production are a way of life for business managers today. All over the world large numbers of business people find that foreign trade is an importance part of their total activities countries rely on foreign countries for much of their raw materials or sell a significant portion of their output abroad.

International trade makes available a range of materials and process that could not conceivably exist in one restricted.

Webster's new encyclopedic dictionary defined trade as exchange, interchange or barter.

International trade therefore means the commercial transaction or exchange that occurs between two or more countries.

Countries trade because they are different from each other. Countries can benefit from their differences by reaching arrangement in what each does or naturally endowed.

International is different from domestic trade which takes place within a country and uses local currency.

This unit also looks at a comprehensive examination of the world trade organization. Forces like technological breakthroughs, economic growth, market evolution, shifts in customer tastes, social changes and political events can expand or shrink business space and world trade. Vast amounts of new track space created today change perspectives. This unoccupied territory represent a land of opportunity for the technological and strategic innovators who can see or create it faster than their competitors do. The opportunities are great, but so are the competition and the chance of failure. To days growth era produces huge discontinuities, creates new industries and destroys old ones, and accelerates global economic growth in the process. Expectations are rising everywhere; human creativity is flowing in every field. Emerging economics are industrializing and everyone is joining the digital revolution of boundless information and seamless electronic commerce. The world trade organization (WTO) is an international body dealing with rules relating to international business operations. The organization is responsible for global agreements, negotiations and ensures regulations and rule made by all is obeyed by all. And to keep various trade policies/rules within agreed limits and bounds. It came into existence on 1st January 1995 as a result of the Uruguay round of trade negotiations URTN. It aims at;

Facilitating trade among countries by creating conditions for competition that are fair and equitable.

It encouraging entering into negotiations for the reduction of tariffs and the removal of other barriers to trade

Requires them to apply a common set of rules to trade in goods and services.

This body is responsible for overseeing the multilateral trading system which has gradually evolved over the last 60 years (Otokity, 2006).

2.0 OBJECTIVES

Upon successful completion of this unit, you should be able to:

- Define and explain international trade
- Discuss the basic concepts and reasons for international trade.
- Explain the various forms of international trade
- Examine the issues surrounding the establishment of world trade organization (WTO)

3.0 MAIN CONTENT

3.1 Definition and Meaning of International Trade

International trade is the exchange of capital, goods and services across international borders or territories. International trade is the trade that takes place between one country and other countries. i.e. it is a trade transaction that takes place between one or more countries. It is different from domestic trade which takes place within a country and uses local currency.

International trade involves the use of international currency (ies) and to obtain this, one has to go through some procedures.

Czinkota etal defined international trade to consists of transaction that are devised and carried out across national boarders to satisfy the objectives of individuals and operations.

International trade uses a variety of currencies, the most important of which are held as foreign resent by governments and central banks.

Here the percentage of global cumulative reserves held for each currency between 1995 and 2005 are shown: the US dollar is the most sought-after currency, with the Euro in strong demand as well.

3.2 The Nature and Scope of International Trade

In most countries, international trades represent a significant share of Net National product and Gross Domestic Product. International trade as the meaning implicate has been presented throughout much of history, its economic social and political importance has been on the rise in recent centuries.

Industrialization, advanced transportation, globalization, multinational corporations and outsourcing are all having a major impact on the international trade continuance of globalization. Without international trade, nations would be limited to the goods and survives produced within their own borders.

International trade is, in principle, not different from domestic trade as the motivation and the behaviour of parties involved in a trade do not change fundamentally regardless of whether trade is across a border or not. The main difference is that international trade is typically more costly than domestic trade. The reasons is that a border typically imposes additional costs such as tariffs, time costs due to border delays and cost associated with country differences such as language the legal system or culture. Another between domestic and international trade is that factors of production such as capital and labour are typically more mobile within a country than across countries. Thus international trade is mostly restricted to trade in goods and services, and only to a lesser extent to trade in capital, labour or others.

3.3 Brief Historical Development of International Trade

The barter of goods or services among different peoples is an age-old practice, probably as old as human history.

International trade, however refers specifically on an exchange between members of different nations and accounts and explanations of such trade begin (despite fragmentary earlier discussions) only with the rise of the modern nation-state at the close of the European middle ages. As political thinkers and philosophers began to examine the nature and function of the nation trade, trade with other countries became a particular topic of their inquiry. It is, accordingly, no surprise to find one of the earliest form of trade.

International trade has been in existence since ancient times. Even in the Bible references were made to trading activities between different countries. Illusion was made in the book of Genesis of sons of Jacob who went to Egypt to buy grains. With increase in civilization and traveling added to the known benefits of specialization and division of labour. International trade among countries of the world has even increased tremendously.

Although early writers recognized the existence of international trade, they felt that it was not much different from domestic trade to warrant the existence of a separate theory. Adam Smith in his much celebrated work published in 1776 and titled "An Inquiry into the Nature and causes of the wealth of Nation" was the first economists to propound the classical theory. Ohlin (1933) argued that international trade" should be regarded as a special case within the general concept of international economics. He further argued that nations engaged in trading for the same reasons for which individuals or groups within the country trade with each other instead of each one producing his own requirement. The reason is that they are enabled to exploit the substantial advantages of division of labour to their mutual advantage.

Trade between different countries developed first where one country could produce something desirable which others could not. International trade, therefore owes its origin to the varying resources and climate of different regions.

3.4 Basic Concepts and Reasons for International Trade

International trade refers to buying and selling of goods and services between countries e.g. between Nigeria and the United States of America, Ghana or Australia etc. In other words the term

"International trade" refers to exchange of goods and services that take place across international boundaries.

International trade is simply defined as the trade across the borders of a country. This may be between two countries, which is called bilateral trade or trade among many countries called multinational trade. International trade is to enable countries obtain the greatest possible advantage from the exchange of one kind of commodity or another.

REASONS FOR INTERNATIONAL TRADE

3.4.1 Opportunity Cost

This is simply the value of using a resource; measured in terms of the value of the best alterative for using that resource.

International trade occurs because no single country has the resources to produce everything well. The products a country decides to produce depend on what must be scarified to produce them; that is, whatever resources a country uses to produce one product are no longer available for producing some other product. Those things we have to give up in order to get more of what we want are called opportunity cost, and they determine what countries produce for trade.

For example, Saudi Arabia exports crude oil. The Saudis could have chosen to export wheat, but they lack the resources (the arable land, the water, and climate) to grow wheat efficiently.

3.4.2 Comparative Advantage/Factor Endowment

The United States also produces both crude oil and wheat, but its opportunity cost is lower than Saudi Arabians. Having smaller reserves of oil and more than ten times the arable land, the united states has to give up only a few barrel of oil (compared with Saudi Arabians innumerable barrels of oil) to produce a bushel of wheat.

Thus, in the production of wheat, the united states has a comparative advantage; that is, it has the ability to produce a given product at a lower opportunity cost than its trading partners.

Factor endowment consists of differences in capital, labour and land. For example, a rich nation like the United States has a large amount of expensive capital equipment hence can specialized in goods such as chemicals, automobiles. Other nations with an abundant labour supply like Japan finds it efficient to concentrate on making television sets, which require the assemblies of components by hand.

3.4.3 Absolute Advantage

If a nation is the sole producer of an item, it has an absolute advantage over all other nations in terms of that item. Another absolute advantage exists when one nation can make something more cheaply than its competitors.

An absolute advantage is a nation's ability to produce a particular product with fewer resources (per unit of output) than any other nation. This absolute advantage might exists because for instance the Saudis have been growing wheat far longer than people in the united states or because the Saudis are simply more talented.

3.4.4 Competition

International trade gives room to competitors. Foreign goods competes with the local goods in the market. Foreign markets may grant local manufacturers greater potentials for growth.

3.4.5 Access to Capital/Greater Returns on Capital

International trade enables countries with limited capital to either borrows from capital rich countries or attract direct investment into the countries and thus enjoy the benefits imported capital and technology investment abroad may yield higher returns than additional domestic investment, particularly where the foreign market is growing.

3.4.6 Economic and Social Development

International trade increases the economic and social development of the under developing countries.
Other reasons for international trade are: differences in tastes, differences in industrial development and the level of technology, existence of special skills in some countries and differences in climate.

3.5 Comparison between International Trade and International Business

International trade is a business transaction between the nationals of two different countries. For example, a Nigerian businessman can import a consignment of a product from a British producer. He needs not to know anything about the business environment of Britain. But opening an international business is more involving. The operator must study and understand the international business environment such as culture, a legal, economic factor which prevails in the environment he would want to locate his business.

3.6 Prevailing Problems of International Trade

Engaging in International trade is a sophisticated activity. It requires great corporate, personal and business skill, experience and knowledge. International trade is being influenced by the following problems:

a. Cultural differences: Deep cultural differences like social expectations, manners and methods of doing business can be persistent problems to a country who is about to enter into a bilateral or multilateral agreement.

b. Currency problem: Trading between sovereign nation creates financial complications because currencies are not of equal value and the rate of exchange between currencies are not fixed.

c. Legal protection: countries often limit International trade by legal means. Example tariff, quota and embargo. This protective tariffs and quotas is to encourage the growth of domestic industries and to protect them from price competition from foreign companies.

d. Foreign political climates: these are often unpredictable. For example, terrorism and foreign tax structures may be favoured to business.

e. Foreign business climates and methods may create ethical problems. Example bribery is more widely accepted in Nigeria than in the United States.

3.7 Forms of International Trade

There are a number of ways in which Nations can participate in International trade.

3.7.1 Direct Exporting

This form of international trade involves soliciting orders from foreign countries for goods and services that are made in a country and then shipped abroad. For example, without International trade, the market for the Nigerian crude oil, columbite, cocoa, rubber, etc would have been limited to domestic economy. Export of goods and services act as foreign exchange earners to the domestic economy. Foreign exchange availability is essential requirement for the survival of any national income.

3.7.2 Foreign Licensing

This is another important form of trade that exists between two or more countries. It involves a country soliciting another country to produce and sell her product to them in a fee and after due procedural arrangement have been made which binds the elements of such countries contract. This is generally used for goods with established brand names.

SELF ASSESSMENT EXERCISE

What do you understand by the term International trade? And name the two major forms you know.

3.8 WTO and the Establishment of General Agreement on Tariff and Trade

The World Trade Organization provides a forum for continuing negotiation to liberalize the trade in goods and services through the removal of barriers and the development of rules in new trade-related subject areas. The World Trade Organization agreements have a common dispute settlement mechanism through which members enforce their right and settle the differences that arise between them in the course of implementation.

The multilateral trading system of WTO can broadly be defined as the body of international rules by which countries are required to abide in their trade relations with one another. The basic aim of these rules is to encourage countries to pursue open and liberal policies. These rules are continually evolving. The existing rules are being clarified and elaborated to meet the changing conditions of world trade. At the same time rules covering new subjects are being added to deal with problems and issues that are being encountered.

A tariff is an indirect taxes imposed upon imports. They can either be specific (Fixed amount per good) or ad valorem (a % of the value). Tariff imposition arises due to reasons such as;

To reduce imports and protect domestic firms from foreign competition.
To reduce imports in order to reduce balance of payment deficits.
The virtual developing country is a case study of Zambia. There are a series of field trips available looking at different issues connected with economic development. This tour is the trade tour, and this unit shall also look at the imposition of tariffs as a form of protection and the welfare loss that result.

If the government of a country imposes a tariff on the imports from another country they raise the world price by the amount of the tariff they impose. The WTO concept is the outcome of the first major effort to adopt rules to govern international trade relations which was made by countries in the years immediately after the Second World War. These efforts resulted in the adoption in 1948 of the General known as; consequently the GATT rules which was basically applicable to international trade in goods for years was modified to include new provisions particularly to deal with the trade problems of developing countries.

3.8.1 The Mechanism of World Trade Organization

Trade is increasingly global in scope today. There are several reasons for this. One significant reason is technological -because of improved transportation and communication opportunities today, trade is now more political. Thus, consumers and businesses now have access to the very best products from many different countries.

Increasingly rapid technology life cycles also increases the competition among countries as to who can produce the newest in technology. In part to accumulate these realities, counties in the last several decades have taken increasing steps to promote global trade through agreements such as the general treaty on trade and tariff GATT, and organizations such as the World Trade Organization (WTO), north American Free Trade agreement (NAFTA), and the European Union (EU).

Similarly, the WTO system as it has emerged from the Uruguay round consisting of the following substantive agreements:

(i) General agreement on trade in services (GATS)

(ii) Multilateral agreement on tariffs and trade (GATT 1995) and all its associate agreements.

(iii) Agreement on trade –related aspects of intellectual property rights (TRIPS).

3.8.2 Legal Instrument at Uruguay Round

The legal instrument embodying the results of the Uruguay round of multilateral trade negotiations were adopted in Marrakech on 15th April, 1994. The complete set covers the legal texts, the ministerial decisions and the Marrakech declaration, the signatory countries, as well as the individual agreements, the schedule of specific commitments on services, the tariff schedule for trade in goods, and the plurilateral agreements. Schedule in the original language only. The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.

The trade in goods involve agreement on implementation of article VII of GATT 1994 (Customs valuation), agreement on Reshipment Inspection (RSI) and others.

3.8.3 The Benefits and Usefulness of World Trade Organization

a. Member countries are obliged to ensure that their (User) national registration; regulations and procedures are in full conformity with the provisions of these agreements.
b. The system helps promote peace.
c. Dispute are handled constructively
d. Rules make life easier for all
e. Freer trade cuts the costs of living.
f. It provides more choice of products and qualities.
g. Trade raises incomes
h. Trade stimulate economic growth
i. The basic principles makes life more efficient
j. Government are shielded

The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictable and freely as possible.

3.8.4 The Dynamic Nature of GATT Members to World Trade Organization

It is of greater important to examine any change in attitude of GATT membership and how GATT rules applied to issues. Such issues do not posit whether a certain policy is environmentally correct or not. They suggest that the US policy could be made compatible with GATT rules if members agreed on amendments or eached a decision to waive the rules especially for any issue that could spring up.

Many developing countries discarded import substitution, policies and are now pursuing export-oriented policies, under which they seek to promote economic growth by exporting more and more of their products. Another issue is related to the pace at which the world economy is globalizing through international trade and the flow of foreign direct investment.

Similarly, this process of globalizing which has increases the dependence of countries on international trade is further accelerated by the shift in economic and trade policies noticeable in most countries. The collapse of communism has led to the gradual adoption of market-oriented policies in most countries where production and international trade had been state controlled. These countries, which in the past traded primarily among themselves are increasingly trading on a worldwide basis (Otokity S. 2006).

In addition, the framework of rights and obligations which the WTO system has created therefore plays a crucial role in the development of trade in the fast globalizing world's economy. The ability of governments and business enterprises to benefit from the system depends greatly on their knowledge and understanding of the rules of the system.

3.8.5 Major Features of World Trade Organization Agreement

The World Trade Organization (WTO), was established in 1st January, 1995 and represents the culmination of an eight-year process of trade organization known as the Uruguay Round 135 countries now belonging to the WTO and more, continue to join. The WTO is based in Geneva and is administered by a secretariat which also facilitates ongoing trade negotiations, and oversees trade dispute resolutions.

Another important feature is that WTO is an international body that effectively creates a ceiling-but no floor for environmental regulation.

Made up of detailed procedural code for environmental law making and regulatory initiatives that would be difficult for even the wealthiest nations meet. Other features of WTO include:

- The objectives and principles of multilateral agreements on trade goods.

- Biding of tariffs
- Most favoured nation treatment (MFN)

National treatment rule: prohibits countries from discriminating among goods originating in different countries. The national treatment rule prohibits them from discriminating between imported products and domestically produced like goods, both in the matter of the levy of internal taxes and in the application of internal taxes.

3.8.6 Settlement of World Trade Organization Dispute

Suppose a trade dispute arises because a country has taken action on trade (for example imposed a tax or restricted imports) under an environment agreement outside the WTO and another country objects. Should the dispute be handled under the WTO or under the GATT agreement? The trade and environmental committee says that if a dispute arises over a trade action taken under an environmental agreement, and if both sides to the dispute have signed that agreement, then they should try to use the environmental agreement to settle the dispute. But if one side in the dispute has not signed the environment agreement, then the WTO would provide the only possible forum for settling the dispute. Preferences for handling dispute under the environmental agreements do not mean environmental issues would be ignored in WTO disputes. The WTO agreements allow panels examining a dispute to seek expert advice on environmental issues.

3.8.7 The Control on World Trade Organization by Government of Importing Countries

The governments seek to limit the level of imports through a quota. Examples of quotas were found in the textile industry under the terms of the multi-fibre agreement which expired in January 2005 and which led, in 2005 to a trade dispute between the European and China over the issue textile imports.

Quotas introduce a physical limit of the volume (number of units imported) or value (value of imports) permitted.

Countries can make it difficult for firms to import by imposing restrictions and being deliberately bureaucratic. These trade barriers range from stringent safety and specification checks to extensive holdups in the customs arrangements. A good example is the quality standards imposed by the European on imports of dairy products.

Preferential government procurement policies and state aid. Free, trade can be limited by preferential behaviour by the government when allocating major spending projects that favours domestic rather than overseas suppliers. These procurement policies run against the principle of free trade within the EU single market.

The use of financial aid from the state can also distort the free trade of goods and services of WTO nations, for example use of subsidies to a domestic cola or steel industry, or the widely criticized use of export refunds;

Control against dumping and anti-dumping: anti dumping is designed to allow countries to take action against dumped imports that cause or threaten to cause material injury to the domestic industry. Goods are dumped when they are sold for export at less than their normal price.

The agreement on safeguards permits importing countries to restrict imports of a product for a temporary period by either increasing tariffs or imposing quantitative restrictions. Such safeguard actions can be resorted to only when it has been established through properly conducted investments that a sudden increase in imports. (Both absolute and relative to domestic production).

3.8.8 The General Agreement on Tariff and Trade (GATT)

A treaty created following the conclusion of World War II. The general agreement on tariffs and trade (GATT) was implemented to further regulate world trade to aide in the economic recovery following the War. GATT's main objective was to reduce the barriers of international trade through the reduction of tariffs, quotas and subsidies. GATT was formed in 1947 and signed into international law on January 1, 1948, GATT remained one of the focal features of international trade agreements until it was replaced by the creation of the World Trade Organization on January 1, 1995. The foundation of GATT was laid by the proposal of the international trade Organization in 1945, however the ITO was never completed.

National Treatment is a concept of international law that declares if a state provides certain right and privileges to its own citizens, it also should provide equivalent rights and privileges to foreigners.

WTO is an international organization dealing with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably, and freely as possible.

3.8.9 World Trade Organization Membership from Year 2000 To Date

The WTO general agreement on trade in services (GATS) commits member's governments to undertake negotiations on specific issues and to enter into successive rounds of negotiations to progressively liberalize trade among member nations. The member nations of WTO are: Argentina, Bulgaria, Czech Republic, Hungary, India, Kenya, Mauritius, Nigeria, Pakistan, Slovenia, Lanka, Turkey, Thailand etc.

SELF ASSESSMENT EXERCISE

Distinguish between WTO and National Treatments

4.0 CONCLUSION

In this unit, you have learnt about the meaning of International trade, the brief historical development of International trade, the reasons why countries are engaged in International trade. The unit has also introduced you to the role of International trade in a countries economy, the prevailing problems affecting International trade and how it is differentiated from International business.

You have also been exposed to the establishment and formation of the WTO and GATTs, the dynamic nature of the world trade governing body, the essential features of WTO, the functions and the Uruguay Round concepts. The unit has also introduced you to government control on importation and WTO membership.

5.0 SUMMARY

International trade is quite wide. It includes not only merchandising, importing or export but trade in services, licensing and franchising as well as foreign investment. Domestic trade pertains to a limited territory. Though the country may have many business establishments in different locations all the trading activities are inside a single boundary. Through International trade, nations gain by way of earning foreign exchange and greater utilization of production capacities.

The goal of the WTO is to deregulate international trade. To accomplish this (and with one important exception) WTO rules seek to limit the capacity of governments regulate international or otherwise “interfere” with the activities of large corporations.

During the early nineties, similar developments were also taking place in Europe and elsewhere, and the environmental implications of the Uruguay round trade negotiations began to emerge as important issues.

The importance of the environment analysis of the free trade and investment agenda lies in both its accessibility and its universal appeal.

6.0 TUTOR-MARKED ASSIGNMENT

1) Critically distinguish between a country Absolute Advantage and Factor endowment.

2) Critically discuss the major instrument of the 1945 Uruguay Round.

ANSWER TO SELF ASSESSMENT 1

The term International trade is the exchange of capital gods and services across international borders or territories. It is the trade that takes place between one country and other countries.

The major forms of International trade include:

- Direct exporting and importing
- Foreign licensing and franchising.

ANSWERS TO SELF ASSESSMENT 2

World trade organization is an international organization dealing with the global rules of trade between nations while national treatment is a concept of international law that declares if a state provides certain right and privileges to its own citizens and also provide equivalent rights and privileges to foreigners.

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UNIT 3 INTERNATIONAL TRADE II

CONTENTS

1.0 INTRODUCTION

The buying and selling of goods and services across national border is known as international trade.

International trade is the backbone of our modern commercial world, as producers in various nations try to profit from an expanded market rather than be limited to selling within their own borders. There are many reasons that trade across the national borders occurs, including lower production costs in one region versus another, specialized industries, lack or surplus of national resources and consumer tastes.

International trade is a complex business system that operates independent of fixed spatial or geographical boundaries. It is concerned mostly with information and technology transfer, international trade in goods (e.g. Gas, petroleum product, raw materials, cement, columbite etc), international trade of flow of labour and money/capital. The fundamental fact upon which international trade rests is that goods and services are much more mobile internationally than the resources used in their production. Each country will tend to export those goods and services for which its resources base is most suited. The reasons for international trade is that it allows a country to specialize in the goods and services that it can produce at a relatively low cost and export those goods in return for import which domestic production is relatively costly. As a consequence, international trade enables a country and the world to consume and produce more than would be possible without trade.

No matter the proximity of one country to another, once there are differences in government currency and cultural values, any form of trade dealing at this level are international.

Any theory of international or foreign trade must explain reasons for trade and gains for trade or why international trade takes place for the same reasons for which inter-local, interstate or interregional trade (trade between districts or regions within a country) takes place.

Trade takes place because by trading, both parties gain and the gain consists of the advantages resulting from the division of labour.

There were lots of evolutionary theories of international trade in the past centuries. Some of which were; era of mercantilism, feudal society, era of classical trade theory.

Owing to the dynamism and the shifting which focus from the country to the firm, from costs of production to the market as a whole and from the perfect the imperfect, this course shall examine critically and extensively the theory of:

The theory of comparative advantage
The rent for surplus theory the theory of factor proportion and
The competitive advantage of nations

2.0 OBJECTIVES

At the end of this unit, you are expected to do the following:

- Dilate copiously the explanation of the term international trade.
- Examine the various key components of international trade.
- Discuss terms of trade and its features.
- Examine the techniques and economic effects of international trade restrictions.

- Examine the theories of International Trade

3.0 MAIN CONTENT

3.1 Major Components of International Trade

International trade refers to the exchange of capital, goods and services across international borders or territories.

International trade is quite wide. It involves not only merchandising, importing or export but trade in services, licensing and franchising as well as foreign investments.

3.1.1 Lower Costs of Production in Developing Nations

There is currently a great deal of concern over jobs being taken away from the united states, members countries of the European union and other developed nations as countries such as China, Korea, India, Indonesia and others produce goods and services at much lower costs. Both the United States and the European Union have imposed severe restrictions on imports from Asia nations to try to stem this tide.

Clearly, a company that can pay its workers the equivalent of dollars a day, as compared to dollars an hour, has a distinct selling advantage. Nevertheless, American and European consumers are only too happy to lower their costs of living by taking advantage of cheaper imported goods.

3.1.2 Specialized Industries

Even though many consumers prefer to buy less expensive goods, some international trade is fostered by a specialized industry that has developed due to national talent and/or tradition. Swiss watches, for example, will never be price- competitive with mass produced watches from Asia. Regardless, there is a strong market among certain consumer groups for the quality, endurance and even "snob appeal" that owing a Rolex-Patek-Philip or Audemars Piquet offers.

German Cutlery, English bone, China, Scottish wool, fine French silks such as Hermes and other such products always find their way onto the international trade scene because consumers in many parts of the world are willing to foster the importation of these goods to satisfy their concept that certain countries are the best at making certain goods.

3.1.3 Volume and Value of Goods Say Oil

Total net oil imports in 2010 are over 96 million barrels per day (U.S. Energy Information Administration figures Imports crude oil, natural gas liquids and refined products). At a recent average of $114 per barrel per day. The natural resources of a handful of nations, most notably the nations of OPEC, the Organization of Petroleum Exporting Countries, are swept onto the international trade scene in staggering numbers each day, and consumer nations continue to absorb this flow. Other natural resources contribute to the movement of international trade, but none to the extent of the oil trade.

Despite complaints about trade imbalances, effects on domestic economics, currency up heavals, and loss of jobs, the reality of goods and services continually crossing borders will not go away.

The global economic system is thus characterized by a growing level of integrated services, finance, retail, manufacturing and nonetheless distribution, which in turn is mainly the outcome of improved transport and logistics, a more efficient exploitation of regional comparative advantage and a transactional environment supportive of legal and financial complexities of global trade.

3.2 Terms of Trade

Terms of trade is a quantitative measure of the rate at which a country's export exchange for its imports. It is a measure of the purchasing power of its exports expressed in its imports or, alternatively, the price of its imports expressed in terms of its exports.

The terms of trade is said to be favourable if for some given imports a country pays with smaller exports, or if for some given exports, it gets more imports. Though, the gains from international trade brings about increase in output, except of course Portugal is able to trade some cloth for wine, workers in Portugal will not get much work done, the same applies to England.

Without trade, workers in England will not get much done. But how much cloth must England give in exchange for Portuguese wine is a question that is very much decided by countries terms of trade. In other words, terms of trade is basically expressed as a relationship between unit prices of a country's export to a unit price of the country's import. In the case of England and Portugal; terms of trade is how much of wine and vice versa.

3.2.1 Essential Features of Terms of Trade

An average: It should be carefully noted that when a country is trading in more than one item a measure of its terms of trade represents an average with prices of individual items of trade scattered around. This is because the measure is derived with the help of price index numbers, which are themselves average of scattered values.

A Derivative: Being a derivative of price index numbers, a measure of terms of trade is bound to suffer from all the limitations which are inherent in the compilation of price index numbers.

3.2.2 Measures of Terms of Trade

Change in a country's terms of trade has some direct an indirect effects on; economic gains from trade, economic growth and potential, and its social welfare. If we take into consideration these "spill-over" effects, several alternative concepts of terms of trade come up for consideration. Hence there exists a plethora of measures of terms of trade going by different names.

Commodity terms of trade (TTC)

This is the most popular measure and it is also known as Net Barter Terms of trade or the unit value index. It is the ratio of the price index number of exports to the price index of imports of the country concerned.

Symbolically, this ratio may be written as: TTC 7(Px/Pm)100

Where,

TTC = Commodity terms of trade

Px = price index of exports

Pm = price index of imports

TTC is limited by the choice of base years, weight and average. Gross Barter terms of trade
This is a measure introduced by F.W. Taussig. It is uses relative change in a country's volume of exports and imports as against the comparative changes in their prices.

This is given as

TTg = (Qm/Qx) x 100

TTg = Gross barter terms of trade Qm = Quantity index of imports Qx = Quantity index of exports

The major limitation of this measure is the problems of compilation, No credit sales, unilateral transfer etc

3.3 Balance of Trade

This is the difference between visible imports and visible exports. It visible imports is greater than visible exports; balance of payments is said to be unfavourable. Where visible exports is greater than visible imports, there is a favourable balance of trade. On the other hand, where visible exports is equal to visible imports, there is a balanced of trade.

3.4 Technique and Economic Effects of International Trade

The theory of comparative advantage is based on free trade in which there are no trade inhibitions among nations; but the government of a country may however decide to limit the amount of some products coming into the country so as to discourage the import of these goods. This concept is what is known as trade restrictions. (Bakare I.O., 2003) The following are the techniques and economic effects of international trade restrictions.

3.4.1 Traditional Technique

Usually in the past, countries have used traditional techniques such as imposition of tariffs and quotas or both as a means of barrier to trade.

They are carefully examined as follows:
A. Tariff

A tariff is a tax imposed on imported goods. It is also called customs duty. Sometimes a customer duty is levied as a percentage of the value of the product. The former is known as specific tariff while the latter is known as advalorem tariff. The higher the tariff rate, the more restrictive the tariff and vice versa. Obviously, if the tariff rate is set higher enough it may stop all imports of that item.

B. Effect of Import Quota

Quota work the same way as tariff. In reality, there is indication that there is a major difference being that while tariffs work through prices, quotas restrict quality.

However, while a tariff raises revenue for the government, a quota goes to protect domestic producers and also benefit importers who manages to get some of this scarce import at low foreign price and resell at the higher domestic price. And absolutely, assuming domestic demand increases, with a tariff the quality of imports would increase, while a quota only price will increases.

NON-TARIFF BARRIERS

Nations have been using other techniques set up to keep foreign goods from being imported. These means are briefly the following:

(1) Government Legislation: These are kind of government barriers in law. Some are domestic preference laws which are preference to domestic suppliers in government purchases, others are laws which were for domestic reasons which makes it more difficult for foreign supplies to compete e.g. difference in safety standards and labeling requirements.
(2) Government commercial policy: This is sum total of actions that a country undertakes to deliberately influence trade in goods and services. Any other commercial policy in any nation other than the ones earlier explained fall under this category (Bakare I.O., 2003).

3.5 The Negative Effects of International Trade

For centuries, economic and policy makers assumed that every country gained from its international trade. Their discussion focused on issues relating to the source, the mechanism, the firms and the extent of these gains.

Doubts however, began to emerged after the second world war when issues relating to economic development and welfare to gain ground.

Analysts found that while developed did gain from international trade this was not necessarily the case with poor countries, rather, they could positively suffer on account of foreign trade. Such long term ill- effects may include:

Inability of a developing country to pursue sustainable development. Exhaustion of non-renewable productive resources and Environmental degradation and pollution.

3.5.1 Immiserising Growth

The concept immiserising growth refers to the situation where an increase in a country's export commodity leads to such deterioration in it terms of trade that there is a net decline in its export earnings and social welfare.

For immiserising growth to occur, the following conditions must hold:

The country's growth should be characterized by a more than proportionate increase in the production of its export commodity.

The supply of its exports commodity should be price inelastic so that it is willing to export more even when price declines.
The share of its export commodity in the total supply in international

(market should be large enough to depress its international prices).

3.5.2 The Dutch Disease

The Dutch disease is an economic loss which a country suffers on account of an increase in its factor endowment or a natural windfall (like the discovery of huge oil resources or deposit of a mineral).

The concept describes a situation where an industrial country stats exploiting a natural product which it was previously importing. In the process, its exchange rate appreciate so much that its competitiveness in traditional industries
weakness and even results in its de- industrialization to some extent. Netherlands developed its natural gas fields from the North Sea and gave birth to this term. Other countries that have suffered from the Dutch Disease are the United Kingdom, Norway, Australia and Mexico.

SELF ASSESSMENT EXERCISE

Distinguish between government legislation and government commercial policy as non-tariff barriers to nations engaged in international trade.

3.6 The Need for International Trade

The reasons for trade between countries are not in any way different from reasons individuals trade within a country. In essence, international trade is not more than trade between individuals who live in different countries.

The importance of international trade is as follows:

3.6.1 Imports Serve Domestic Industry

Domestic industries would have pretty difficult time if basic raw materials, machinery and other needs are not met. Some domestic industrial needs are only met by import.

3.6.2 Import Serves Domestic Consumers

International trade enlarges the range of consumer's choices of goods and services. Without international trade consumers will have fewer choices.

3.6.3 Exports Are Vital To Many Domestic Producers

The market for nations export is very important. For example without international trade, the market for the Nigerian crude oil, columbite, cocoa, rubber etc would have been limited to domestic economy.

3.6.4 Exports Serves as a Foreign Exchange Earners

Exports of goods and services act as foreign exchange earners to the domestic economy. Foreign exchange availability is essential requirement for the survival of any national income.

3.6.5 Exports Act As Agent of Growth

Other countries demand for goods and services produced within a domestic economy acts as a catalyst to the growth of the total spending and hence growth in the gross national product of such an economy.

3.7 Theories of International Trade

These are also known as the basic of international trade.

3.7.1 The Theory of Absolute Advantage

The classical economists, Adam Smith said that the basis of international trade falls along the division of absolute advantage, which may be defined as the good, or services in which a country is more efficient or can produce more than the other country or can produce the same amount with other country using fewer resources.

This theory was proposed in 1776, by Adam Smith. He also states that trade between two countries will take place if each of the two countries can produce one commodity at an absolute lower cost of production than the other country.

Example, Nigeria can produce one unit of cocoa with 10 labour hours and one unit of textile material say lace with 20 labour hours while
Australia can produce one unit of cocoa with 20 labour hours and one unit of lace textile material with 10 labour hours.

Note that from the above given example, it would be to their mutual advantage. If Nigeria produces only cocoa and Australia produced only lace textile material with the former exporting her surplus cocoa to Australia while Austria exported her surplus production of lace textile material to Nigeria. This shows that there is absolute difference in terms of cost since each country can produce one commodity (Nigeria cocoa and Austria lace textile material) at an absolute lower cost than the other country.

3.7.2 The Theory of Comparative Advantage

This theory was first stated by Adam Smith and later developed by David Richardo and John Stuart Mill.

According to Adam Smith, "it is the maximum of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy".

If two countries, for instance Nigeria and Togo are two countries of the world. Nigeria produces cassava better than Togo and Togo is better at producing fish. Nigeria should specialize in the production of cassava, while Togo concentrates its resources; on the production of fish. They can trade their products. But even if Nigeria is better than Togo in the production of both cassava and fish, while Togo is at a disadvantage, both countries can still benefit by each one specializing in the production of the goods where it has the greater comparative cost advantage or the least comparative cost advantage.

Richardo took the application of the law to trade between two countries and conclude that both countries will benefit if each of them concentrates on producing the commodity where it can perform more efficiently and exchange the product with the one it can produce less efficiently.

3.7.3 The Rent for Surplus Theory

This theory has its origin with the classical economists just like the theory of comparative cost advantage; it was first propounded by Adam smith. According to him, a country carries out that surplus part of the produce of their land and labour for which there is no demand; it gives a value of these surplus by exchange them for something else, which may satisfy a part of their wants, and increase their enjoyment. The important aspect of the rent for surplus theory includes:

International trade does not necessarily reallocated factors of production but enables the output of the surplus resources to be used to meet foreign demand.

The population density of a country largely determines its export potential since the total volume of production is based on available labour so also is internal consumption level as well as what will be the surplus to be exported.
The surplus productive capacity of resources enables farmers to produce export crops without necessarily compromising the production of food crops which enter into the domestic market.

3.7.4 The Theory of Factor Proportions

This theory is also known as Hecksher – Onlin theory. The theory was based on a more modern concept of production, one that raised capital to the same level of importance as labour. Heckscher –Ohlin theory states that the differences in the relative prices of commodities in the two isolated regions (and this is the basic cause of international trade) depend upon the conditions of the demand and the supply of the commodities in the two regions.

This theory is based on four basic assumptions which are:

a. The theory assumes two(2) countries, two (2) products and two(2) factors of production hence, the so-called 2x2x2 assumption.

b. The markets for the inputs and the outputs are perfectly competitive. That is, the factors of production, labour and capital were exchanged in markets that paid them only what they were worth, hence, perfect competition ensured between the two countries involved, with no on one having market power over the other.

c. Third assumption says, increase in the production of a product can experience a diminishing returns. This means that, as a country increasingly specialized in the production of one of the two outputs, it eventually would require more and more inputs per unit of output.

d. Lastly, assuming both countries make use of identical technologies, each production was produced in the same way in both countries. This meant that, the only way in which a god production can be produced more cheaply in one country than the other is when the factors of production used (Labour & capital) are cheaper.

3.7.5 Competitive Advantage of Nations

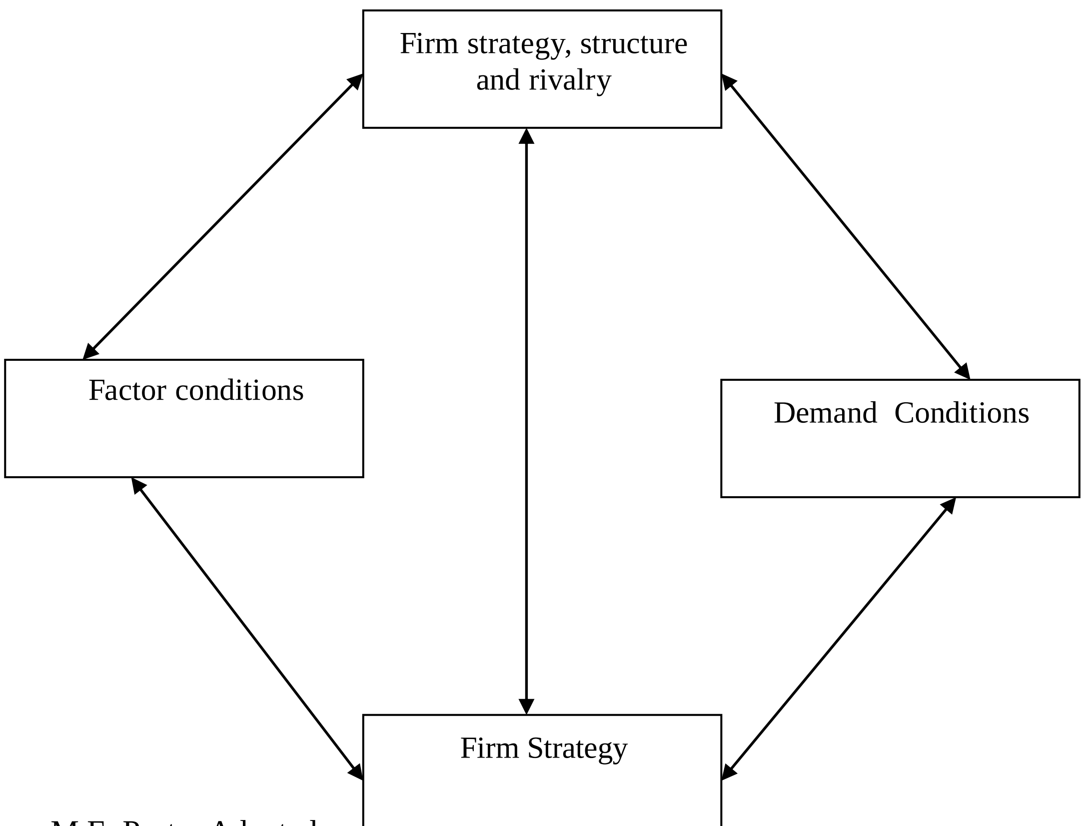
Michael Porter of Harvard Business School developed this theory which attempt to explain why particular nations achieve international success in particular industries.
Porter states that “National Prosperity is created, not inherited. It does not grow out of a country’s natural endowments its labour pools, its interest rates, or its currency’s values, as classical economics insists.” A nations competitiveness depends on the capacity of its

industry to innovate and upgrade. Porter points out the importance of country factors which he categorized into four major component. They are:

- Factor conditions
- Demand conditions
- Related and supporting industries
- Firm strategy, structure and rivalry.

The above mentioned four (4) components constitute what nations and firms must strive to create and sustain through a highly localized process" to ensure their success. It is also illustrated in the diagram below:

DETERMINANT OF NATIONAL COMPETITIVENESS



Source: M.E. Porter Adapted.

3.8 The Gain from Trades

Arising from the law of comparative advantage as stated earlier, countries would benefit from trade with a rise in world output without additional factor inputs when countries specialize in the production of those goods in which their opportunity cost is lower.

For example, let us assure that:

England and Portugal are the only two countries in the world. Wine and cloth are also the only two goods in the world. Transport cost is non-existent.

Each of England and Portugal has equal workers of say 100 each. Survival need deserve that each worker has two units of clothes.

From the forgoing, it means that England must commit 50 workers to cloth production i.e. 50 x4 =200. And Portugal 25 workers i.e. 25 x 8 = 200.

By extension, 50 workers will be left for the production of wine in England i.e. 50 x 2 = 100 and in Portugal, 75 workers will be left also for the production of wine i.e. 75 x 6 =450. This is given in the table below:

Countries	Cloth	Wine
England	50 x 4 = 200	50 x 2 = 100
Portugal	25 x 8 = 200	75 x 6 = 450
World output	400	550

If we again assume that each country should now specialize, England on cloth and Portugal on wine; world output will increase, as in

Countries	Cloth	Wine
England	100 x 4 = 400	0

Portugal	0	100 x 6 = 600
World output	400	600

Source: Bakare I.O Adopted 2003:

Therefore, the following benefits will follow specialization

Increase in world output: There is certainly more of cloth i.e. 600 though output of wine still remains at 400.

Increase in specialization and skills.

SELF ASSESSMENT EXERCISE

Highlight the major theories of international trade you know.

4.0 CONCLUSION

This unit is indeed self explanatory. You could see how broad and complex international trade is. You have learnt about the in-depth explanation of the term international trade, the major components of international trade, the terms of trade and balance of trade concept. You have also learnt about the techniques and economic effects of international trade restrictions and the common ill effects of trade.

Waoh! What a journey. Can you see how international trade covers a wide spectrum knowledge that are derived from economics and other field of study, beside you have learnt about why international trade is necessary. The possible gains from trade and the various theories with assumption of international trade.

5.0 SUMMARY

International trade is quite wide. It involves not only merchandising, importing or export but trade in services, licensing and franchising as well as foreign investments.

The major components of international trade – lower cost of production of developing nations.

While the theory of comparative cost advantage explains the principles of international division of labour, the rent for surplus theory, on the other hand, seeks to explain the principles of international trade in terms of both domestic and foreign demands.

It therefore infers that a country will not export its produce merely on the basis of comparative cost advantage if the volume produced cannot meet domestic demand. The point at which a country's product enters into international trade is determined at the time when it can produce a surplus.

6.0 TUTOR MARKED ASSIGNMENT

1) Discuss succinctly the three key components of international trade

2) Carefully discuss the rent for surplus theory of international trade.

ANSWERS TO SELF ASSESSMENT 1

Government legislations are sometimes domestic preference laws which give preference to domestic suppliers in government purchases and other laws which were for domestic reasons which makes it more difficult for foreign supplies to compete. While government commercial policy is sum total of actions that a country undertakes to deliberately influence trade in goods and services relationship with other nations.

ANSWER TO SELF ASSESSMENT 2

The following theories are available in international trade.

The theory of absolute advantage

The theory of comparative cost advantage

The rent of surplus theory

The theory of factor proportions

The competitive advantage of nations.

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UNIT 4: BALANCE OF PAYMENT

Table of contents

1.0 INTRODUCTION

International trade involves payments and receipts resulting from international transactions. A country earns money when it exports goods to the rest of the world and makes payments when it imports goods from other countries. Hence, international trade gives rise to indebtedness among countries. The balance of payments shows the relationship between a country's payments to other countries and its receipts from them. The balance of payments is thus a statement of income and expenditure on international account. Before we go ahead, consider whether you can reconcile the fact that Nigeria imports capital goods and consumer goods from other countries; yet it exports so little especially when the monetary values are considered.

However, the balance of payments accounting technique is basically that of simple double entry bookkeeping. If a transaction involves the purchase of foreign currency, thereby reducing the foreign exchange holdings of a country, it is a debit transaction; for example imports. Where a transaction leads to foreign countries buying the country's goods, and so raises the foreign exchange holdings of a country, then it is a credit transaction; for example, exports. Like other accounts, balance of payments accounts could either be a plus or minus. Here, a plus item is called a credit and a minus is called a debit.

2.0 OBJECTIVES

The objectives of this unit are that you should be able to:

- Define balance of payments concepts.
- Identify the various components of balance of payments.
- Explain the causes of and solutions to balance of payments problems.
- Discuss the effects of balance of payments on business decisions.

3.0 MAIN CONTENT

3.1 Components of balance of payments Current account

It shows all transactions in goods and services, which include both visible and invisible goods. Visible goods are goods like foodstuffs, cars, computers, iron, etc. that can be seen when they cross international borders. Invisible goods are services like tourism services and freight haulage. Another important item among the invisible items in the current accounts is the receipts of interest and dividends on loans and investments in foreign countries. A Nigerian resident, for instance, who holds shares in Elf, will receive dividend payments in US dollars, if he wishes. Such foreign loans and investments thus provide foreign exchange and are entered as credit items.

3.1.1 Capital account

Whereas the current account covers income earning and spending in the course of trade, capital account deals with movement of long- and short-term capital. A Nigerian investor, who wishes to invest abroad by lending money to a British industry, is exporting capital from Nigeria to Britain. Furthermore, a Nigerian investor who wishes to buy bonds being sold in the United

States by an expanding firm, say, in New Jersey, is also exporting capital to the United States. To do so, the investor needs to obtain dollars. He has to buy dollars with the naira.

3. 2 Equilibrium, deficit and surplus in the balance of payments

3.2.1 Equilibrium

Equilibrium in the balance of payments is said to exist when the values of the credit items in the balance of payments account exactly match the value of the debit items. That is to say, the country's receipts and payments with the rest of the world are equal. It should be noted that the balance of payments equilibrium is not always possible. A balance of payments surplus, as we shall see in unit 3.2.2, arises when the items on the credit side are greater than the debit items. This means that the country's reserves are increasing. A deficit in the balance of payments account (see also unit 3.2.3) arises where the items on the debit side are greater than the items on the credit side. This means that the nation is spending more than it is earning. A deficit means the reserves of the central bank are running down or its foreign indebtedness is rising.

3.2.2 Balance of payments surplus

A balance of payments surplus means that the flow of resources into the country from the rest of the world is greater than the outflow of resources from the country in the period under consideration. It can be regarded as a situation in which the country exports more than she exports during a given period.

A balance of payments surplus is always a thing of joy to a country because it implies that citizens of the country would be better off. A balance of payments surplus often brings about the following economic effects to a country and her citizens:

1. Greater net income

2. Debt retirement

3. Quickening of economic activities

4. Inflationary tendency

3.2.3 Balance of payments deficit

A balance of payments deficit means a country is importing more than she is exporting, implying that more resources go out of the country than come into the country during the period under consideration. It is clear that a balance of payments deficit does not augur well for the economy of a country. As a result, once a deficit occurs in the balance of payments, the government quickly takes a number of measures to rectify the deficit. Some of these measures are discussed in unit 3.4.

3.3 Causes of balance of payments deficit

1. Loss of market. Since the balance of payments is the relationship between receipts and payments of a country, a fall in the level of the country's exports will lead to poor export earnings, with a negative impact on the balance of payments.

2. Excessive visible imports over invisible imports. Any time there is a rise in the level of imports without a corresponding increase in exports, a balance of payments deficit will likely occur. This was evident in Nigeria in the early 80s when excessive importation led to the country experiencing balance of payments disequilibrium.

3. Exchange rate. A country with an over-valued currency will likely import more and export less and vice versa. This would lead the country to pay more than it is receiving and as a result, experience a balance of payments deficit.

4. Level of domestic prices. A country with a high level of inflation is most likely to have balance of payments disequilibrium. As a result, its exports will fall and its imports will rise.

5. Interest rate. A high interest rate attracts foreign capital and, hence, a favourable balance of payments. However, low rates of interest could lead to capital flight and this would cause a state of disequilibrium.

6. Income growth. An increase in a nation's income will usually cause increased demand for imports. This would adversely affect the balance of payments.

3.4 Measures of correcting balance of payments deficit

Countries normally aim at a surplus balance. A deficit is a matter of concern. However the effect of a deficit depends partly on its cause. If it is due to loans or investment overseas, it may mean that the country is increasing its wealth abroad and so strengthening its future current account through the resulting inflow of interest and profits. On the other hand, deficits on current account mean that the nation is spending more than it is earning abroad. This is similar to an individual living beyond his income.

Balance of payments deficits, especially if persistent, stand to be a greater threat to a country, especially a developing country. A country with a balance of payments deficit can either adopt temporary measures which are aimed at arresting the deteriorating situation, or look for long-term solutions, which involve the overhauling of the whole economy.

Temporary measures

1. Borrowing.

A country with a deficit, as part of temporary measures, can borrow to finance the deficit. This entails borrowing from the IMF, international credit organisations (London Club or Paris Club), or from other wealthy countries (US, Germany, France, etc.). Equally, a country can raise domestic loans denominated in foreign currencies.

2. Reducing imports.

The country can also reduce imports, especially if the deficit is in the current account. This can be done by the use of tariffs or quotas on imports, thereby restoring balance of payments equilibrium.

3. Controlling the flow of capital.

If a deficit in the balance of payments is reducing the nation's reserves, this may be relieved by government restrictions on investment and other capital flow abroad. However, this measure can only be used when the deficit is in the capital account. In any case, restricting the flow of capital does nothing to relieve a deficit on current account, the crucial part of balance of payments.

4. IMF loan.

The country can equally seek assistance from the International Monetary Fund (IMF) through the special facilities normally given by the fund to countries with balance of payments deficits.

Long-term measures

1. Expanding exports.

Export expansion is the ideal solution to a current account deficit since it avoids the need to cut back on imports. Direct government subsidies to exporters may be given to encourage firms to export, for instance, by giving them tax incentives. The government could also try to assist exporters by helping to promote and advertise their products through trade fairs, exhibitions, providing information about overseas markets, arranging loans on favourable rates of interest, and so on. In Nigeria, the Nigerian Export Promotion Council was established as part of this measure.

2. Deflation.

This can be achieved through a tight monetary policy to retard inflation and drive up interest rates (at least in the short run). The tight monetary policy can reduce the country's rate of inflation and thereby lower its prices relative to those in other countries. This would make its exports relatively cheaper than they were before (if other nations did not enact a tight monetary policy), promote exports and discourage imports, as well as generate a flow of investment funds into the country since interest rates are higher.

3. Devaluation.

This is seen as the last resort, which means a reduction in the value of a nation's currency (that is, the rate at which it can be changed into other currencies). Suppose the rate of exchange between the naira and the dollar was originally $1 = N100, an American product priced at $100 would then sell in Nigeria for N10,000 (assuming that there are no transport costs). Now suppose the dollar is devalued to N50 a dollar. The same product would now cost N5,000 in Nigeria. By devaluing a currency, countries make their products cheaper to foreigners and so encourage their exports. Similarly, devaluation makes imports more expensive, since it makes the local currency cheaper, so that the citizens of other countries will give less of their currencies to purchase goods from the country with a devalued currency.

3.5 Problems of devaluation

1. The success of devaluation depends on how foreign demand responds to cheaper export prices. In the language of economics, it is necessary for demand to be elastic. Similarly, if the demand for imported goods is price inelastic, devaluation will not work because it will not succeed in reducing imports.

2. Devaluation when used to correct a balance of payments deficit makes imports very expensive. So, it raises the cost of living especially in a country that depends on imports for essential items like foodstuffs. it also makes people worse off by diverting goods from the home market to export.

3. Inflation. By making imports very expensive, devaluation leads to a rise in the cost of machines and raw materials used by domestic industries. This forces manufacturers to increase their prices, thereby causing inflation.

4. Devaluation leads to a fall in government revenue as a result of the decrease in imports.

5. Devaluation also leads to deterioration in the country's terms of trade since a country that devalues its currency will receive less for its exports and pay more for its imports.

4.0 CONCLUSION

Every country is striving to maintain at least a balance in its balance of payments account. This is because of its impact on business activities in the economy. Therefore countries adopt the measures we have highlighted above to ensure a favourable balance of payments. The success of each measure, as we have seen, depends on the circumstances of the problem.

5.0 SUMMARY

The balance of payments is the record of what comes into a country in the form of receipts and what goes out as payments abroad. It has been defined in the unit. Different components of balance of payments like current account, capital account and reserve asset account have been explained. The unit has also dealt with the causes and corrective measures to solve balance of payments problems. It has been shown that a balance of payments analysis is very relevant to business decisions.

6.0 TUTOR -MARKED ASSIGNMENT

Briefly explain:

1. Devaluation

2. Surplus balance of payments

3. Current account

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UNIT 5: EXCHANGE RATES

Table of contents

1.0 INTRODUCTION

In the foreign exchange market, currencies of different nations are traded. In the course of exchanging one currency for another, an exchange rate is established. This exchange rate determines how much of one country's currency should be exchanged for that of another. This activity is of particular interest to the government of every nation and to the business community, especially those that deal with the international market. Based on this, business managers would be able to design better policies for their firms when they possess knowledge of the exchange rate. In this section of the work, we will be examining the concept of exchange rate and the types of exchange rates. Now if, in considering the movement in the exchange rate of the naira against foreign currencies, your friend asks you, 'When does a currency gain value or lose value in the exchange market?' What would be your reply?

2.0 OBJECTIVES

By the end of this unit, the student is expected to:

- explain the concept of exchange rate.
- be able to appreciate the implication of this rate for the business environment.

3.0 MAIN CONTENT

3.1 Concept of exchange rate

Exchange rates have a number of concepts. In this section we are going to consider the most salient ones.

3.2 Definition of exchange rate

The exchange rate is simply the price of one currency in terms of another. That is to say, how much of one currency can be given up to obtain another (e.g. $1 = N100). Here, we can say that the exchange rate of the US dollar in Nigeria is $1 to N100.

3.3 Types of exchange rate

The following are the types of exchange rates commonly used around the globe:

3.3.1 Flexible exchange rate

This is a system whereby exchange rates are determined by the forces of demand and supply. Since the forces of demand and supply purely determine the exchange rate under this system, there is no government intervention in the market.

The demand for US dollars and supply of the naira are linked, as are the demand for the naira and supply of US dollars. Suppose an American wants to buy Nigeria's groundnuts, before he purchases Nigerian groundnuts, he must buy the naira, hence the naira is demanded. But the American will buy the naira with dollars; that is, he supplies dollars to the foreign exchange market in order to demand Nigeria's naira. We then conclude that the American's demand for Nigerian goods has led to a demand for the naira and to a supply of U.S. dollars in the foreign exchange market. The process is the same if a Nigerian importer wants to buy goods from the U.S. He must buy dollars first, hence U.S. dollars are demanded. He buys the dollar with the naira. It can be concluded that the Nigerian's demand for American goods has led to the demand for U.S. dollars and to the supply of the naira in the foreign exchange market. At the equilibrium exchange rate, the demand for dollars equals the supply of the naira. There is no shortage or surplus of dollars. At any other exchange rate, however, either an excess demand for the dollar or excess supply of the naira exists. The factors that can cause a change in the equilibrium flexible exchange rate include a difference in income growth rates, differences in the relative inflation rate, and change in real interest rates.

3.3.2 Fixed exchange rate

This is a system where a nation's currency is set at a fixed rate relative to all other currencies and central banks intervene in the foreign exchange market to maintain the fixed rate. The major alternative to the flexible exchange rate system is the fixed exchange rate system. This system works the way it sounds: exchange rates are fixed or pegged; they are not allowed to fluctuate freely in response to the forces of supply and demand.

For instance if the naira price of dollars is above its equilibrium level (which, for example, is the case at the official price of $1 = N100), the naira is said to be overvalued. It follows that if the naira is overvalued, the dollar is undervalued. Similarly, if the naira price of the dollar is below the equilibrium level, the naira is undervalued. It follows that if the naira is undervalued, the dollar must be overvalued.

A nation that persistently has a deficit or a surplus in its combined current and capital accounts has several options under a fixed exchange rate system. These options include devaluation and revaluation, protectionist trade policies and change in macroeconomic policies.

3.3.3 Managed floating system

A managed flexible rate system is that in which nations now and then intervene to adjust their official reserve holdings and to moderate major changes in the exchange rate. Today's international monetary system is best described as a managed flexible exchange rate system. Sometimes it is referred to more casually as a managed float. It is a kind of compromise between the fixed and flexible exchange rates. Nations now and then intervene to adjust their official reserve holdings to moderate major swings in exchange rates. Buying up or supplying foreign currency at the market price does this.

Proponents of the managed float system stress the following advantages:

1. It allows nations to pursue independent monetary policies. Under a (strict) fixed exchange rate system, fixed either by agreement or by gold, a nation with a merchandise trade deficit might have to enact a tight monetary policy in order to retard inflation and promote its export. This would not be the case with a managed float system.

2. It solves trade problems without trade restrictions. As we have stated earlier, to solve trade imbalances. For example, a nation in deficit can impose tariffs or import quotas so that import and exchange rate trade imbalances are solved through changes in the exchange rate.

3. It is 'flexible' and therefore can easily adjust to shocks. In 1973/74 the OPEC nations dramatically raised the price of oil, which resulted in many oil-importing nations running trade deficits. A fixed exchange system would have had a hard time accommodating such a major change in oil prices. The managed floating system has little trouble, however:

The disadvantages of the managed floating system include the following:

1. It promotes inflation. For example, a nation with a deficit is somewhat restrained from changing the exchange rate because this will worsen the deficit problem, as it will make its goods more expensive.

2. It promotes exchange rate volatility and uncertainty, and results in less international trade than would be the case under a fixed exchange rate system.

3. Changes in exchange rates alter trade balances in the desired direction only after a long time. In the short run, depreciation in a currency can make the situation worse instead of better.

4.0 CONCLUSION

The significance of exchange rates to business decisions cannot be ignored. Firms and their managers as well as government representatives must be informed of changes in the foreign exchange market so as to reap maximum benefits from this variable.

5.0 SUMMARY

This unit has examined exchange rates and has tried to link up the analysis to business firms. Managers with knowledge of the exchange rate may have an upper hand among competitors in making business decisions.

6.0 TUTOR -MARKED ASSIGNMENT

1. What are exchange rates?

2 Explain in detail how flexible and managed exchange rates function.

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UNIT 6: INTERNATIONAL FINANCIAL INSTITUTION 1

CONTENT

1.0 INTRODUCTION

The centre for Global Development (CGD) research examines how the International Financial Institutions or IFIs – the IMF, World Bank, multilateral development banks, and other international development agencies – can become more responsive to the need of developing countries and ensures that growth opportunities they promote reach the world's poorest people. Publish what you pay (PWYP) calls for International Financial Institutions (IFIs) to require public disclosure of revenues and contracts for all extractive industry investment projects development policy lending and technical assistance programmes. In addition, PWYP request IFIs to ensure the development, implementation and monitoring of the transparency program includes meaningful civil society participation.By International Financial Institutions, we mean recognize international economic organizations established primarily to provide adjustments, financing of external balances, creating and distribution of liquidity of their members. However, the discussion below encapsulates all recognized bodies that are of international status.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Examine International Financial Institution by meaning and definition.
- Discuss International Monetary Fund (IMF)
- Explain the formation of IMF and its objectives
- Explain the organization management and criticisms of IMF.
- Discuss the role of world bank as an international financial institution.
- Examine the role of regional development banks, such as African Development Bank (ADB), Asian Development Bank and other regional financial institutions e.g. European investment banks etc.
- Discuss the controversies surrounding the organization and management of OPEC.

3.0 MAIN CONTENT

3.1 DEFINITION AND MEANING OF INTERNATIONAL FINANCIAL INSTITUTIONS (IFIS).

International Financial Institutions can refer to any of the following:

- International Bank for Reconstruction and Development (IBRD).Recognized international economic organizations established primarily to provide adjustments, financing of external imbalances, creating and distributions of liquidity to their members. (Bakare, 2003).
- International development association (IDA)
- International Finance Corporation etc.

IFIs offer loans, grants, and policy reforms mainly in low-income and middle-income countries. The specific mission of each IFI varies, but typically includes elements ranging from poverty reduction, to economic development, to promotion of international trade. The World Bank group and the major regional development banks directly finance, to varying degrees, extractive industry projects, investing a total of & 2.2 billion in 2006 and $2.6billion in 2007, according to Bank information centre statistics. Two institutions, the international finance corporation (IFC) and the European investment Bank (EIB) have dominated IFI financing of European investment together accounting for almost three-fourth of total financing for 2009- 2011.

International financing institution transparency activities represent a critical first step towards addressing the challenges of developing the extractive industries. A typical specific measure should include public disclosure of extractive industry revenues should be a core condition for all development policy lending relevant to the oil, gas and mining sectors and for all non-humanitarian aids, as well as for all technical assistant and other non investment activities.

3.2 INTERNATIONAL MONETARY FUND

Following the breakdown, International Gold Standard in the thirties.Countries embarked on policies aimed at increasing their exports and reducing their imports, such as currency depreciation. Foreign exchange and trade controls, currency devaluation, thus generating retaliatory action from other countries. As a result of which led to total international money disorder. In short, this acute commercial rivalry resulted in straining of political relations with one another, which was one of the remote causes of the Second World War. (Bakare, 2003). After the Second World War, there was therefore the need for reconstruction and development, thus an international institution was needed for the orderly international monetary cooperation as well as reconstruction. Therefore, in July 1944, some leads national of the world met as a conference in Bretton Wood, New Hampshire in the USA and decided to from the twin institutions namely. (Andy C.E. 2001).

3.2.1 INTERNATIONAL MONETARY FUND FORMATIONS

The United Nations Monetary and Financial Conference held at Breton Woods in USA in July 1944 decided to establish the International Monetary Fund to help the countries to tide their temporary difficulties in their balance of payments and maintain their rates of exchange fairly at stable level. 44 countries and its currency operation in March 1947 signed the articles of agreement in December 27, 1945.

3.2.2 OBJECTIVES/PURPOSE

The objectives of the fund as contained in paragraph one of its
Articles of Agreement are as follows:

1. To promote international Monetary cooperation among member countries, through the establishment of a permanent institution.
2. To pursue with vigour, the expansion and balance growth of world trade so as to improve the standard of living of mankind.
3. To provide means of international payments (i.e. promotion of multilateral method of payment).
4. To assist in the promotion of exchange stability of the effective maintenance of orderly exchange relations among member countries and to avoid competitive devaluation that characterized the pre-Bretton Wood era.
5. To provide financial resources to member countries in order to enable them clear their fundamental dis-equilibrium evident in the balance of payment.
6. To promote investment of capital in backward and underdeveloped countries by means of exporting capital from the richer to the poorer countries so that the latter could develop their economic resources for achieving higher living standard.

3.2.3 MEMBERSHIP

Every member of the UNO is free to become a member of the IMF. It should be note that the defunct USSR although played a major role in the establishment of the institutions is not a member. As at September 1981, the
fund had 141 members subscribing to its shares China became member of the IMF only in April 1980.

Capital

The financial resources of the fund consist of the aggregate of the quotas to member countries. Contributions to the IMF pool are partly in gold or US Dollars and partly in the members 'local currencies. Member's gold contribution is normally 25 percent while the local currency is 75 percent. The IMF might decide to keep the national currency of the member with the country's Central Bank. The contribution of a member's quota start from strength especially in such areas as the volume of the country's international trade fluctuations in it balance of payments and the level of its international reserves. Among the Central banks appointed by IMF as its gold depositories for members to deposit gold are Federal Reserve Bank of New York, the Bank of England, Bank of France and Reserve Bank of India.

Organization and Management

Two bodies run the IMF. These bodies are:

a. Board of Governors

It is the highest of the authority of fund, consisting of one person from each member country normally appointed for a term of 5 years. Each participant has 250 votes plus one vote.

b. Board of directors

There are 21 members in the board of directors. Seven of them are permanent members appointed by the seven member nations with the highest quota holdings while 14 are elected from among the remaining members. One of the directors is designated as the Managing Directors of the Fund. He is the chief executive of IMF and control the day to day affairs of the fund.

3.2.4 CRITICISMS/SHORTCOMINGS OF IMF

- The funds has been unable to effect a fixed exchange rate because the fund can object or oppose changes in the per value of currencies but is cannot prevent a member country from change per value of its currency for political, social or economic circumstances.
- It has not been accused of discriminations against African and devaluation, which is common among its member.
- The IMF has also been accused of discriminations against African and Asian member countries. In actual fact. It has been observed that the fund is working under the political consideration of both EUROPE and USA.
- The fund has power to correct any dis-equilibrium in the balance of payments of the country if it caused by wrong economic policy embarked upon by the member country.
- It has a limited scope, in that deals with foreign exchange problem pertaining to current transactions only the problems of war debts, imports and export of capital, etc, are beyond its scope.

- The quotas allotted to member countries do not appear on quite reasonable, as they allotted bearing in mind the economic and political interest of both USA and UK. The two countries that have been dominating the funds since its origin.
- Other criticisms against the fund are:

a. Inability to remove exchange controls.
b. Non-provision for automatic revelation of currency
c. Incomplete solution to international liquidity problem
d. Failure to recycle surpluses.

3.3 THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD).

The International Bank for Reconstruction and development (IBRD) otherwise known as the World Bank was established at a conference in Breton Woods in 1945 along with International Monetary Fund (IMF). They are expected to complement one another. The need for international finance at the end of the Second World War for reconstruction of infrastructures destroyed during the war and to enhance and increases productivity and living standards of the underdeveloped areas of the world was in the minds of the participants of the Breton Wood Conference. As they felt that private capital alone could not cope with these problems (Andy C.E. 2001).

3.3.1 AIMS AND OBJECTIVES

The primary aim of the bank is to guide international investment into productive channels.

- To assist the member countries in the reconstruction and development of their economies through facilitation of capital for productive purpose. Since the bank provides such capital for restoration of the destroyed economies during the Second World War. It is called bank for reconstruction and since it also provide finance for the development.
- To promote private foreign investment by means of guarantees or direct participation in loans in less developed countries either from its capital or borrowed funds.
- To promote long range balanced growth of international trade and consequently indirect maintenance of balance of payments equilibrium through deliberate encouragement of international investments for the development of the productive resources of nation.
- To provide technical assistance to the less developed countries which in most cases have less experts available in the field of investment projects.

3.4 The World Bank.
3.4.1 CAPITAL OF THE WORLD BANK

a. The bank capital was $10billion made up of shares of $100 each. The actual amount subscribed by the members amounted to $9.4billion, which the USA subscribing the highest amount of more than 30 percent. The bank capital is divided into two parts.
b. Loan fund made up of 20 percent of all contributions. 20 percent of which is payable in gold or US Dollars and the remaining 18 percent payable in the currencies with the consent of contributing member.

c. Guarantee fund, which made up 80 percent of the subscription that is subject to call whenever the bank requires it to meet its obligations.

The other resources of the bank are borrowed on special resources. Members can always contribute to the resources of the bank especially when bank is sourcing for funds for specified project of a member nation of the IMF are equally members of the World Bank.

Organization of the Bank

The board of governors is the highest authority of the bank like that case of the IMF. Consisting of one governor and another alternate governor appointed by each member nation. The board meets annually to deliberate many of its power to board of executive directors consisting of 21 directors, six appointed by the six members with the largest capital subscription and the remaining 15 elected from among other members. The board of executive directors meets regularly once in a month to carry out routine working of the bank. The president of the bank is the chairman of the board and executive directors. He is the chief executive and its responsible for the day-today business of the bank. Other structures of the bank include, its committee comprising of seven members on playing advisory role on banking concerns, industry, agriculture and labour. There is also a loan committee, which advises on loan matters.

Banks Operations

For the purpose of efficiency the World Bank and its affiliate, the international development association (IDA) has divided the member nations into the following groups:

- Eastern African
- Western Africa
- East Asia
- Latin American and Caribbean
- South Asia
- Europe, Middle East and North Africa.

Each office is responsible for planning and supervising of the execution of the banks development assistance programme within its assigned countries.

Functionally, the World Bank investments are mainly for agriculture, transportation water supply telecommunication, power generation, industry education urban development and finance etc.

The banks loans are commercial in nature with its own interest and period of amortization. However, it is worthy to note that the bank is to empower to give soft loans or grants. Its loans are granted to private investors in member country. The bank lends for project, which cannot be financed by private investors either because of the low rate of return or magnitude of resources required for such a project. Besides granting of loans, the banks give technical assistance member countries in form of:

a. Feasibility studies for projects

b. Setting of industrial or development banks.

c. Supplement private investment in agriculture productivity etc.

3.4.2 PROCEDURES FOR LENDING

There are four stages involved in the granting of loan by the bank, which are:

- **Exploratory Discussion and Preliminary Investigations:** under this stage, discussions between the bank and the intending borrower are held, basically on the latter ability to repay. In case of a first time borrows, experts are sent to make a detailed study of its economy and its ability for repayment.
- **Investigation of the specific project**: Based on satisfactory recommendation of the bank under the first stage, the bank then proceeds to investigate the specific project in all its aspect, technical financial and administrative.
- **Negotiation of term of Loan**: If the second phase is successful, the bank proceeds further to determine the amount of loan and securing assurances and guarantees for safe guarding the bank's interest.
- **Administration of Loan**: This is the final phase of the bank's representatives at this stage continue to visit the borrowing country to check whether the fund is being used as agreed upon. Regular progress reports are also demanded by the bank to keep abreast and monitor the project.
- The bank has also helped in setting international economic disputes. An example is the settlement of financial dispute between UK and Egypt over Suez Canal.

3.4.3 SHORTCOMINGS OF THE BANK'S OPERATIONS
The bank has been criticized on the following ground:
- The banks resources have been inadequate when compared to the needs of the member nations.
- The bank has also been accused of discrimination against both its African and Asian members who are as a matter of fact have large population, vast areas and un-exploited resources.
- The bank charges high rate of interest on its loan from member countries attempting to justify the high rate of interest to the cost of borrowing of their loan by the bank.
- The huge sum of loan required by the underdeveloped countries for their development programmes are not met in required quantity.
- Private enterprises in underdeveloped countries have been finding it difficult to secure loans from the bank due to lack of guarantee by their various governments.

3.5 THE WORLD BANK GROUP
This group presently has three affiliates such as the International finance corporation, International development association and the multilateral investment guarantee agency.

3.5.1 THE INTERNATIONAL FINANCE CORPORATION (IFC)
The international finance corporation was formed to provide equity capital to underdeveloped countries without government guarantee, which the World Bank refuses on the ground that there is no guarantee for the government. The body came into existence in July 1956 as an affiliate of the World Bank.

Its aims and objectives are:
- To encourage the growth of productive private enterprises in developing countries.
- To further economic development if it's less developed member countries by investing directly in private enterprise. The IFC capital when established in 1956 was $100million subscribed in gold or US Dollars by member countries. The figure has increased over the

years. However, half of the total resources of the IFC was subscribed by the USA and Great Britain. The Board of Governors and Board of Executive Directors of the World Bank manage the IFC itself except that their action is independent of the World Bank.

3.5.2 INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

The need to provide development finance on more lenient terms and bearing less heavily on the balance of payments of developing countries than the World Bank's loan gave both the International Association in September 1960. It is worthy to note that borrowing countries were allowed longer period of repayment say 50 years or these about 10 years of grace, and loans can be repaid in borrower's currencies instead of gold or US Dollars as is the case with the World Bank. Based on this, the IDA is often regarded as the "Soft Loan Window" of the World Bank.

OBJECTIVES OF THE IDA

- The main objectives of IDA are to expand loan to the poorer member nations on terms, which are more favourable to them.
- To extend its credit its facility to the private sectors and also on projects which aimed at developing the economics of the member countries?

3.6 EXPORT CREDIT AGENCIES OF INDIVIDUAL COUNTRY GOVERNMENT.

3.6.1 THE MULTINATIONAL INVESTMENT GUARANTEE AGENCIES (MIGA).

This body was established in April 1988. It has been created to supplement the World Bank and the IFC to assist where the Bank and the IFC do not reach. It is a joint venture with the international finance Corporation. The MIGA has an authorized capital of $1.08 billion.

OBJECTIVES OF MIGA

The MIGA has the following objectives:

1. Its primary objective is to encourage the flow of direct foreign investment into developing member countries.
2. It provides insurance cover to investors against political risks.
3. The MIGA's guarantee programme to protect investors against four types of non-commercial risks. They are: any danger involved in currency transfer, expropriation, war and civil disturbance and breach of contract by governments.
4. It insures only few investments including the expansion of existing investment. Privatization and financial restricting.
5. It provides promotional and advisory services to the governments of developing countries to enable them to increase the attractiveness of their investment climate.
6. Another objective of the MIGA is to establish among global banking and finance markets of its members.

Membership and its operations

It order to become a full-fledge member of the MIGA, a country has to ratify the convention and pay its capital subscription. By 30 June 1996, 152countries had signed the MIGA convention of these, 128 countries had become it's full-fledge members. Before the investments are made, projects are to be registered with the MIGA 90 percent of the investments amount can be insured. By the MIGA subject to equity loans made or guarantee by equity holders, and certain other types of extended to 20 years in exception cases. It also insures eligible investment in cooperation with national insurance agencies and private insurers. All projects insured by the MIGA have to support the environmental and development objectives of the World Bank. The MIGA provides promotional advisory services to its developing member's countries to help them attract more foreign direct investments. These services include the organization of investment promotion conferences; executive development programmes foreign investment advisory services in policy institutional and legal matter relating to direct foreign investment. It also gives advice on such policies and programme, which promote backward linkages between foreign investors and local investors. (Andy C. E. 2001).

3.6.2 AFRICAN DEVELOPMENT BANK (ADB)

In international financial system made up of the World Bank Group. The international bank for Reconstruction and Development (IBRD), the International Development Finance Corporation (IFC) and the international Monetary Fund (IMF). Third world countries have only a minority voice in the manner in which economic assistance is being provided and used. These financial institutions focus little or no attention on problems peculiar to the third world countries of which the African states from the largest percentage.

The African continent with about 240 million population covers almost one quarter of the earth's land mass. Though vast, the continent's resources are yet to be adequately exploited due mainly to lack of capital and shortage of technicians and identifiable projects. As a result of this situation, the Africans resolve to create an effective instrument, which would help to spread up development of its vast resources. It was decided that the best instrument for this purpose would be a financial institution common to all African countries. This idea originated in Tunis (Tunisia) in 1960 during the All People's Conference (Bakare, 2003). Thus the adoption of resolution 2711/on February 16, 1961 by the United Nations Economic Commission for Africa (UNECA) at its meeting was the genesis of the ABD. A nine-nation committee made up Nigeria, Ghana, Cameroon, Liberia, Mali, Sudan, Tanzania, Ethiopia and Tunisia made far reaching recommendations, which were the basis of the agreement for its establishment. On August 4, 1963, the agreement establishing ABD was signed in Khartoum, Sudan by 30 independent African countries. In November 1964, the member countries participated in the inaugural meeting of the Board of Governors held in Lagos. Election of the President, Vice-President and Board of Directors took place, and Abidjan in Ivory Coast was chosen as the site for its headquarters. It commenced business in July 1966 with representative offices in London and Nairobi, and its authorized capital was initially fixed at 250 million units of account. (One unit of account $ is 115060). Membership of the bank is restricted to independent African nations. However, in May 1978, the Board of Governors passed a resolution to admit non-African nations as members with the provision that the

President of the bank should always be an African. The main objectives of the ADB include:

a. Financing of investment projects with potential for social and economic development of member (African) states.

b. Preparing, studying and identifying project for development of member states.

c. Mobilization of resources for financial of development of selected projects inside and outside Africa.

d. Providing technical assistance for project preparation, study and execution.

3.7 THE ORGANIZATION OF PETROLEUM EXPORTING COUNTRIES (OPEC)

5 oil-producing countries of Venezuela, Iran, Iraq, Kuwait and Saudi Arabia formed the body in 1960. The membership increased to 13 with the admission of Qatar, Indonesia and Libya in 1962, UAE (1967), Algeria (1969) Nigeria (1971). Equador and Gabon (1973). (Andy C. E 2001). The main aim of the member countries is to coordinate the production, development and pricing of crude petroleum resources among them. Its formation has helped.

OBJECTIVES OF OPEC

(1) To adopt a uniform policy towards oil importing countries
(2) To maintain stability of price of oil in the international market.
(3) To ensure steady and effective supply of petroleum products to importing countries.
(4) To fix and allocate production quota to each member state.
(5) To assess and examine the effects of the involvement of foreign companies in oil exploitation and exploration vis-à-vis the OPEC and exploitation.

ACHIEVEMENTS OF OPEC

The Organization has been able to attain some levels of achievements in the area of:
1) Regulation of oil prices, to a large extent, ensuring stability of prices in the international markets.
2) Adoption of uniform policies towards importing countries.
3) Curbing the exploitative tendencies of foreign multinational companies that are involved in oil exploration.
4) Participation of its member nations in oil exploration.
5) Protection of the interest of the member states by provision of financial assistance in times if need.

PROBLEMS OF OPEC

1. The activities of non-OPEC member oil producing countries such as Norway, Mexico etc. tend to negate the rules, regulations and expectations of OPEC in the international oil market.
2. Dishonesty on the part of member countries would act deviance of the directive of the organization.
3. The rivalry for the leadership of the organization between Saudi Arabia and Iran is a big problem to OPEC.
4. World economic depression has brought about a fall in oil prices.
5. The emergence in the international oil market in the 1980s of the North Sea oil producers of the UK and Norway added to the problems of the organization.
6. The activities of most oil importing countries in stockpiling oil, most of the time creates fluctuation in the international oil market.
7. Declining loyalty by member countries in another problem confronting OPEC.
8. Political disagreements, which sometimes lead to war between member nations, have a destabilizing on the organization.

SELF ASSESSMENT EXERCISE

Discuss the major problems confronting OPEC today.

4.0 CONCLUSION

This unit has succinctly taken you round the operation and existence of International Financial Institutions. You have learnt about the meaning, formation and structure of the World Bank and International Monetary Fund. The unit has also introduced you to the international bank for reconstruction and development, the organization of OPEC and its criticisms etc.

5.0 SUMMARY

International Financial Institutions (IFIs) are financial institutions that have been established (or chartered) by more than one country, and hence are subjects of international law. Their owners or shareholders are generally national governments, although other International Institutions and other organizations occasionally figure as share holders. The regional development banks consist of several regional institutions that have function similar to the
world bank group's activities, but with particular focus on a specific region. The best known of these regional banks – African development bank, inter-American development bank, European bank for reconstruction and development etc. Several regional groupings of countries have established international financial institutions to finance various projects.

6.0 TUTOR–MARKED ASSIGNMENT

- Examine the comprehensive objectives of Multinational Investment Guarantee Agencies (MIGA).

Answers to Self Assessment Exercise

The purpose for the establishment of OPEC is thwarted by reasons such as:

a. The activities of non-OPEC member oil producing countries such as Norway, Mexico etc, tend to negate the rules, regulations and expectations of OPEC in the international oil market.

b. Dishonesty on the part of member countries of OPEC. Most of the time some of the member countries would act in deviance of the directives of the organization.

c. The rivalry for the leadership of the organization between Saudi Arabia and Iran is a big problem to OPEC.

d. World Economic depression has brought about a fall in oil prices.

e. The activities of most oil importing countries in stockpiling oil, most of the time creates fluctuation in the international oil markets.

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UNIT 7: INTERNATIONAL FINANCIAL INSTITUTIONS 11

CONTENTS

1.0 INTRODUCTION

Today, organizations are conducting their businesses in the global environment. Many large firms have become multinationals doing business across national boundaries. Even small firms source their production inputs overseas. Overseas firms are producing their products here. The supply chain for many goods is global. United States firms, for instance, are acquiring firms abroad.

The vogue is to shift to international market and acquire as much market shares as possible. Globalization goes with trade liberalization among nations and the removal of all trade barriers So that commerce and industry can flourish smoothly around the world without hitches and impediments.

2.0 OBJECTIVES

At the end of this unit, the learners should be able to:

- Demonstrate the understanding of global business
- Be knowledgeable about the New International Economic Order
- Understand Foreign Trade and Comparative Advantages

3.0 MAIN CONTENT

3.1 New International Economic Order

The demand for a New International Economic Order (NIEO) especially by developing nations goes back to the first session of the UNCTAD in 1964. The various resolutions adopted in the subsequent sessions of the UNCTAD contain a systematic account of the various elements of a NIEO. At the root of the call for a New International Economic Order lies the dissatisfaction of the Less Developed Countries (LDCs) with regard to trading, financial, technological and other policies pursued by the developed countries towards the LDCs. The developed nations have oppressed the LDCs, discriminated against them, drained their income and denied them access to advanced technology. Such policies have obstructed their development efforts, perpetuated inequalities in wealth and incomes and increased unemployment and poverty in them. There were three phenomena that gave an impetus to the demand for a new international economic order in the early 1970s. These were:

(a) A severe energy crisis
(b) The breakdown of the Bretton Woods System in 1973
(c) The disappointment with development aid which was much below the United Nations target of 0.7% of Gross Domestic Product (GDP) of developing countries.
(d) The formation of the Organization of Petroleum Exporting Countries (OPEC) in 1973 and its success in raising oil prices.
(e) The existence of high rates of inflation and unemployment in LDCs

Specific proposals for the NIEC were put forward at the Summit Conference of Non-Aligned Nations held in Algiers in September, 1973. The success of OPEC led the developing countries to call the Sixth Session of the UN General Assembly in April, 1974. This session adopted, without a vote, a declaration and a Programme of Action on the Establishment of New International Economic Order based on equity, sovereign equality, interdependence, common interest and cooperation among all states, irrespective of their economic and social systems which shall correct inequalities and redress existing injustices, make it possible to eliminate the widening gap between the developed and the developing countries and ensure steady acceleration of economic and social development and peace and justice for present and future generations.

In December 1974, the UN General Assembly approved the Charter of Economic Rights and duties of States. These three Resolutions constitute the documents of the New International Economic Order.

The most important objectives of the New International Economic Order based on the proposals of the UN Resolutions include; international trade, technology transfer, regulation and control of the activities of multinational corporations, reformation of the international monetary system and special aid programme, and interdependence and cooperation.

3.1.1 International Trade

The New International Economic Order lays emphasis on a greater role of LDCs in international trade by adopting the following measures which aim at improving the terms of trade of LDCs and removing their chronic trade deficits; (i) establishment of LDC sovereignty over natural and especially mineral resources for export, (ii) promoting the processing of raw materials for exports, (iii) Increasing the relative prices of the exports of LDCs through integrated programme for commodities, compensatory financing, establishment of international buffer stocks and creation of a common fund to finance stocks, and formation of producers, associations, (iv) providing proper framework for establishing prices of raw materials and primary products so as to stabilize export income earnings, (v) indexation of LDC export prices to rising import prices of manufactured exports of developed countries, (vi) increase in the production of manufactured goods, and (vii) improving access to markets in developed countries through progressive removal of tariff and non-tariff barriers and restrictive trade practices.

It is important to recognize that foreign trade is of great importance to both developing and developed nations of the world. Trading activities occur between nations because it brings about specialization, and specialization increases output. Because the United States can trade with other countries, it can specialize in the goods and services it produces well and cheaply. Then the U.S. can trade its goods for goods and services produced cheaply by other countries.

International differences in resource endowments, and in the relative quantity of various types of human and non-human resources, are important bases for specialization. Consider countries with lots of fertile soil, little capital, and much unskilled labour. They are likely to find it advantageous to produce agricultural goods while countries with poor soil, much capital, and highly skilled labour will probably do better to produce capital intensive, high technology goods.

3.1.2 Technology Transfer

The proposals of the New International Economic Order stress the establishment of mechanism for the transfer of technology to LDCs based on the needs and conditions prevalent in them. In this context, particular emphasis is on the

(i) establishment of a legally binding international code regulating technology transfers,
(ii) establishment of fair terms and prices for the licensing and sale of technology,

(iii) expansion of assistance to LDCs in research and development of technologies and in the creation of indigenous technolo9gy, and
(iv) adoption of commercial practices governing transfer of technology to the requirements of LDCs.

3.2 Regulation and Control of the Activities of Multinational Corporations (MNCs)

The New International Economic Order declaration also emphasizes the formulation, adoption and implementation of an international code of conduct for multinational or transnational corporations based on the following criteria; (i) to regulate their activities in host countries so as to remove restrictive business practices in LDCs, (ii) to bring about assistance, transfer or technology and management skills to LDCs. on equitable and favourable terms, (iii) to regulate the repatriation of their profits, (iv) to promote reinvestment of their profits in LDCs.

3.2.1 Reformation of the International Monetary System and Special Aid Programme

The New International Economic Order declaration proposes to reform the international monetary system on the following lines;
(i) elimination of instability in the international monetary system due to uncertainty of the exchange rates,
(ii) maintenance of the real value of the currency reserves of LDCs as a result of inflation and exchange rate depreciation,
(iii) full and effective participation by LDCs in the decisions of the IMF and the World Bank,
(iv) attainment of the target of 0.7% of GNP of developed countries for development assistance to LDCs,
(v) debt re-negotiation on a case-by-case basis with a view to concluding agreements on debt-cancellation, moratorium or rescheduling,
(vi) deferred payment for all or parts of essential products,
(vii) commodity assistance including food aid, on a grant basis without adversely affecting the exports of LDCs
(viii) long term suppliers’ credit on easy terms,
(ix) long term financial assistance on concessionary terms,
(x) provision on more favourable terms of credit goods and technical assistance to accelerate the industrialization of LDCs,
(xi) investment in industrial and development projects on favourable terms.

3.2.2 Interdependence and Cooperation

Above all, the New International Economic Order declaration lays emphasis on more efficient and equit6able management of interdependence of the world economy. It brings into sharp focus the realization that there is close interrelationship and interdependence between the prosperity of developed countries and the growth and development of LDCs. For this reason, there is need to create an external economic environment conducive to accelerated social and economic development of LDCs. Furthermore, it requires the strengthening of mutual economic, trade, financial and technical cooperation among LDCs mainly on preferential basis.

3.3 International Institutions using Indian economy as a case study

In our study of international institutions, we are going to use the Indian economy as a case study. We shall be looking at the objectives and achievements of Indian plans and how these plans affect the national and international institutions within the Indian economy.

3.3.1 History

Planning as an instrument of economic development in India goes back to the year 1934 when Sri Visves published his book "Planned economy for India." This was a bold and constructive blue print for a ten-year programme of planned economic development of India. This pioneering work created keen interest in academic circles in the cult of planning. As a result, some more books appeared on the subject by other prominent writers in India.

In 1938, first attempt was made to evolve a national plan for India, when the National Planning Committee was set up under the Chairmanship of Pandit Nehru. The work of the committee was interrupted due to the Second World War and the political disturbance following the resignation of the Congress ministries. It was only in 1948 that the Committee could release a series of reports on Planning in India.

In the next few years, eight leading industrialists of Bombay became convinced of the need for planning and took the initiative of preparing a plan of economic development for India. It was published in January 1944 and came to be known as the "Bombay Plan." It was a 15-year plan envisaging an expenditure of 10,000 Rupees. It was aimed at doubling the per capita income and trebling the national income during this period. It proposed to increase agricultural output by 130 per cent, industrial output by 500 per cent and services by 200 per cent of the 1944 figures during fifteen years.

3.3.2 Objectives and Achievements of Plans

India embarked on the path of planned economic development on April 1, 1951. Since then, shye has gone through ten Five-Year Plans. A critical appraisal of the overall achievements and failures during this period of planning is attempted below:

Objectives: There are various objectives that run through one or the other plan. They are:
(1) To increase national income and per capita income
(2) To raise agricultural production
(3) To industrialize the economy
(4) To achieve balanced regional development
(5) To expand employment opportunities
(6) To reduce inequalities of income and wealth
(7) To remove poverty
(8) To achieve self-reliance

In a broad sense, these specific objectives can be grouped into four basic objectives; growth, modernization, self-reliance and social justice.

We critically evaluate the performance of Indian Plans in the light of the following objectives

(a) Growth

One of the basic objectives of planning in India has been rapid economic growth. This is measured by the overall growth rate of the economy in terms of real GDP. The overall growth rate of the economy 1950 – 2006 in terms of GDP at factor cost at constant prices has been characterized by extreme variations from year to year. Consequently, the targets of growth rate fixed for various plans were not achieved except for the First, Fifth, Sixth, Seventh and Eight Five-Year Plans. In the First Plan, the growth rate of 3.7% per annum was achieved which was higher than the estimated growth rate of 21%. During the second plan, the actual growth rate was a little less than 4.2% as against the targeted growth rate of 4.5%. In the Third plan, the actual growth rate of 2.8% was much lower than the targeted rate of 5.6%. The Fourth Plan also showed a large decline in the actual growth rate which was 3.4% as against the estimated rate of 5.7%. But the Fifth Plan achieved a higher growth rate of 5% against the targeted rate of 4.4%. The Sixth Plan had set the target growth rate of 5.2% but achieved a higher growth rate of 5.5%. The Seventh Plan achieved the growth rate of 5.8% against the envisaged target of 5%. The Eight Plan achieved a growth rate of 6.8% as against the target of 5.6%. The Ninth Plan had the growth rate of 5.5% against the target rate of 6.5%, and the Tenth Plan 7.6% against the targeted of 8%. But except for the year 2002-2003, the growth rate was 8.6% for the remaining four years of the tenth plan.

(b) Modernization

Modernization refers to "a variety of structural and instituti8onal changes in the framework of economic activity." A shift in the sectorial composition of production, diversification of activities, and advancement of technology and institutional innovations have all been part of the drive to change a feudal and colonial Indian economy into a modern and independent entity.

National Income: The sectorial distribution of national income reflects the str45uctural transformation of the Indian economy. The composition of GDP shows significant changes over the period 1950-2006. In 1950-51, 59% of GDP came from the primary sector (agriculture) which dropped to 18.5% in 2006. This is a concomitant result of the development process whereby the primary sector gives place to the secondary sector (industry) and the tertiary sector (services) in the economy.

Agriculture: Modernization and structural changes in agriculture have played an important role in the process of planned development. The country has made giant strides in the production foodstuff especially grains, cash and horticultural crops to meet the consumption requirements of the growing population, the raw material needs of the expanding industry and for exports. The phenomenal increase in the output of food-grains by four times has been due to the spread of high-yielding varieties of inputs, extension of irrigation facilities and water management programmes, establishment of a system of support prices, procurement and public distribution, promotion of agricultural research, education and extension, and institutional arrangements to suit small and marginal farmers.

Industry: The main component in the drive for structural diversification has been towards modernization and diversification of industr5ies. Over the past 50 years. India has achieved a broad-based industrial development. Apart from quantitative increase in the output of industrial products, the industrial structure has been widely diversified covering the entire range of consumer, intermediate and capital goods. Chemicals, engineering, transport, petro-chemicals, synthetics, electronics, etc. have made rapid strides. In most of the manufactured products, the country has achieved a large measure of self-reliance.

Social Services: Modernization is also reflected in the spread of social services. There has been a significant increase in development expenditure on social services whose share in GDP grew from 3% in 1950 to 28% in 2006. There has been a marked expansion of health services. The number of doctors, nurses and hospitals has increased substantially, and villages have been electrified. Drinking water has been supplied to many villages. There has been a spectacular spread of education in rural areas. The number of secondary schools, colleges, universities, medical and engineering institutes has multiplied manifold.

Self-Reliance: Self-Reliance means "a reduction in the dependence on foreign aid, diversification of domestic production and a consequential reduction in imports for certain critical commodities and the promotion of exports to enable us to pay for imports from our own resources. A major constraint towards achieving the objective of self-reliance has been unfavourable balance of payments. The deficit in current account balance continues to increase till the end of the Seventh Plan. It started declining from the Eighth Plan.

4.0 CONCLUSION

The developed nations have oppressed the Less Developed countries(LDCs) and discriminated against them, drained their income and denied them access to advanced technology. Such policies have obstructed their development efforts, perpetuated inequalities in wealth and incomes and increased unemployment and poverty in them. The phenomena that gave impetus to the demand for a new international economic order in the early 1970s include: severe energy crisis, the breakdown of the Bretton Woods System, the disappointment with development aid which was much below the United Nations target of 0.7% of Gross Domestic Product (GDP) of developing countries.

5.0 SUMMARY

The vogue is to shift to international market and acquire as much market shares as possible.
Globalization goes with trade liberalization among nations and the removal of all trade barriers
So that commerce and industry can flourish smoothly around the world without hitches and hazards. International operations go with cultural differences which must serve international firms and businessmen for success in the international markets.

6.0 TUTOR-MARKED ASSIGNMENT

- What are the main issues that led to the demand for a New International Economic Order by developing countries?

- List the major factors that gave impetus to the demand for New International Economic Order.

- Discuss the advantages of international trade.

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UNIT 8: GLOBAL ECONOMIC ENVIRONMENT

Content

1.0. INTRODUCTION

The world is now closely knit than ever before. This process is conceptualized as globalization which is concerned with international integration in the area of products, trade, ideas and culture, among other areas, especially through Information and Communications Technology (ICT). Globalization has promoted advances in the industrial sector, especially in transportation, communication, banking and cultural influences. This unit discusses industrialization strategies in a global economic environment. Industrial strategies are based on local environmental factors that could enhance economies of scale and put countries at an advantage over the other countries. Nations now have opportunities to new operate on the basis of competitive advantage. This is why this unit is important for business management.

2.0. OBJECTIVES

At the end of this unit, you should be able to:

- Define global economy
- Explain the global economy environment concept
- Evaluate the status of global economic environment in developed and developing countries.

3.0. MAIN CONTENT

3.1. Concept Of Global Economy

The global economy or world economy refers to the economies of all the world nations. Hence, the aggregate of national economies makes up the global economy. The global economy refers to an integrated world economy with unrestricted and free movement of goods, services and labour. This is why the term 'global village' is being applied to describe the current world's economic order. You would recall that the introduction discusses the issue of globalization. In the current global economic environment, globalization would increase the economy of the whole world through transnational economic activities. In order to have an even ground for comparing these economies, they are usually judged in monetary terms. Such monetary values are based on the purchasing power of the local currency in terms of the US dollar or Euros. Global economy is usually limited to human activities.

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According to the International Monetary Fund (IMF), in 2011, the largest economies in the world with more than $3trillion, £1.25 trillion by national GDP are the United States of America, China, Japan, Germany, France, United Kingdom and Italy.

3.1.1 Characteristics of global economy

A global economy is characterized by a unified market for all goals and services produced across the world. The following are some of the characteristics of the global economy.

- It gives national producers the opportunity to export their goods and services to other countries
- This implies that goods and service across the globe would be produced to meet international standards, since buyers have a choice of other producers.
- It gives opportunity to domestic consumers to choose from a vast array of imported goods. Nigeria for example, has been inundated with too many imported goods sometimes to the detriment of local producers.
- The global economy is characterized by reduction in the level of tariffs and quotas under the new World Trade Organizations restrictions. Goods and service can now flow between developing and developed countries, better than in this past.
- The global economy is seeing more of multinational corporations in different parts of the world. Supermarket chains such as Shoprite, manufacturing companies such as KIA, Hyundai, and Toyota are established all over the world.
- Transfer of learning takes place through the employment of nationals in the multi-national corporations. Skills are transferred over time to the local industries.
- The global economic environment provides the conditions for raising world productivity and consequently, the standards of living at a global scale.

- A global economy leads to movement of jobs from the developed countries to the developing countries; especially in countries with many skilled labour force especially China. This is oftentimes called “outsourcing” which implicitly leads to exploitation of workers in developing countries.

3.2. Economic environment

Now that you understand what global economy is all about, you will now proceed to know what economic environment means. The whole world operates in a political, economic, social, technological cultural environment. The economic environment is one of these, which encompasses economic factors which have effects on national and international business performance. Such economic factors include; government policies; the type of economy (mixed, capitalistic or socialist), economic resources, level of income, distribution of income and wealth as well as purchasing power. The economic environment like all other environment is never static, it is dynamic and complex.

Five main components of the environment are:

a. National economic conditions
b. National economic system
c. National economic policies
d. International economic environment
e. National economic legislations.

Economic conditions include the standard of living, purchasing power of members of the public, demand and supply of goods and services, and distribution of income. The prevailing business cycle is also part of the economic conditions. These are stages of prosperity in form of, boom, decline, depression and recovery.

At the national level, economic conditions relate to:

1. Stages of the business cycle
2. National income, per capital income, and distribution of income
3. Rate of capital formulation
4. Demand and supply trends
5. Inflation rate in the economy
6. Industrial growth rate, exports growth rate
7. Interest rate prevailing in the economy
8. Efficiency of the public and private sectors
9. Growth of primary and secondary capital markets

b. Economic system: This may be defined as a framework of rules, goal and incentives that control economic relations in a country. The economic system could be described as:

- Capitalism – an economic system in which business units or factors of production are privately owned and governed.
- Socialism - a system where all economic activities of the country are controlled and regulated by the government in the interest of the public as was in the case in the Soviet Russia.
- Democratic socialism – is a system where all economic activities are controlled and regulated by the government but the people have freedom of choice of occupation and consumption.
- Totalitarian socialism – is a system known as communism where people are obliged to work under the directions of government
- Mixed economy – a system in which both public and private sectors co-exist. Factors of production are owned by both government and the people, and there is freedom of choice of occupation and consumption.

c. **Economic policies** – These are policies that are aimed at managing business and factors of production. These include monetary, fiscal, foreign, trade, foreign investment and industrial policies. Monetary policies are usually formulated by the Central Bank of a country to control the supply of money and interest rates. Fiscal policies are used as an instrument of economic and social growth of a country through taxation, government expenditures, borrowings, deficit budgeting, among others. Foreign trade policies are aimed at protecting the local businesses from foreign competition. Foreign investment policies are related to policies to guide investment by foreigners in a country. Industrial policies promote and regulate industrialization in a country.

d. **Global economic environment** – refers to the role of international economic environment on national business. This involves imports and exports of goods and the various rules and guidelines for international trade. The international organizations Involved are World Bank, World Trade Organization and International Monetary Fuel, among other world financial institutions.

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e. **Economic legislatures-** These are legislation by government of different countries to guide and control business activities.

Self assessment exercise

1. In your own words, define the term global economy.
2. Explain five (5) main components of an environment.

3. Define global economic environment.

3.3. Status of global economic environment

Lai and Kenkyujo (1992) discussed the stages of global industrialization with distinctive policy stances. The early stage was the mercantilist period during which industrialization first started In Britain. This era was that of innovations in cotton, textiles, iron smelting and steam engine. This was a period of foreign trade controls. This was followed by a period of abolishing tariffs in Europe and the rise of protectionism in the US after civil war in 1865. It was during this phase that the second industrial revolution, consisting of a cluster of innovation based on greater use of and institutionalization of applied research become important.

Current Global economy refers to the current trends in the global economy over a period of time. The current global economy has become a level playing field for all countries on account of the effect of globalization. Healthy interaction between the developed and the developing countries in the field of trade and the exchange of technological know-how has helped the global economy prosper remarkably. There has been a significant growth of real Gross Domestic Product (GDP) in most countries of the world and a consequent rise in the global income levels. Globalization has made it possible for domestic producers to expand and emerge on the international scene. Therefore it has been possible for consumers to choose from a wide range of local and imported commodities.

The following are some of the important features observed from studies of the current global economy (Economy Watch, 2010):
The current global economy is in a relatively stable stage with the economies of US and Japan showing an upward growth trend in recent years. USA had experienced a healthy growth rate 3.5% for the year 2005 and 5 % for the first quarter of 2006. However, this rate of growth could not be sustained due to the continued rise in global oil prices and the widespread devastation caused by hurricane Katrina. Adoption of sound monetary and fiscal policies by the US Government has once again brought back stability to the growth rate. In Japan, the economy got a major boost with phenomenal growth rates experienced by its long trading partner, China. Europe as a whole Union had also grown marginally over the past few years. Most free trade agreements like the NAFTA (North American Free Trade Agreement) and SAFTA (South Asian Free Trade Agreement) have been signed in the current years as a means of boost international trade, worldwide. The "dollarization" of world currencies, has helped economies measure its currencies against the US dollar. This has in turn led to reduced independence of monetary policies of these economics.

China has recently adopted a major monetary reform with pegging the Renminbi or Yuan to a basket of currencies. The Indian Rupee is also showing positive signs of appreciating against the dollar. Other world currencies such as the Yen and Euro have been relatively stable over the past few years. Global Stock Markets have also rallied to reach unheard of levels after the US slowdown of 2001.Sensitive issues that have surfaced in recent times include rising income inequality in developing economies like India, China, Brazil and Uruguay, and strict immigration laws applicable in some developed economies. Rationalization of domestic tax laws, tariff and quota laws with international regulations have to be implemented in all countries uniformly. The Doha round of World Trade talks therefore require to be effectively implemented (Economic Watch, 2010). Economic growth is often associated with high inflation levels and it has been the case in recent years for the current global economy also. However, inflation is not good for the health of the economy in the long run and has to be effectively dealt with.

4.0. CONCLUSION

Having gone through this unit, you would have realized that global economic environment is influenced by many factors which vary from one country to another. But because the world is now interconnected through Information and Communications Technology what happens economically in one country affects the other. The various world recessions usually starts in one country and then spread to the others due to interconnectivity in financial investments. Depending on the type of economic system, each country has specific laws and regulations to protect local industries and at the same time attract foreign direct investment. Importation and exportation of goods and services are key components of the global economic environment.

5.0. SUMMARY

This unit is the first part of the discussion on *global economic environment: industrialization strategies.* It focuses on the definition of terms and the current general status of the global economic environment. The global economy refers to the economies of all the world nations. It is usually limited to human economic activities. Industrial strategies are based on local environmental factors that enhance business activities. Economic environment encompasses economic factors which have effects on national and international business performance, such as national economic conditions, national economic system, national economic policies, international economic environment and economic legislations. Current global economy is in a relatively stable stage with the economies of USA and Japan showing and upward growth in recent years until 2008 when the mortgage market collapsed. Current global economic environmental issues including, rising unequal income in developing countries and strict immigration laws applicable is some developed economies.

6.0. TUTOR MARKED ASSIGNMENT

1. Explain conditions that are inherent in the economic environment
2. What are the economic systems operated in the world? Discuss any three of these systems.
3. How would you describe the current global economy?

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UNIT 9: ECONOMIC COOPERATION

CONTENT

1.0 INTRODUCTION

The world trade organization (WTO) is an organization that intends to supervise and liberalized international trade. The organization officially commenced on January 1st, 1995 under the Marrakech Agreement, replacing the General Agreement on Tariff and Trade (GATT), which commenced in 1948. The organization deals with regulation of trade between participating countries; it provides a framework for negotiating and formalizing trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements which are signed by representatives of member governments and ratified by their parliaments. The activities of Economic Cooperation organization are conducted through directorates under the supervision of secretary General and his Deputies which considered and evolve projects and programmes of mutual benefit in the fields of:

- Trade and investment
- Transport and telecommunications
- Energy, minerals and environment
- Agriculture, industry and tourism etc.

2.0 OBJECTIVES

At the end of this unit, learners should be able to:

- Examine the key role played by economic cooperation and international trade.
- Dilate copiously the history and role of economic cooperation.
- Discuss the major principles of cooperation
- Explain the nexus between WTO and economic cooperation.
- Identify the success story of the Economic Community of West African State.

3.0 MAIN CONTENT

3.1 ECONOMIC COOPERATION AND INTERNATIONAL TRADE

The economic cooperation organization (ECO) is an intergovernmental organization involving seven Asian and three Eurasian nations, part of the south central Asian union. It provides a platform to discuss ways to improve development and promote trade and investment opportunities. The ECO is an adhoc organization under the United Nations. The common objective is to establish a single market for goods and services much like the European union. ECO's secretariat and cultural department are located in Tehran, its economic bureau is in Turkey and its scientific bureau is situated in Pakistan.

3.2 HISTORY AND ROLE OF ECONOMIC COOPERATION

Economic cooperation organization is an intergovernmental regional organization established in 1985 by Iran, Pakistan and Turkey for the purpose of promoting economic, technical and cultural cooperation among the member states. It was the successor organization of what was the regional cooperation for development (RCD), founded in 1964, which ended activities in 1979. The status and power of the ECO is growing. However, the organization faces many challenges. Most importantly, the member states are lacking appropriate infrastructure and institutions which the organization is primarily seeking to develop, to make full use of the available resources in the region and provide sustainable development for the member nations. The Economic Cooperation Organization Trade Agreement (ECOTA) was signed on 17 July 2003 in Islamabad. ECO Trade Promotion Organization (TPO) is a new organization for trade promotion among member states located in Iran 2009.

3.3 THE PRINCIPLE OF COOPERATION

Sovereign equality of the member states and mutual advantage. Linking of national economic, development plans with ECO's immediate and long-term objectives to the extent possible. Joint efforts to gain freer access to markets outside the ECO region for the raw materials and finished products of the member states. Effective utilization of ECO institutions, agreements and cooperative arrangements with other regional and international organizations including multilateral financial institutions; Common endeavours to develop a harmonized approach for participation in regional and global arrangements.
Realization of economic cooperation strategy and exchange in educational, scientific technical and cultural fields.

3.4 THE WTO AND ECONOMIC COOPERATION

World Trade Organization deals with foreign trade and cooperation. The organization is known for its unique responsibilities such as issuing the permit of quotas; examining and approving the qualification of those enterprises dealing with imports and exports; coordinating the effort of international cargo-delivery agents in Dalian.Studying and promoting contemporary trading approaches, such as ECommerce, advancing the development of processing trade; supporting name brand product for exports; managing those state-owned public institutions dealing with foreign trade and economic cooperation. Enact laws and regulations on foreign trade and economic cooperation. Organized, draft laws and regulations concerning foreign trade carry them out. Make strategic plans for foreign trade and economic cooperation. Propose strategies beneficial to Dalian and coordinate the work of foreign trade and economic growth. Utilize foreign capital. Coordinate bidding for investment and provide hospitable services to key projects; examines and approved establishment of foreign enterprises and modification of their institutions. Supervise those corporations and manage them to follow the regulations.

3.5 INTERNATIONAL COOPERATION NEEDS DOMESTIC SUPPORT FOR OPENNESS

Governments are only able to make the sacrifices necessary to sustain international and economic cooperation if they can rely, in turn one domestic political support for an open world economy. The national publics unconvinced of the value of international integration will not back policies often costly and difficult policies – to maintain it. This can lead –again, as in the 1930s– to a perverse process in which global economic failure undermines support for economic openness, which leads governments to pursue uncooperative policies, which further weakens the global economy. On dimensions, international and domestics we are in trouble. So far despite high-sounding internationalist rhetoric, governments have resounded to the crisis with policies that take little account of their impact on other nations. And the crisis has dramatically reduced domestic public support for globalization, and for national policies to sustain it.

3.6 THE AIM OF ECONOMIC COOPERATION ANDDEVELOPMENT

The OECD defines itself as a forum of countries committed to democracy and the market economy, providing a setting to compare policy experiences, seek answers to common problems, identify good practices, and co-ordinate domestic and international policies. Its mandate covers economic environmental and social issues. It acts by peer pressure to improve policy and implement soft law-non binding instruments that can occasionally lead to binding treaties. In this work, the OECD cooperates with businesses, trade unions and other representatives of civil society. Collaboration at the OECD regarding taxation, for example, has fostered the growth of a global web of bilateral tax treaties.

The OECD promotes policies designed:

- To achieve the highest sustainable economic growth and employment and a rising standard of living in members countries, while maintaining financial stability, and thus to contribute to the development of the world economy.
- To contribute to sound economic expansion in member as well as non members countries in the process of economic development; and
- To contribute to the expansion of world trade on a multilateral, non discriminatory basis in accordance with international obligations.

Building on the respective rights and obligation under the agreement establishing the world trade organization. Other multilateral instruments, in particular of the organization for economic cooperation and development (OECD) as well under bilateral instruments of trade and economic cooperation.

3.7 GUIDELINES FOR MULTINATIONAL ENTERPRISES

An example of one aspect of work that is driven by the OECD and its membership are its guidelines for multinational enterprises. These guidelines set out voluntary principles and were last updated in 2011.These are designed to help multinational firms operate in harmony with the policies and societal expectations of their national activities with international best practice. The guidelines coverage is broad, touching on issues such as information disclosure, employment, industrial relations, the environment, combating disclosure, consumer interest, science and technology, competition and taxation. The guidelines were developed by 39 governments, and are increasingly being used to guide the development of ethical codes in business.

3.8 ECONOMIC COMMUNITY OF WEST AFRICAN STATE ECOWAS

The body was unified in May 1975 by the treaty of Lagos signed by 15 states with the objective of promoting trade cooperation and self-reliance in West Africa. Outstanding protocols bringing certain key features of treaty into effect were ratified in November 1977. According to the articles of the treaty, the community aims at promoting cooperation and development in the fields of industry transport, telecommunications, energy, agriculture, natural resources, commerce, monetary and financial relations and socio-cultural matters (Bakare, 2003). The specific steps to be taken to accomplish these broad objectives include the following:

- Harmonization of economic and industrial policies of member states as well as the elimination of inequalities in the levels of development of each member state.
- Establishment of funds for cooperation compensation and development.
- Elimination of obstacles to free mobility of people, services and capital.
- Elimination of customs and other duties on both imports and exports of member states.
- Establishment of a common customs tariff and commercial policies.

SELF ASSESSMENT EXERCISE

Give a very good reason why economic cooperation and development is necessary.

4.0 CONCLUSION

You have learnt in this unit, about the role of economic cooperation, the principles of economic cooperation, the WTO and economic cooperation. The unit has also introduced you to some of the reasons why the economic community of West African State ECOWAS came to existence.

5.0 SUMMARY

Economic cooperation organization is an intergovernmental regional organization established in 1985 by Iran, Pakistan and Turkey for the purpose of promoting economic, technical and cultural cooperation among the member states. It was the successor organization of what was the regional cooperation for development (RCD), founded in 1964, which ended activities in 1979.
The status and power of the ECO is growing. However, the organization faces many challenges.

6.0 TUTOR-MARKED

- Discuss some of the principles of economic cooperation you know.

Answer to Self Assessment Exercise
The major objectives of economic cooperation are:

- Sustainable economic development of member states
- Progressive removal of trade barriers and promotion of intraregional trade; greater role of ECO region in the growth of world trade; gradual integration of the economics of the member states with the world economy.
- Economic liberalization and privatization
- Effective utilization of the agricultural and industrial potentials of economic cooperation.

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UNIT 10: FINANCE AND MANAGEMENT OF FOREIGN OPERATIONS.

CONTENT

1.0 INTRODUCTION

Many companies that have significant foreign operations derive a high percentage of their sales overseas. Financial manager of the company require an understanding of the complexities of international finance to make sound financial and investment decisions. International operations in the finance aspect or perspective involve consideration of managing working capital, financing the business, control of foreign exchange and political risks, foreign direct investments. Most importantly, the financial manager has to consider the value of the US dollar relative to the value of the currency of the foreign country in which business activities are being conducted. Currency exchange
rates may materially affect receivables and payables, and imports and exports of the US Company in its multinational operations. The effect is more pronounced with increasing activities abroad.

2.0 OBJECTIVES

Upon successful completion of this unit, you should be able to:

- Examine clearly the major types of foreign operations we have.
- Discuss joint ventures as a type of foreign operation.
- Identify the major issues of Nations/Organizations with foreign operations.
- Explain currency risk management in international operations management.
- Discuss financial strategies concept in foreign operations management.
- Dilate copiously types of foreign exchange exposure (risk).

3.0 MAIN CONTENT

3.1 MANAGEMENT OF FOREIGN OPERATIONS AND INTERNATIONAL TRADE

The efficient and cost effective production and delivery of goods and services to customers is essential for business to flourish. Achieving this in the global marketplace poses unique and exciting challenges, and international companies require skilled operations manages to deliver these goals.

3.2 TYPES OF FOREIGN OPERATIONS

Companies, nations involved in foreign operations business may structure their activities in the following three ways.

3.2.1 WHOLLY OWNED SUBSIDIARIES

A large, well established company with much international experience may eventually have wholly owned subsidiaries.

3.2.2 IMPORTS/EXPORTS ACTIVITIES

A small company with limited foreign experience operating in “risky areas” may be restricted to export and import activity. If the company’s sales force has minimal experience in export sales, it is advisable to use foreign brokers when specialized knowledge of foreign markets is needed. When sufficient volume exists, the company may establish a foreign branch sales offices, including sale people and technical services staff.

3.2.3 JOINT VENTURES

A joint venture with a foreign company is another way to proceed international and share the risk. Some foreign governments require this to be the path to follow to operate in their countries. The foreign company may have local goodwill to assure success. A drawback is less control over activities and a conflict of interests.

3.3 ISSUE OF NATIONS/ ORGANIZATIONS WITH FOREIGN OPERATION

Nations involved in foreign operations are to take cognizance of the three key issues below:

a. **Multiple-currency problem**: sales revenues may be collected in one currency, assets denominate in another, and profits measured in a third.

b. Various legal, institutional and economic constraints: There are variations in such things as tax, labour practices, balance of payment policies, and government controls with respect to the types and sizes of investment, types and amount of capital raised, and repatriation of profits.

c. **Internal control problem**: When the parent office of a foreign operation company and its affiliates are widely located, international organization difficulties arise.

3.4 THE CONCEPT OF CURRENCY RISK MANAGEMENT

Foreign exchange rate exists when a contract is written in terms of the foreign currency or denominated in the foreign currency. The exchange rate fluctuations increase the riskness of the investment, incur cash loses. The financial manager must not only seek the highest return on temporary investments but must also be concerned about changing values of the currencies invested. You at this point do not necessarily eliminate foreign exchange risk.

3.4.1 FINANCIAL STRATEGIES

In countries where currency values are likely to drop financial managers of the subsidiaries should:

- Avoid paying advances on purchases orders unless the sellers pays interest on the advances sufficient to cover the loss of purchasing power.
- Not have excess idle cash. Excess cash can be used to buy inventory or other real assets.
- Buy materials and supplies on credit in the country in which the foreign subsidiary is operating, extending the final payment date as long as possible.
- Avoid, giving excessive trade credit. If accounts receivable balances are outstanding for an extended time period, interest should be changed to absorb the loss in purchasing power.
- Borrow local currency funds when the interest rate charged does not exceed US rates after taking into account expected devaluation in the foreign country.

3.5 TYPES OF FOREIGN EXCHANGE EXPOSURE (RISK)

National and companies with foreign operations are faced with the dilemma of three different types of foreign exchange risk. They are;

3.5.1 TRANSLATION EXPOSURE

It is often called accounting exposure, measures the impact of an exchange rate change on the firms financial statements. An example would be the impact of an Euro devaluation on a US firms reported income statement and balance sheet. A major purpose of translation is to provide data of expected income statement and balance sheet. A major purpose of transaction is to provide data of expected impacts of rate changes on cash flow and equity. In the transaction of the foreign subsidiaries financial statements into the US parents financial statements, the following steps are involved.

- The foreign financial statements are put into US generally accepted accounting principles.
- The foreign currency is translated into US dollars. Balance sheet account are translated using the current exchange rate at the balance sheet date. If a current exchange rate is not available at the balance sheet date, use the first exchange rate available after that date. Income statement accounts are translated using the weighted average exchange rate for the period.
- Translation gains and losses are only included in net income when there is a sale or liquidation of the entire investment in a foreign entity.

3.5.2 TRANSACTION EXPOSURE

This measures potential gains or losses on the future settlement of outstanding obligations that are denominated in a foreign currency. An example would be a US dollar loss after the European devaluates, on payments received for an export involved in francs before that devaluation. Foreign currency transactions may result in receivables or payables fixed in terms of the amount of foreign currency to be received or paid. Transaction gains and losses are reported in the income statement. Foreign currency transacted are those transactions whose terms are denominated in a currency other than the entities functional currency.

3.5.3 OPERATING EXPOSURE

It is often called economic exposure. It is the potential for the change in the present value of future cash flows due to an unexpected change in the exchange rate. Operating or economic exposure is the possibility that an unexpected change in exchange rates will cause a change in the future cash flows of a firm and its market value. It differs from translation and transaction exposure in that it is subjective and thus not easily quantified. Note the best strategy to control operation exposure is to diversify operations and financing internationally.

SELF ASSESSMENT EXERCISE

- State any two steps you know about translation exposure.

4.0 CONCLUSION

This unit has introduced you to the various types of foreign operations that we have, the issues of nations and organizations in foreign operations management. You have also learnt about the concept of currency risk management.

5.0 SUMMARY

The foreign exchange market (forex, fx or currency market) is a global worldwide–decentralized financial market for trading currencies. Financial centres around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekend. The foreign exchange market determines the relative values of different currencies. The foreign exchange market assists international trade and investment, by enabling currency conversion.

6.0 TUTOR-MARKED ASSIGNMENT

- Discuss the financial strategies that are involved in currency risk management.

Answer to Self Assessment Exercise

Translation exposure has it that;

- The foreign financial statements are put into US generally accepted accounting principles.
- The translation gains and losses are only included in net income when there is a sale or liquidation of the entire investment in a foreign entity.

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UNIT 11: FOREIGN EXCHANGE MARKET

CONTENTS

1.0 INTRODUCTION

Foreign Exchange Market (Forex, FX or Currency Market) can be defined as a global decentralized market for the trading of currencies. The foreign exchange market provides the physical and institutional structure through which the currency (money) of one country is exchanged for that of another country, the rate of exchange between currencies is determined, and foreign exchange transactions are physically consummated.
A foreign exchange transaction is an agreement between a buyer and a seller that a given amount of one currency is to be delivered at a specified rate for some other currencies.

2.0 OBJECTIVES

After reading this unit the student will be able to

- Provide the definition of foreign exchange market.
- Understand the functions of major participants in the Foreign Exchange Market

- Understand the theories of Exchange Rate Determination

3.0 MAIN CONTENT

3.1 Major Participants in the Exchange Market

The foreign exchange market consists of a spot market and a forward market. In the spot market, foreign currencies are sold and bought for delivery within two business days after the day of a trade. In the forward market, foreign currencies are sold or bought for future delivery.

There are many types of participants in the foreign exchange market: exporters, governments, importers, multinational companies, tourists, commercial banks, and central banks. But large commercial banks and central banks are the two major participants in the foreign exchange market. Most foreign exchange transactions take place in the commercial banking sector. It is also possible to arrange foreign currency transactions in specialized markets such as the black market.

3.1.1 Commercial Banks

Commercial banks participate in the foreign exchange market as intermediaries for customers such as multinational companies and exporters. These commercial banks also maintain an interbank market. In other words, they accept deposits of foreign banks and maintain deposits in banks abroad. Commercial banks play three key roles in international transactions:

1. They operate the payment mechanism
2. They extend credit
3. They help to reduce risk.

Operating the Payment Mechanism

The commercial banking system provides the mechanism by which international payments can be efficiently made. This mechanism is a collection system through which transfers of money by drafts, notes and other means are made internationally. In order to operate an international payment mechanism, banks maintain deposits in banks abroad and accept deposits of foreign banks. These accounts are debited and credited when payments are made. Banks can make international money transfers very quickly and efficiently by using telegraph, telephones, facsimiles, computer and e-mail services.

Extending Credit

Commercial banks also provide credit for international transactions and for business activity within foreign countries. They make loans to those engaged in international business on either unsecured or a secured basis. Normally, U.S banks cannot have branches outside their home state. They also cannot own shares of foreign banking subsidiaries.

However, the Edge Act of 1919 allowed American banks to act as holding companies and to own stock in foreign banks. Thus American Banks can provide loans and other banking services for American-owned companies in most countries around the word. Furthermore, since December, 1981, U.S. banks have been permitted to establish international banking facilities at their offices in the United States.

Reducing Risk

The letter of credit is used as a major means of reducing risks in international transactions. It is a document issued by a bank at the request of the importer. In the document, the bank agrees to honour a draft drawn on the importer if the draft accompanies specified documents. The letter of credit is advantageous to exporters. Exporters sell their goods abroad against the promise of a bank rather than a commercial firm. Banks are usually larger, better known, and better credit risks than most business firms. Thus, exporters are almost completely assured of payment if they meet specific conditions under letters of credit

3.1.2 Central Banks

Central banks, such as the Federal Reserve System of the United States and the Bank of Japan, attempt to control the gr4owth of the money supply within their jurisdictions. They also strive to maintain the value of their own currency against any foreign currency. In other words, central bank operations reflect government transactions, transactions with other central banks and various international organizations, and intervention to influence exchange rate movements.

Central banks serve as their governments' banker for domestic and international payments. They handle most or all foreign exchange transactions for the government as well as for important public sector enterprises. They may also pay or receive a foreign currency not usually held in official reserves. For example, the Federal Reserve Bank of New York handles a substantial volume of foreign exchange transactions for its correspondents who wish to buy or sell dollars for other currencies. Moreover, most central banks frequently enter into exchange transactions with international and regional organizations which need to buy or sell the local currency. The most important role of central banks in exchange market operations is their intervention in the exchange market to influence market conditions or the exchange rate. They carry out intervention operations either on behalf of the country's treasury department or for their own account.

In a system of fixed exchange rates, central banks usually absorb the difference between supply of and demand for foreign exchange in order to maintain the par value system. Under this system, the central banks agree to maintain the value of their currencies within a narrow band of fluctuations. If pressures such as huge trade deficits and high inflation develop, the price of a domestic currency approaches the lower limit of the band. At this point, a central bank is obliged to intervene in the foreign exchange market. This intervention is designed to counteract the forces prevailing in the market. In a system of flexible interest rates, central banks do not attempt to prevent fundamental changes in the rate of exchange between their own currency and any other currency. However, even within the flexible exchange rate system, they intervene in the foreign exchange market in order to maintain orderly trading conditions rather than to maintain a specific exchange rate.

3.1.3 Specialized Markets

Foreign exchange transactions take place in a number of specialized markets. Here we discuss three of them: the black market, the currency futures market, and the currency options market.

Black Market: The black market cannot exist under the freely flexible exchange system, because exchange rates are determined by supply and demand without government intervention. It is important to recognize, however, that more or less stringent official restrictions prevent the free play of the market forces for the great majority of the world's monetary units. A black market often exists in countries where currencies are pegged and exchange controls are imposed. When a particular black market is illegal, there is usually a large difference between the official rate and the black market rate. Nevertheless, multinational companies should not operate in the black market, not only because it is illegal, but also because it is not easy to arrange large transfers of money in the black market

Currency Futures Market: The international monetary market (IMM) was established in 1972 by the Chicago Mercantile Exchange to facilitate futures trading in foreign currencies. The IMM was conceived as an extension of an already well-established commodity futures market in which specific quantities of corn, soya beans, and wheat were traded for delivery at specified future dates. This market is a good source of funds for multinational companies, but it is relatively small and inflexible. In spite of its drawbacks, the rapid growth of trading in futures contracts for foreign currencies is one of the most remarkable developments in financial markets in recent years.

Currency Options Market: Another specialized exchange market is the foreign-currency options market. The Philadelphia Stock Exchange started currency options trading in 1983; in addition, some commercial banks have just begun to offer currency options trading. Currency options are treated in standard contracts half the size of the IMM futures contracts. A currency option is simply a contract that gives the holder the right to buy or sell a foreign currency at specified price during a prescribed period. Currency options do not need to be exercised at maturity, but payment and delivery in futures contract .

3.2 Spot and Forward Exchange Rates

The foreign exchange market employs both spot and forward exchange rates. The spot rate is the rate paid for delivery of a currency within two business days after the day of the trade. Most currency transactions take place in the spot market. The forward rate is the rate to be paid for delivery of a currency at some future date. The exchange rate is established at the time the contract is made, but payment and delivery are not required until maturity. Forward rates are usually quoted for fixed periods of 30, 90 or 180 days from the day of the contract. In some instances, actual contracts in major currencies can be arranged for delivery at any specified date up to one year.

3.3 Theories of Exchange Rate Determination

In this unit, specific attention is given to the theory of foreign exchange-rate determination. This theory is based on a relationship between the money market and the foreign exchange market; this re4latikonship prevails without restrictions imposed by government policy on the extent to which rates can move. Such a free market situation will establish the nature of interrelationships among the money markets and the foreign exchange markets. In other words, we can postulate a simple set of equilibrium relationships that should hold among inflation rates, interest rates, spot rates, and forward rates. This idea, commonly known as the law of one price, is enforced by arbitragers who, by following the famous dictum of “buy low, sell high,” prevent all but minor deviations from equality.

There are five major theories of exchange-rate determination:

1. The Theory of Purchasing Power Parity
2. The Fisher Effect
3. The International Fisher Effect
4. The Theory of Interest-Rate Parity
5. The Forward Rate as an Unbiased Predictor of the Future Spot Rate.

It is important to remember that the economic relationships of these five theories result from arbitrage activities.

4.0 CONCLUSION

As discussed in the text, the foreign exchange market consists of a spot market and a forward market. Currencies are sold and bought for delivery within two business days in the spot On the other hand, in the forward market, sales of currencies are made on the basis of future delivery. the day of a trade. In the forward market, foreign currencies are sold or bought for future delivery. Participants in the foreign exchange market include: exporters, governments, importers, multinational companies, tourists, commercial banks, and central banks.

5.0 SUMMARY

In this unit, we discussed foreign exchange and participants in the foreign exchange market. The foreign exchange market has a multiplicity of participants including governments, multinational companies, importers and exporters, commercial and central banks. In the next unit, we shall be discussing the efficiency of the foreign exchange market.

6.0 TUTOR-MARKED ASSIGNMENT

* Define Foreign Exchange

* List and discuss two participants in the foreign exchange market

* List three theories of foreign exchange

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UNIT 12: EFFICIENCY OF THE FOREIGN EXCHANGE MARKET

CONTENTS

1.0 INTRODUCTION

This chapter has two major parts: the introduction to the principles of market efficiency and a review of the empirical evidence on efficiency as they apply to the foreign exchange market.

2.0 OBJECTIVES

After reading this unit the student will be able to

- Understand the mechanism of Foreign Exchange Transactions.
- Explain the Efficiency of the Foreign Exchange Market
- Understand why market efficiency is regarded as an important benchmark

3.0 MAIN CONTENT

3.1 What Constitutes Efficiency of Foreign Exchange Market

The foreign exchange market consists of a spot market and a forward market. In the spot market, foreign currencies are sold and bought for delivery within two business days after the day of a trade. In the forward market, foreign currencies are sold or bought for future delivery. The importance of the concept of market efficiency is discussed at the beginning of the chapter. The concept plays an important role in the study of financial markets. As a theoretical matter, prices in a market economy are assumed to efficiently aggregate available information.

3.1.1 Market Efficiency as an important Benchmark

As a practical matter, market efficiency is an important benchmark that has a strong bearing on policies in the private sector pertaining to risk management and forecasting and policies in the public sector pertaining to central bank intervention.

The theory of market efficiency is discussed in the first major part of the chapter. The characteristics of an efficient market including the equilibrium benchmark and available information set are defined. The text highlights the distinction between the efficient market hypothesis and the random-walk model of asset prices, which is sometimes incorrectly identified as requirement for market efficiency. It also illustrates that all tests of market efficiency are tests of a joint hypothesis;

(1) the hypothesis that defines market equilibrium prices or market equilibrium returns as some function of the available information set, and
(2) the hypothesis that market participants have actually set prices or returns to conform to their expected values.

3.1.2 Fair-Game Process in Market Efficiency

Market efficiency requires that errors in expectation follow a fair-game process. When markets are efficient, no excess profit opportunities are consistently available to market participants. The second major part of the chapter reviews empirical evidence on market efficiency in the foreign exchange market. Rather than test directly whether prices or returns in foreign exchange market conform to their equilibrium-expected values, empirical studies have preferred to test for the availability of unusual or risk-adjusted profit opportunities. In the case of certainty or risk-free investment such as covered interest arbitrage, the empirical evidence is clear-cut and supportive of market efficiency. Once transaction costs and other factors are taken into account, most risk-free arbitrage opportunities in foreign exchange are quickly eliminated.

3.1.3 Uncertainty and Risky Investment

However, in the case of uncertainty and risky investment such as spot speculation and forward speculation, empirical tests of market efficiency are difficult to interpret. Many studies have reported techniques for profitable trading or superior forecasting in both spot and forward markets.

One implication of these empirical results is the possibility of earning speculative profits by using technical trading models. A second implication is the possibility to “out forecast” the forward rate by building a composite forecast that combines additional information with the forward rate. The broader implications of the empirical evidence on market efficiency for private enterprises and public policy makers are examined later in this unit.

3.2 The Foreign Exchange Market as part of the Money Market?

The foreign exchange market is merely a part of the money market in the financial centers is a place where foreign moneys are bought and sold. The buyers and sellers of claims on fore' money and the intermediaries together constitute a foreign exchange market. It is not restricted to any given country or a geographical area.

Thus, the foreign exchange market is the market for a national currency (foreign money) anywhere in the world, as the financial centers of the world are united in a single market.

There is a wide variety of dealers in the foreign exchange market. The most important amongst them are the banks. Banks dealing in foreign exchange have branches with substantial balances in different countries. Through their branches and correspondents the services of such banks, usually called 'Exchange Banks', are available all over the world.

These banks discount and sell foreign bills of exchange, issue bank drafts, effect telegraphic transfers and other credit instruments, and discount and collect amounts for such documents. Other dealers in foreign exchange are bill brokers who help sellers and buyers in foreign bills to come together. They are intermediaries and unlike banks are not direct dealers.

Acceptance houses are another class of dealers in foreign exchange. They help foreign remittances by accepting bills on behalf of customers. The central bank and treasury of a country are also dealers in foreign exchange. Both may intervene in the market occasionally. Today, however, those authorities manage exchange rates and implement exchange controls in various ways. In India, however, where there is a strict exchange control system, there is no foreign exchange market as such.

3.2.1 Functions of the Foreign Exchange Market:

The foreign exchange market performs the following important functions:

(i) to effect transfer of purchasing power between countries- transfer function;

(ii) to provide credit for foreign trade - credit function; and

(iii) to furnish facilities for hedging foreign exchange risks - hedging function.

3.2.2 Transfer Function:

The basic function of the foreign exchange market is to facilitate the conversion of one currency into another, i.e., to accomplish transfers of purchasing power between two countries. This transfer of purchasing power is effected through a variety of credit instruments, such as telegraphic transfers, bank drafts and foreign bills.

In performing the transfer function, the foreign exchange market carries out payments internationally by clearing debts in both directions simultaneously, analogous to domestic clearings.

Credit Function:

Another function of the foreign exchange market is to provide credit, both national and international, to promote foreign trade. Obviously, when foreign bills of exchange are used in international payments, a credit for about 3 months, till their maturity, is required.

Hedging Function:

A third function of the foreign exchange market is to hedge foreign exchange risks. In a free exchange market when exchange rates, i.e., the price of one currency in terms of another currency, change, there may be a gain or loss to the party concerned. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilities which are to be met in foreign money.

Exchange risk as such should be avoided or reduced. For this the exchange market provides facilities for hedging anticipated or actual claims or liabilities through forward contracts in exchange. A forward contract which is normally for three months is a contract to buy or sell foreign exchange against another currency at some fixed date in the future at a price agreed upon now. No money passes at the time of the contract. But the contract makes it possible to ignore any likely changes in exchange rate.

3.3 Exchange-rate flexibility

A **flexible exchange-rate system** is a monetary system that allows the exchange rate to be determined by supply and demand

Every currency area must decide what type of exchange rate arrangement to maintain. Between permanently fixed and completely flexible however, are heterogeneous approaches. They have different implications for the extent to which national authorities participate in foreign exchange markets. According to their degree of flexibility, post-Bretton Woods-exchange rate regimes are arranged into three categories: currency unions, dollarized regimes, currency boards and conventional currency pegs are described as “fixed-rate regimes”; Horizontal bands, crawling pegs and crawling bands are grouped into “intermediate regimes”; Managed and independent floats are described as flexible regimes. All monetary regimes except for the permanently fixed regime experience the time inconsistency problem and exchange rate volatility, albeit to different degrees.

3.3.1 Fixed rate programs

In a fixed exchange rate system, the monetary authority picks rates of exchange with each other currency and commits to adjusting the money supply, restricting exchange transactions and adjusting other variables to ensure that the exchange rates do not move. All variations on fixed rates reduce the time inconsistency problem and reduce exchange rate volatility, albeit to different degrees.

Under dollarization/Euroization, the US dollar or the Euro acts as legal tender in a different country. Dollarization is a summary description of the use of foreign currency in its capacity to produce all types of money services in the domestic economy. Monetary policy is delegated to the anchor country. Under dollarization exchange rate movements cannot buffer external shocks. The money supply in the dollarizing country is limited to what it can earn via exports, borrow and receive from emigrant remittances.

A currency board enables governments to manage their external credibility problems and discipline their central banks by “tying their hands” with binding arrangements. A currency board combines three elements: an exchange rate that is fixed to another, “anchor currency”; automatic convertibility or the right to exchange domestic currency at this fixed rate whenever desired; and a long-term commitment to the system. A currency board system can ultimately be credible only if central bank holds official foreign exchange reserves sufficient to at least cover the entire monetary base. Exchange rate movements cannot buffer external shocks.

A fixed peg system fixes the exchange rate against a single currency or a currency basket. The time inconsistency problem is reduced through commitment to a verifiable target. However, the availability of a devaluation option provides a policy tool for handling large shocks. Its potential drawbacks are that it provides a target for speculative attacks, avoids exchange rate volatility, but not necessarily persistent misalignments, does not by itself place hard constraints on monetary and fiscal policy and that the credibility effect depends on accompanying institutional measures and a visible record of accomplishment.

3.3.2 Monetary union

A currency or monetary union is a multi-country zone where a single monetary policy prevails and inside which a single currency or multiple substitutable currencies, move freely. A monetary union has common monetary and fiscal policy to ensure control over the creation of money and the size of government debts. It has a central management of the common pool of foreign exchange reserves, external debts and exchange rate policies. The monetary union has common regional monetary authority i.e. common regional central bank, which is the sole issuer of economy wide currency, in the case of a full currency union.

The monetary union eliminates the time inconsistency problem within the zone and reduces real exchange rate volatility by requiring multinational agreement on exchange rate and other monetary changes. The potential drawbacks are that member countries suffering asymmetric shocks lose a stabilization tool—the ability to adjust exchange rates. The cost depends on the extent of asymmetric costs and the availability and effectiveness of alternative adjustment tools.

Flexible exchange rate regimes

These systems do not particularly reduce time inconsistency problems nor do they offer specific techniques for maintaining low exchange rate volatility.

A crawling peg attempt to combine flexibility and stability using a rule-based system for gradually altering the currency's par value, typically at a predetermined rate or as a function of inflation differentials. A crawling peg is similar to a fixed peg, however it can be adjusted based on clearly defined rules Often used by (initially) high-inflation countries or developing nations who peg to low inflation countries in attempt to avoid currency appreciation At the margin a crawling peg provides a target for speculative attacks. Among variants of fixed exchange rates, it imposes the least restrictions, and may hence yield the smallest credibility benefits. The credibility effect depends on accompanying institutional measures and record of accomplishment.

Exchange rate bands allow markets to set rates within a specified range; endpoints are defended through intervention. It provides a limited role for exchange rate movements to counteract external shocks while partially anchoring expectations. This system does not eliminate exchange rate uncertainty and thus motivates development of exchange rate risk management tools. On the margin a band is subject to speculative attacks. It does not by itself place hard constraints on policy, and thus provides only a limited solution to the time inconsistency problem. The credibility effect depends on accompanying institutional measures, a record of accomplishment and whether the band is firm or adjustable, secret or public, band width and the strength of the intervention requirement.

3.3.3 Managed Float and Pure Float

Managed float exchange rates are determined in the foreign exchange market. Authorities can and do intervene, but are not bound by any intervention rule. The arrangement provides a way to mix market-determined rates with stabilizing intervention in a non-rule-based system. Its potential drawbacks are that it doesn’t place hard constraints on monetary and fiscal policy. It suffers from uncertainty from reduced credibility, relying on the credibility of monetary authorities. It typically offers limited transparency.

In a pure float, the exchange rate is determined in the market without public sector intervention. Adjustments to shocks can take place through exchange rate movements. It eliminates the requirement to hold large reserves. However, this arrangement does not provide an expectations anchor. The exchange rate regime itself does not imply any specific restriction on monetary and fiscal policy.

4.0 CONCLUSION

We discussed under this unit that market efficiency is an important benchmark that has a strong bearing on policies in the private sector pertaining to risk management and forecasting and policies in the public sector pertaining to central bank intervention. Market efficiency requires that errors in expectation follow a fair-game process. We noted that when markets are efficient, no excess profit opportunities are consistently available to market participants.

5.0 SUMMARY

This unit looked at factors that constitute efficiency of foreign exchange market. The foreign exchange market exists as part of the money market. There are many functions which the foreign exchange market performs. They include; transfer function, credit function and hedging function. In the next unit, we shall be looking at the market covered by international finance.

6.0 TUTOR-MARKED ASSIGNMENT

* Explain the reasons why market efficiency is regarded as Important Benchmark

* Among the functions of the foreign exchange market, explain "Hedging Function"

7.0 REFERENCE/FURTHER READING

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UNIT 13: MARKET COVERED BY INTERNATIONAL FINANCE

CONTENTS

1.0 INTRODUCTION

This unit will introduce you to market covered by International Finance, Bond Market Volatility and International Equity Market as it relates to international finance.

2.0 OBJECTIVES

After reading this unit, the student should be able to :

- Explain Markets covered by International Finance
- Examine Bond Market Volatility
- Identify International Equity Market

3.0. MAIN COTENT

3.1 The market covered by international finance

The market covered by international finance can be summarized as follows:

The Foreign Exchange Market
Eurocurrency Markets and Lending
International Bond Markets
International Equity Markets

3.1.1 The Foreign Exchange Market

The foreign exchange market facilitates economic interaction among different countries.
Foreign exchange markets constitute a globally-connected network of currency broker dealers who make the market for the buying and selling of currencies from around the world. The advent of the Internet fostered unprecedented growth in the foreign exchange market worldwide. With practical applications for international trade, the foreign exchange market also boosts phenomenal speculative opportunities for day traders as a source of potential profit.
In terms of a commodity, foreign exchange, or Forex, broadly refers to the currencies issued by the countries of the world. The relative value of a given currency against that of another forms the basis for the exchange of one currency for another. The price at which this exchange occurs is called an exchange rate. This exchange occurs via currency broker-dealers in the global foreign exchange market.

Bid and Ask Prices

In order to cover service commissions of foreign exchange trades, currency broker-dealers frequently adjust the market exchange. For this reason, a broker-dealer offers to buy and sell a given currency at two different prices. A broker-dealer buys a currency at a bid price (exchange rate adjusted downward) and offers to sell a currency at an ask price (exchange rate adjusted upward).

Practical Considerations

Despite the many changes and innovations experienced by the foreign exchange market, its most basic function remains unchanged. It functions to facilitate transactions of goods and services across national borders. This includes activities which range from changing money before traveling abroad to payment deliveries on industrial imports. The foreign exchange market also allows portfolio investors to buy and sell offshore securities.

Currency Speculation

Apart from its practical applications, the foreign exchange market is a viable source of potential profits for speculative short-term investors. Speculation has accounted for the vast majority of currency trades since the growth in web-based currency trading which began in the early 2000s. Though it is now possible for nearly anyone with a bank debit card and an internet connection to easily engage in currency trading, the practice itself carries extremely high risk and can result in phenomenal losses as well as gains.

3.1.2 Euro-Currency Market and Lending

Definition of 'Eurocurrency Market'

The money market in which Eurocurrency, currency held in banks outside of the country where it is legal tender, is borrowed and lent by banks in Europe. The Eurocurrency market is utilized by large firms and extremely wealthy individuals who wish to circumvent regulatory requirements, tax laws and interest rate caps that are often present in domestic banking, particularly in the United States.

Rates on deposits in the Eurocurrency market are typically higher than in the domestic market, because the depositor is not protected by domestic banking laws and does not have governmental deposit insurance. Rates on loans in the Eurocurrency market are typically lower than those in the domestic market, because banks are not subject to reserve requirements on Eurocurrency and do not have to pay deposit insurance premiums.

3.1.3 International Bond Market

The **bond market** (also **debt market** or **credit market**) is a financial market where participants can issue new debt, known as the primary market, or buy and sell debt securities, known as the secondary market. This is usually in the form of bonds, but it may include notes, bills, and so on. The primary goal of the bond market is to provide a mechanism for long term funding of public and private expenditures.

References to the "bond market" usually refer to the government bond market, because of its size, liquidity, relative lack of credit risk and, therefore, sensitivity to interest rates. Because of the inverse relationship between bond valuation and interest rates, the bond market is often used to indicate changes in interest rates or the shape of the yield curve. The yield curve is the measure of "cost of funding".

Types of bond markets

The Securities Industry and Financial Markets Association (SIFMA) classifies the broader bond market into five specific bond markets.
Corporate
Government & agency
Municipal
Mortgage backed, asset backed, and collateralized debt obligation
Funding
Bond market participants
Bond market participants are similar to participants in most financial markets and are essentially either buyers (debt issuer) of funds or sellers (institution) of funds and often both.
Participants include:

Institutional investors
Governments
Traders
Individuals
Because of the specificity of individual bond issues, and the lack of liquidity in many smaller issues, the majority of outstanding bonds are held by institutions like pension funds, banks and mutual funds. In the United States, approximately 10% of the market is currently held by private individuals.

3.2 Bond market volatility

For market participants who own a bond, collect the coupon and hold it to maturity, market volatility is irrelevant; principal and interest are received according to a pre-determined schedule.
But participants who buy and sell bonds before maturity are exposed to many risks, most importantly changes in interest rates. When interest rates increase, the value of existing bonds falls, since new issues pay a higher yield. Likewise, when interest rates decrease, the value of existing bonds rises, since new issues pay a lower yield. This is the fundamental concept of bond market volatility: changes in bond prices are inverse to changes in interest rates. Fluctuating interest rates are part of a country's monetary policy and bond market volatility is a response to expected monetary policy and economic changes.
Economists' views of economic indicators versus actual released data contribute to market volatility. A tight consensus is generally reflected in bond prices and there is little price movement in the market after the release of "in-line" data. If the economic release differs from the consensus view, the market usually undergoes rapid price movement as participants interpret the data. Uncertainty (as measured by a wide consensus) generally brings more volatility before and after an economic release. Economic releases vary in importance and impact depending on where the economy is in the business cycle.

3.2.1 Bond market influence

Bond markets determine the price in terms of yield that a borrower must pay in order to receive funding. In one notable instance, when President Clinton attempted to increase the US budget deficit in the 1990s, it led to such a sell-off (decreasing prices; increasing yields) that he was forced to abandon the strategy and instead balance the budget.
I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody.
—James Carville, political advisor to President Clinton, Bloomberg

Bond investments
Bonds typically trade in $1000 increments and are priced as a percentage of par value (100%). Many types of bonds have minimum increments imposed either by the bond itself or by the dealer selling them.

Bonds typically pay interest at set intervals. Bonds with fixed coupons divide the stated coupon into parts defined by their payment schedule, for example, semi-annual pay. Bonds with floating rate coupons have set calculation schedules where the floating rate is calculated shortly before the next payment. Zero-coupon bonds do not pay interest. They are issued at a deep discount to account for the implied interest.
Because most bonds have predictable income, they are typically purchased as part of a more conservative investment scheme. Nevertheless, investors have the ability to actively trade bonds, especially corporate bonds and municipal bonds with the market and can make or lose money depending on economic, interest rate, and issuer factors.
Bond interest is taxed as ordinary income, in contrast to dividend income which receives favorable taxation rates. However many government and municipal bonds are exempt from one or more types of taxation.

3.2.2 Bond Valuation and Analysis

Every rational investor tries to earn a return that full compensates them for risk. In the case of bondholders, that required return has three components; the real rate of return, an expected inflation premium, and a risk premium.

The real rate of return and the inflation premium are external economic factors, and together, they equal the risk-free rate. Now, to find the required return, we need to consider the unique features and properties of the bond issue itself. We can do this by adding the bond's risk premium to the risk-free rate. A bond's risk premium will take into account key issue and issuer characteristics, including such variables as the type of bond, maturity, call features, and bond rating. The three components, that is, the real rate of return, the expected inflation premium and the risk premium, work together to determine interest rate levels at a given point in time.

Because interest rates have such a significant bearing on bond prices and yields, they are closely monitored by both conservative and aggressive investors. Interest rates are important to conservative investors because one of their major objectives is to lock in high yields. Aggressive traders also have a stake in interest rates because their investment programmes are often built on the capital gains opportunities that accompany major swings in rates.

3.2.3 Keeping Tabs on Market Interest Rates

Just as there is no single bond market but a series of different market sectors, so too there is no single interest rare that applies to all segments of the market. Rather, each segment has its own, unique level of interest rates. Granted, the various rates tend to drift in the same direction over time and to follow the same general pattern of behaviour, but it is also common for yield spreads (that is interest rate differentials) to exist in the various market sectors. We can summarize the more important market yields and yield spreads as follows:

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(1) Local government bonds usually carry the lowest market rates because of the tax-exempt feature of these obligations. As a rule, their market yields are about two-thirds those of corporate organizations. In the taxable sector, treasuries have the lowest yields because they have the least risk, followed by agencies and then corporate bodies, which provide the highest returns.

(2) Issues that normally carry official ratings generally display similar behaviour. That is to say, the lower the rating, the higher the yield.

(3) Bonds that are freely callable generally provide the highest returns, at least at date of issue. These are followed by deferred call obligations and then by non-callable bonds, which yield the least.

(4) As a rule, bonds with long maturities tend to yield more than short issues. However, this rule does not hold all the time; sometimes short-term yields exceed the yield on long-term bonds.

As an investor, you should pay close attention to interest rates and yield spreads, and try to stay abreast, not only of the current state of the market, but also of the future direction in market rates. For example, if you are a conservative (income-oriented) investor and think that rates have just about peaked, that should be a clue to you to try to lock in the prevailing high yields with some form of call protection. In contrast, if you are an aggressive bond trader who thinks rates have peaked (and are about to drop), that should be a signal to buy bonds that offer maximum price appreciation potential (example, low-coupon bonds that still have a long time before they mature). Clearly, in either case, the future direction of interest rates is important.

But how does a bond investor formulate such expectations? Unless you have considerable training in economics, you will probably have to rely on various published sources. Fortunately, a wealth of such information is available. Your broker is an excellent source for such reports, as are investor services. Finally there are widely circulated business and financial publications that regularly address the current state and future direction of market interest rates. Make no mistakes about it. Prediction of future direction of interest rates is not an easy task. The best you can offer is experienced educated guesswork, and guesswork, like you know it, lacks exactitude.

What Causes Rates to Move

Although, the subject of interest rates is a complex economic issue, we do know that certain forces are especially important in influencing the general behavioour of market rates. Serious bond investors should make it a point to become familiar with the major determinants of interest rates and try to monitor those variables, at least informally.

And in that regard, perhaps no variable is more important than inflation. Changes in the inflation rate (or even expectations about the future course of inflation) have direct and pronounced effect on market interest rates and have been a leading cause of wide swings in interest rates. Clearly, if expectations are for inflation to slow down, then market interest rates should fall as well.

In addition to inflation, there are at least five other important economic variables that can significantly affect the level of interest rates. These are:

1. Changes in the Money Supply. An increase in the money supply pushes rates down (as it makes more funds available for loans), and vice versa. This is true only up to a point, however. If the growth in the money supply becomes excessive, it can lead to inflation, which, of course, means higher interest rates.

2. The Size of the Federal Budget Deficit. When the Federal Government must borrow large amounts to cover the budget deficit, the increased demand for funds exerts an upward pressure on interest rates. That is why bond market participants view the prospect of a balanced federal deficit so favourably. That is, as the federal budget deficit declines/disappears, so will a lot of the pressure on bond interest rates (which usually brings with it the potential for falling market rates).

3. The Level of Economic Activity. Businesses need more capital when the economy expands. This need increases the demand for funds, and rates tend to rise. During a recession, economic activity contracts, and rates typically fall.

4. Policies of the Federal Reserve. Actions of the Federal Reserve to control inflation also have a major effect on market interest rates. For example, when the Federal Government wants to slow real or perceived inflation down, it usually does so by driving up interest rates.

3.3 International Equity Market

A stock market or equity market is the aggregation of buyers and sellers (a loose network of economic transactions, not a physical facility or discrete entity) of stocks (shares); these are securities listed on a stock exchange as well as those only traded privately.

3.3.1 Size of market

Stocks are partitioned in various ways. One common way is by the country where the company is domiciled. For example, Nestle, Roche, and Novartis are domiciled in Switzerland, so they are part of the Swiss stock market.

The size of the world stock market was estimated at about $36.6 trillion at the beginning of October 2008. The total world derivatives market has been estimated at about $791 trillion face or nominal value, 11 times the size of the entire world economy. The value of the derivatives market, because it is stated in terms of notional values, cannot be directly compared to a stock or a fixed income security, which traditionally refers to an actual value. Moreover, the vast majority of derivatives 'cancel' each other out (i.e., a derivative 'bet' on an event occurring is offset by a comparable derivative 'bet' on the event not occurring). Many such relatively illiquid securities are valued as marked to model, rather than an actual market price.

3.3.2 Stock exchanges

Stocks are listed and traded on stock exchanges which are entities of a corporation or mutual organization specialized in the business of bringing buyers and sellers of the organizations to a listing of stocks and securities together.
Generally considered major stock exchanges are the Amsterdam Stock Exchange, London Stock Exchange, New York Stock Exchange, Paris Bourse, Bursa Malaysia (formerly Kuala Lumpur Stock Exchange) and the Deutsche Börse (Frankfurt Stock Exchange) and Toronto Stock Exchange. In Africa, examples include Nigerian Stock Exchange, JSE Limited, etc. Asian examples include the Philippine Stock Exchange, the Singapore Exchange, the Tokyo Stock Exchange, the Hong Kong Stock Exchange, the Shanghai Stock Exchange, and the Bombay Stock Exchange. In Latin America, there are such exchanges as the BM&F Bovespa and the BMV. Australia has a national stock exchange, the Australian Securities Exchange, due to the size of its population. The stock exchange is based in Sydney.

Market participants include individual retail investors and traders, institutional investors such as mutual funds, banks, insurance companies and hedge funds, and also publicly traded corporations trading in their own shares. Some studies have suggested that institutional investors and corporations trading in their own shares generally receive higher risk-adjusted returns than retail investors.

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A few decades ago, worldwide, buyers and sellers were individual investors, such as wealthy businessmen, usually with long family histories to particular corporations. Over time, markets have become more "institutionalized"; buyers and sellers are largely institutions (e.g., pension funds, insurance companies, mutual funds, index funds, exchange-traded funds, hedge funds, investor groups, banks and various other financial institutions).
The rise of the institutional investor has brought with it some improvements in market operations. There has been a gradual tendency for "fixed" (and exorbitant) fees being reduced for all investors, partly from falling administration costs but also assisted by large institutions challenging brokers' oligopolistic approach to setting standardized fees.

3.3.3 Importance of Stock Market

The stock market is one of the most important sources for companies to raise money. This allows businesses to be publicly traded, or raise additional financial capital for expansion by selling shares of ownership of the company in a public market. The liquidity that an exchange affords the investors gives them the ability to quickly and easily sell securities. This is an attractive feature of investing in stocks, compared to other less liquid investments. Some companies actively increase liquidity by trading in their own shares.

History has shown that the price of shares and other assets is an important part of the dynamics of economic activity, and can influence or be an indicator of social mood. An economy where the stock market is on the rise is considered to be an up-and-coming economy. In fact, the stock market is often considered the primary indicator of a country's economic strength and development.

Rising share prices, for instance, tend to be associated with increased business investment and vice versa. Share prices also affect the wealth of households and their consumption. Therefore, central banks tend to keep an eye on the control and behavior of the stock market and, in general, on the smooth operation of financial system functions.

Exchanges also act as the clearinghouse for each transaction, meaning that they collect and deliver the shares, and guarantee payment to the seller of a security. This eliminates the risk to an individual buyer or seller that the counterparty could default on the transaction.
The smooth functioning of all these activities facilitates economic growth in that lower costs and enterprise risks promote the production of goods and services as well as possibly employment. In this way the financial system is assumed to contribute to increased prosperity.

The financial system in most western countries has undergone a remarkable transformation. One feature of this development is disintermediation. A portion of the funds involved in saving and financing, flows directly to the financial markets instead of being routed via the traditional bank lending and deposit operations. The general public interest in investing in the stock market, either directly or through mutual funds, has been an important component of this process.

Statistics show that in recent decades, shares have made up an increasingly large proportion of households' financial assets in many countries. In the 1970s, in Sweden, deposit accounts and other very liquid assets with little risk made up almost 60 percent of households' financial wealth, compared to less than 20 percent in the 2000s. The major part of this adjustment is that financial portfolios have gone directly to shares but a good deal now takes the form of various kinds of institutional investment for groups of individuals, e.g., pension funds, mutual funds, hedge funds, insurance investment of premiums, etc.

4.0 CONCLUSION

We discussed under this unit the markets covered by international finance. The markets include: foreign exchange market, euro-currency market and lending, and international bond market.
We also looked at the volatile nature of bonds and the influence bonds have in the stock exchange market.

5.0 SUMMARY

This unit looked at international finance and the market covered by international finance. In the next unit we shall be dealing with the nature of capital and the relationship between capital and wealth.

6.0 TUTOR-MARKED ASSIGNMENT

* Explain the influence bonds have in the stock exchange market.

* Explain the importance of stock exchange market

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UNIT 14: NATURE OF CAPITAL

CONTENT

1.0 INTRODUCTION

Capital itself does not exist until it is produced. Then, to create wealth, capital must be combined with labor, the work of individuals who exchange their time and skills for money. When people invest in capital by foregoing current consumption, they can enjoy greater future prosperity.

Capital has value because of property rights. Individuals or companies can claim ownership to their capital and use it as they please. They can also transfer ownership of their capital to another individual or corporation and keep the sale proceeds. Government regulations limit how capital can be used and diminish its value; the tradeoff is supposed to be some benefit to society. For example, when you sell a stock that has increased in value since you purchased it, you must pay tax on the capital gains. Those taxes are used for public purposes, such as national defense.

Different subjects like Book-keeping, organization of commerce (O.C) and secretarial practice (S.P) in commerce, economics, etc., indicate different meaning of the term Capital.

In book-keeping, capital means amount invested by businessman in the business .In commerce subjects like O.C and S.P, capital means finance or company's capital. But, in economics, capital is that part of wealth which is used for production. This unit shall consider meaning of term capital from economic point of view.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Give detail explanation on the Nature of capital
- explain the relation between capital, wealth, money and income.
- explain characteristics of capital
- consider the types of capital.

3.0 MAIN CONTENT

3.1 Relations of Capital

The word Capital is related with the following three terms, viz.

1. Wealth,

2. Money, and

3. Income.

The relation of capital with wealth, money and income is explained below:-

1. **Relation with Wealth**:-Capital is that part of wealth which is used for production. So, wealth is a broad concept and capital is a narrowed concept.

Relation of Capital and Wealth is explained with the help of following items. (A) Car (B) furniture’s.

If a commodity is having features like scarcity, utility, externality and transferability, it becomes wealth. A motor car has all above features, so it is a wealth. (This is related to item 'A' above). When wealth is used in production process, it becomes capital. If that car is used for taxi (cab) business, it becomes capital. (As per item 'B' above). Therefore, any commodity as a wealth becomes the capital, if it is used for production. Thus, all capital is wealth but all wealth is not capital.

2. **Relation with Money**:-The relation between Capital and Money is explain below.

Normally, capital means investment of money in business. But in economics money becomes capital only when it is used to purchase real capital goods like plant, machinery, etc. When money is used to purchase capital goods, it becomes Money Capital. But money in the hands of consumers to buy consumer goods or money hoarded does not constitute capital. Money by itself is not a factor of production, but when it acquires stock of real capital goods, it becomes a factor of production. For production we need real capital and money capital but money capital acquires real capital.

3.Relation with Income: **-** Capital generates income. So, capital is a source and income is a result. E.g. refrigerator is a capital for an ice-cream parlour owner. But, the profit which he gets out of his business is his income. So, Capital is a FUND concept and Income is a FLOW concept.

SELF ASSESSMENTS EXERCISE

Explain the relation between capital, income, money and wealth.
Define capital in line with difference discipline.

3.2 Features of Capital

The characteristics or features of capital are:-

1. **Man-made Factor**: Capital is not a gift of nature. So it is not a primary or natural factor, it is made by man in capital goods industry. It is secondary as well as an artificial factor of production.

2. **Productive Factor**: Capital helps in increasing level of productivity and speed of production.

3. **Elastic Supply**: Supply of capital depends upon capital formation process. Capital formation depends upon savings and investment. By accelerating capital formation, capital supply can be increased. But it is a long term process.

4. **Durable:** Capital is not perishable like labour. It has a long life subject to periodical depreciation.

5**. Easy Mobility**: Movement of capital from one place to another is easily possible.

6. **Is a Wealth**: Since capital has all features of wealth viz. utility, scarcity, transferability and externality, capital is a wealth but wealth doesn't necessarily become capital.

7. **Derived demand:** As a factor of production, capital has a derived demand to produce finished goods which have a direct demand. e.g. demand for raw cotton is derived from demand for cotton cloth.

8. **Round about production**: Capital goods do not satisfy our wants directly. But resources should be diverted towards production of capital goods first. And thereafter such produced mean can be used to produce consumer goods having direct demand.

9. **Social Cost**: Resources have alternative uses. Either they can be put to production of capital goods or consumer goods. When resources are used for producing capital goods, it means society has sacrificed enjoyment of consumer goods. This is called social cost.

3.3 Types of Capital

The forms, classification or types of capital are:-

1. **Fixed capita**l: It refers to durable capital goods which are used in production again and again till they wear out. Machinery, tools, means of transport, factory building, etc are fixed capital. Fixed capital does not mean fixed in location. Since the money invested in such capital goods is fixed for a long period, it is called Fixed Capital.

2. **Working capital**: Working capital or variable capital is referred to the single use produced goods like raw materials. They are used directly and only once in production. They get converted into finished goods. Money spend on them is fully recovered when goods made out of them are sold in the market.

3. **Circulating capital**: It is referred to the money capital used in purchasing raw materials. Usually the term working capital and circulating capital are used synonymously.

4. **Sunk capital**: Capital goods which have only a specific use in producing a particular commodity are called Sunk capital. E.g. A textile weaving machine can be used only in textile mill. It cannot be used elsewhere. It is sunk capital.

5. **Floating capital**: Capital goods which are capable of having some alternative uses are called floating capital. For e.g. electricity, fuel, transport vehicles, etc are the floating capital which can be used anywhere.

6. **Money capital**: Money capital means the money funds available with the enterprise for purchasing various types of capital goods, raw material or for construction of factory building, etc. it is also called liquid capital. At the beginning the money capital is required for two purposes one for acquiring fixed assets i.e. fixed capital goods and another for purchasing raw materials, payment of wages and meeting certain current expenses i.e. working capital.

7. **Real capital**: On the other hand, real capital is referred to the capital goods other than money such as machinery, factory buildings, semi-finished goods, raw materials, transport equipments, etc.

8. **Private capital**: All the physical assets (other than land), as well as investments, which bring income to an individual are called private capital.

9. **Social capital**: All the assets owned by a community as a whole in the form of non-commercial assets are called social capital e.g. roads, public parks, hospitals, etc.

10. **National capital**: Capital owned by the whole nation is called national capital. It comprises private as well as public capital. National capital is that part of national wealth which is employed in the reproduction of additional wealth.

11. **International capital**: Assets owned by international organizations like UN, WTO, World Bank, etc., constitutes an International Capital.

3.4 Theories of Capital Structure

1st Theory of Capital Structure

The Net Income Theory of Capital Structure

This theory gives the idea for increasing market value of firm and decreasing overall cost of capital. A firm can choose a degree of capital structure in which debt is more than equity share capital. It will be helpful to increase the market value of firm and decrease the value of overall cost of capital. Debt is cheap source of finance because its interest is deductible from net profit before taxes. After deduction of interest company has to pay less tax and thus, it will decrease the weighted average cost of capital. For example if you have equity debt mix is 50:50 but if you increase it as 20: 80, it will increase the market value of firm and its positive effect on the value of per share. High debt content mixture of equity debt mix ratio is also called financial leverage. Increasing of financial leverage will be helpful to for maximize the firm's value.

2nd Theory of Capital Structure

The Net Operating income Theory of Capital Structure

Net operating income theory or approach does not accept the idea of increasing the financial leverage under NI approach. It means to change the capital structure does not affect overall cost of capital and market value of firm. At each and every level of capital structure, market value of firm will be same.

3rd Theory of Capital Structure

The Traditional Theory of Capital Structure

This theory or approach of capital structure is mix of net income approach and net operating income approach of capital structure. It has three stages which you should understand:

1st Stage

In the first stage which is also initial stage, company should increase debt contents in its equity debt mix for increasing the market value of firm.

2nd Stage

In second stage, after increasing debt in equity debt mix, company gets the position of optimum capital structure, where weighted cost of capital is minimum and market value of firm is maximum. So, no need to further increase in debt in capital structure.

3rd Stage

Company can gets loss in its market value because increasing the amount of debt in capital structure after its optimum level will definitely increase the cost of debt and overall cost of capital.

4th Theory of Capital Structure

The Modigliani and Miller

MM theory or approach is fully opposite of traditional approach. This approach says that there is not any relationship between capital structure and cost of capital. There will not effect of increasing debt on cost of capital.

Value of firm and cost of capital is fully affected from investor's expectations. Investors' expectations may be further affected by large numbers of other factors which have been ignored by traditional theorem of capital structure.

Financial Leverage And Capital Structure Policy - Modigliani And Miller's Capital Structure Theories

Modigliani and Miller, two professors in the 1950s, studied capital-structure theory intensely. From their analysis, they developed the capital-structure irrelevance proposition. Essentially, they hypothesized that in perfect markets, it does not matter what capital structure a company uses to finance its operations. They theorized that the market value of a firm is determined by its earning power and by the risk of its underlying assets, and that its value is independent of the way it chooses to finance its investments or distribute dividends.

The basic M and M proposition is based on the following key assumptions:

•No taxes

•No transaction costs

•No bankruptcy costs

•Equivalence in borrowing costs for both companies and investors

•Symmetry of market information, meaning companies and investors has the same information

•No effect of debt on a company's earnings before interest and taxes

Of course, in the real world, there are taxes, transaction costs, and bankruptcy costs, differences in borrowing costs, information asymmetries and effects of debt on earnings. To understand how the M&M proposition works after factoring in corporate taxes, however, we must first understand the basics of M&M propositions I and II without taxes.

Modigliani and Miller's Capital-Structure Irrelevance Proposition

The M and M capital-structure irrelevance proposition assumes no taxes and no bankruptcy costs. In this simplified view, the **weighted average cost of capital** (WACC) should remain constant with changes in the company's capital structure. For example, no matter how the firm borrows, there will be no tax benefit from interest payments and thus no changes or benefits to the WACC. Additionally, since there are no changes or benefits from increases in debt, the capital structure does not influence a company's stock price, and the capital structure is therefore irrelevant to a company's stock price.

However, as we have stated, taxes and bankruptcy costs do significantly affect a company's stock price. In additional papers, Modigliani and Miller included both the effect of taxes and bankruptcy costs.

Modigliani and Miller's Tradeoff Theory of Leverage

The tradeoff theory assumes that there are benefits to leverage within a capital structure up until the optimal capital structure is reached. The theory recognizes the tax benefit from interest payments - that is, because interest paid on debt is tax deductible, issuing bonds effectively reduces a company's tax liability. Paying dividends on equity, however, does not. Thought of another way, the actual rate of interest companies' pay on the bonds they issue is less than the nominal rate of interest because of the tax savings. Studies suggest, however, that most companies have less leverage than this theory would suggest is optimal. (Learn more about corporate tax liability in How Big Corporations Avoid Big Tax Bills and Highest Corporate Tax Bills by Sector.)

In comparing the two theories, the main difference between them is the potential benefit from debt in a capital structure, which comes from the tax benefit of the interest payments. Since the MM capital-structure irrelevance theory assumes no taxes, this benefit is not recognized, unlike the tradeoff theory of leverage, where taxes, and thus the tax benefit of interest payments, are recognized.

In summary, the MM I theory without corporate taxes says that a firm's relative proportions of debt and equity don't matter; MM I with corporate taxes says that the firm with the greater proportion of debt is more valuable because of the interest tax shield.

MM II deals with the WACC. It says that as the proportion of debt in the company's capital structure increases, its return on equity to shareholders increases in a linear fashion. The existence of higher debt levels makes investing in the company more risky, so shareholders demand a higher risk premium on the company's stock. However, because the company's capital structure is irrelevant, changes in the debt-equity ratio do not affect WACC. MM II with corporate taxes acknowledges the corporate tax savings from the interest tax deduction and thus concludes that changes in the debt-equity ratio do affect WACC. Therefore, a greater proportion of debt lowers the company's WACC.

4 0 CONCLUSION

Capital means investment of money in business. But in economics money becomes capital only when it is used to purchase real capital goods like plant, machinery, etc. When money is used to purchase capital goods, it becomes Money Capital. Capital itself does not exist until it is produced. Then, to create wealth, capital must be combined with labor, the work of individuals who exchange their time and skills for money. When people invest in capital by foregoing current consumption, they can enjoy greater future prosperity.

But money in the hands of consumers to buy consumer goods or money hoarded does not constitute capital. Money by itself is not a factor of production, but when it acquires stock of real capital goods, it becomes a factor of production. For production we need real capital and money capital but money capital acquires real capital.

5.0 SUMMARY

Capital is that part of wealth which is used for production. It is a portion of wealth which is used for production. So, wealth is a broad concept and capital is a narrowed concept. This unit focused on economics Interpretations of capital, its relates capital with money, wealth and income. The nature of capital consist types, characteristics and relation of capital as explain above. We shall extend the analysis on nature of capital in the next unit by considering international capital flow or foreign capital flow as preferred by different writers.

6.0 TUTOR-MARKED ASSIGNMENT

1) Discuss the various types of capital?

2) List and explain the four theories of capital structure?

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UNIT 15 INTERNATIONAL CAPITAL FLOWS

CONTENT

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1Foreign capital Flows
3.2 Forms of foreign capital
3.3 Uses and determinants of foreign capital
3.4 The major determinants of various forms of foreign capital flows are as follows
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

Meaning of Capital Flows

The movement of money for the purpose of investment, trade or business production. Capital flows occur within corporations in the form of investment capital and capital spending on operations and research and development. On a larger scale, governments direct capital flows from tax receipts into programs and operations, and through trade with other nations and currencies. Individual investors direct savings and investment capital into securities like stocks, bonds and mutual funds. Capital flows are aggregated by the U.S. government and other organizations for the purpose of analysis, regulation and legislative efforts. Different sets of capital flows that are often studied include the following:

• Asset-class movements – measured as capital flows between cash, stocks, bonds, etc.

• Venture capital – investments in startup businesses

• Mutual fund flows – net cash additions or withdrawals from broad classes of funds

• Capital-spending budgets – examined at corporations as a sign of growth plans

• Federal budget – government spending plans

Capital flows can help to show the relative strength or weakness of capital markets, especially in contained environments like the stock market or the federal budget. Investors also look at the growth rate of certain capital flows, like venture capital and capital spending, to find any trends that might indicate future investment opportunities or risks.

2.0 OBJECTIVES

At the end of this unit, you should be able to:
- give meaning to capital flow
- identify forms of foreign capital and its uses..
* explain the various determinants of foreign capital flow .

3.0 MAIN CONTENT

3.1 Foreign capital Flow

Foreign capital is of a different genre from domestic capital. It's use involves not only the commercial, financial and economic considerations but also wider concerns such as systemic volatility, national sovereignty, dependency, international hegemony, covert colonial exploitation, and the ultimate resources drain.

3.2 FORMS OF FOREIGN CAPITAL

The sources through which the FC is available can be categorized as official, non-official or private, multilateral, bilateral, commercial, concessional, etc. The Official Assistance (OA) channels include the bilateral government funding arrangements and the multilateral financial institutions. The main instruments of the supply of official foreign capital are loans aid gifts grants and mixed credits. This source has so far financed mainly the government and public sector projects;

its small part accruing to the private corporate sector has been mostly channelised indirectly, i.e., through the government and the public financial institutions in the -host country. The official funding has usually been on concessional terms in respect of the cost, maturity, and repayment schedule. In the recent past, there has been a significant decline in the availability of the official foreign capital.

Private foreign capital is available from private individual and institutional investors on commercial terms in the form of euro-issues comprising External Commercial Borrowings (ECBs) or loans, equity capital, Portfolio Investment (PI), Foreign Direct Investment (FDI), and operations of the Multi National Corporations (MNCs), deposits and investments by Non-Resident Nigeria (NRNs) and Overseas Corporate Bodies (OCBs), and investments by Foreign Financial Institutions (FIIs).

Due to the suspicion and resentment against the FDI because of its political, cultural, social interference and dominance in the host countries, certain new heterogeneous forms of investment have, of late, emerged in the international financial markets. They constitute a grey area between the wholly-or majority-o FDI and exports, and they are particularly relevant for financing the corporate sector.

3.3 USES AND IMPORTANCE OF FOREIGN CAPITAL

In the process of economic development, foreign capital is said to (a) relax the domestic savings constraint (b) help to overcome the foreign exchange barrier, (c) provide access to the superior technology, superior managerial skills, and bigger markets, (d) provide risk sharing capital financing, (e) furnish the funds needed for the full utilization of the existing production capacity, and (f) promote efficiency and productivity through international competition.

3.4 THE MAJOR DETERMINANTS OF VARIOUS FORMS OF FOREIGN CAPITAL FLOWS ARE AS FOLLOWS:

(i) The imbalances between saving and investment leading to current account gaps. A massive increase in the surpluses of the OPEC countries and Japan, and large current account deficits of the US has caused the recent surge in capital flows.

(ii) The relative levels of the nominal and real expected rates of return or interest rates, and the risk and uncertainty in respect of the real and financial investments. Like population migration, capital migration can be and has been explained in terms of the ‘pull” and “push factors”. As far as the recent increase in capital flows is concerned, greater weight has to be given to the push factors, particularly the falling interest rates in the US and sonic other countries Empirical evidence has established that aggregate private capital inflows to developing countries have exhibited a strong negative association with the interest rates in the US.

(iii) The degree of openness of the financial and other markets or the extent of their internationalization or international integration. The worldwide adoption of the policy of deregulation, liberalization, stabilization and structural adjustments, and the dismantling of the trade, exchange, investment, price, ownership, capital flows controls have spurred the recent surge in capital flows.

(iv) The legal and institutional structure which is transparent and easily understood.

(v) The relative stability of the international value of different currencies, i.e., the relative rates of inflation.

(vi) The relative stability of the external value of different currencies, i.e., the relative stability of the exchange rates.

(vii) The relative terms of trade of different countries.

(viii) The absorption capacity of the receiving countries.

(ix) The business cycle phases or the growth (economic) prospects in different countries.

(x) The credit standing or credit rating of nations, which depends, inter alia, on political and social stability.

(xi) The requests, and the negotiation skills of different countries.

(xii) The extent of the cross-country penetration of the foreign ownership of banks, business firms, and security firms.

(xiii) Changes in the preferences of the investors for the international diversification of their portfolios.

(xiv) The extent of the Innovativeness of the markets in respect of designing and supplying a whole range of new financial products.

(xv) Advances in the computer and telecommunication technologies leading to a revolution in the availability of information, and in the working of the payments and transfer mechanism.

(xiv) Bandwagon effects resulting from the signaling of the information on fundamentals, or from the speculative bubbles.

4.0 CONCLUSION

Capital Flows is the movement of money for the purpose of investment, trade or business production. Foreign capital involves not only the commercial, financial and economic considerations but also wider concerns such as systemic volatility, national sovereignty, dependency, international hegemony, covert colonial exploitation, and the ultimate resources drain.

5.0 SUMMARY

The main instruments of the supply of official foreign capital are loans aid gifts grants and mixed credits. The unit gave detail analysis on the uses and importance of foreign capital, major determinants of various forms of foreign capital flows. Next unit shall focused on international financial instrument as a core mobilization foreign capital flow.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss various determinants of foreign capital flow?

7.0 REFERENCES/FURTHER READING

M L BHOLE: Financial Institutions and Market, Structure, Growth and Innovation. Fourth Edition: Tata McGraw-Hill Publishing Company Limited.

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UNIT 16: FEATURES, INSTRUMENTS AND PERFORMANCE OFB INTERNATIONAL FINANCE

CONTENT

1.0 INTRODUCTION

International financial institutions (IFIs) are financial institutions that have been established (or chartered) by more than one country, and hence are subjects of international law. Their owners or shareholders are generally national governments, although other international institutions and other organizations occasionally figure as share-holders. Financial Instruments can be thought of as easily tradeable packages of capital, each having their own unique characteristics and structure. The wide array of financial instruments in today's marketplace allows for the efficient flow of capital amongst the world's investors.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- give meaning to international financial institution
- identify the functions of international and their performance in LDC's like Nigeria, India and the like.
- classify international financial institution based on their purpose across region.
- identifying the various international financial instruments.

3.0 MAIN CONTENT

3.1 International financial institutions

International financial institutions (IFIs) are financial institutions that have been established (or chartered) by more than one country, and hence are subjects of international law. Their owners or shareholders are generally national governments, although other international institutions and other organizations occasionally figure as shareholders. The most prominent IFIs are creations of multiple nations, although some bilateral financial institutions (created by two countries) exist and are technically IFIs. Many of these are multilateral development banks (MDB).

3.2 Multilateral Financial Institutions

The four well-known multilateral institutions which have vast resources and tremendous influence, and which supply foreign capital for different purposes are:

(a) The International Bank for Reconstruction and Development (IBRD) widely known as the World Bank (WB) with its three affiliates;

(b) The Asian Development Bank (ADB);

(c) The International Monetary Fund (IMF), and;

(d) The Bank for International Settlements (BlS).

They are also known as international development banks -or non-commercial banks. Both IMF and IBRD were created at the same time in 1944. While the IMF supplies funds to tide over short-term financial difficulties, the World Bank pro vides long-term, developmental capital. The IMF membership is a prerequisite for WB member ship. In 1994, IMF and WB had 174 and 150 members respectively.

World Bank The WB provides assistance with a view to (a) -help in the reconstruction and development of member countries by promoting investment in high quality projects and for productive purposes; (b) promote private foreign investment by providing guarantees or by participating in loans and other investments made by private parties; (e) promote long-term and balanced growth of international trade; and (d) help to bring about a smooth transition from a wartime to -a peacetime economy. On the whole, WB assistance is for infrastructural development in the areas such as transportation, urban development, electricity and other energy generation, dams, education, rural development, etc.

The WB provides assistance to governments, public sector units, autonomous bodies, municipalities, etc. in both developed and developing countries. Its loans have to be guaranteed by the respective governments. The maturity of its loans varies from 15 to 20 years, and they are at relatively low rates of interest. In the recent past, the WB has been emphasising on giving loans to help countries to meet BOP difficulties, and it has been using its loans window to make debtor countries to adopt policies of free trade, privatization, deregulation, liberalisatron. And globalisation Its financial resources are raised through membership contributions or quotas. borrowings from governments and private sources, and issuing bonds in capital markets.

The WB and its affiliates together are known as World Bank Group of institutions. The affiliates include (a) International Development Agency (IDA); (b) International Financial Corporation (IFC); and (c) Multilateral Investment Guarantee Agency (MIGA).

IDA One of these affiliates, namely, International Development Association or Agency was established in 1960 to provide development assistance particularly to “poi’ countries or to those parties who could not meet the terms of WB loans. Its loans have a maturity up to 50 years and are provided free-of cost or at concessional interest; they are “soft” loans. These loans, however, require government guarantees. The wealthy countries contribute to the resources of the IDA. -

IFC Another affiliate of the WB is the International Finance Corporation (IFC). It was set up in 1956 with a view to provide long-term loans and risk or equity capital to private sector enterprises, and to encourage the flow of foreign private capital to developing countries through the establishment and expansion of capital markets and institution in those counties. The unique feature of the IFC is that it gives assistance for promoting the development of financial markets or the market-oriented financial sectors It advises governments on the legal fiscal, and regulatory frame works needed for this purpose. It attracts international investors to the securities markets in host counties by sponsoring, underwriting and distributing the shares of both individual companies and funds that invest in those securities H does not supply funds to the governments, and it does not require government guarantees. Its capital is provided by its 135 member countries.

MIGA The third affiliate of the WB namely, Multilateral Investment Guarantee Agency (MIGA) wag set up in 1988. It guarantees or provides insurance protection to-foreign investors up to 90 percent of an investment against noncommercial risk currency transfer risk, expropriation risk, risk of war, revolution and civil disturbance, and breach of contract risk, for typically a 15-year period .Through its services of this nature MIGA encourages foreign investors to make long-term commitments in developing countries. It also provides policy and advisory services to the developing countries for creating an attractive investment climate.

ADB The Asian Development Bank (ADB) provides or guarantees direct loans to private ventures in Asian or Pacific countries. It also helps to develop local capital markets by underwriting the securities issued by private enterprises.

IMF The IMF was established in 1944 to help countries to abstain from changing their exchange rates for obtaining a trading advantage, by collecting and allocating international liquidity reserves Its Articles of Agreement require member countries to promote international monetary co-operation to facilitate balanced growth of international trade, to promote exchange rate stability, to establish a system of multilateral payments, and to create a reserves base. Although the nations are supposed to borrow from the IMF primarily for meeting international reserves requirements its lending possibilities have been expanded considerably over the years by establishing the Following various “facilities Stand by Arrangements (introduced in 1952) enable countries to obtain funds ahead of the need so as to lessen risk of attack on then currencies. The Compensating Financing Facility

(1963) helps countries with temporal inadequate foreign exchange reserves. The Extended Fund Facility (1974) provides loans to countries with structural difficulties that take longer time to be corrected. The Trust Fund (1976) allows IMF to sell its gold and use the proceeds for special development loans. The Supplementary Financing Facility gives stand by credits to countries with temporary difficulties arising from oil price increases. The Buffer Stock Facility grants loans to countries to purchase crucial inventories.

BIS. BIS is a Central Bank for Central Banks. It was set up in 1930. It assists Central Banks (CBs) in the world to invest monetary reserves, acts as agent or trustee in carrying out international loan agreements, and acts as a forum for international monetary co-operation. Its funds, which are required for lending to Central Banks, are placed in the world financial markets as deposits with commercial banks, purchases of short-term negotiable paper, US treasury bills, etc.

3.3 Regional Development Banks

The regional development banks consist of several regional institutions that have functions similar to the World Bank group's activities, but with particular focus on a specific region. Shareholders usually consist of the regional countries plus the major donor countries. The best-known of these regional banks cover regions that roughly correspond to United Nations regional groupings, including the Inter-American Development Bank, the Asian Development Bank; the African Development Bank; and the European Bank for Reconstruction and Development.

3.4 Sub-regional" multilateral development banks.

There are also several "sub-regional" multilateral development banks. Their membership typically includes only borrowing nations. The banks lend to their members, borrowing from the international capital markets. Because there is effectively shared responsibility for repayment, the banks can often borrow more cheaply than could any one member nation. These banks include:

- CAF - Latin America Development Bank (CAF)
- Caribbean Development Bank (CDB)
- Central American Bank for Economic Integration (CABEI)
- East African Development Bank (EADB)
- West African Development Bank (BOAD)
- Black Sea Trade and Development Bank (BSTDB)
- Eurasian Development Bank (EDB)

3.5 BILATERAL DEVELOPMENT BANKS AND AGENCIES

A bilateral development bank is a financial institution set up by one individual country to finance development projects in a developing country and its emerging market, hence the term bilateral, as opposed to multilateral. Examples include:

The Netherlands Development Finance Company FMO, headquarters in The Hague; one of the largest bilateral development banks worldwide.

The French Development Agency AgenceFrançaise de Développement, and Caisse des dépôts, founded 1816, both headquartered in Paris, France.

Other regional financial institutions

Financial institutions of neighboring countries established themselves internationally to pursue and finance activities in areas of mutual interest; most of them are central banks, followed by development and investment banks.

SELF ASSESSMENTS EXERCISE

Explain the difference between Bilateral and Multilateral Development Banks
Highlights the various Sub-regional" multilateral development banks**.**

3.6 INTERNATIONAL FINANCIAL INSTRUMENTS

Financial instruments are used to mobilize foreign capital for varieties of developmental project in the globe. Among the **international financial instruments are:**

(a) Syndicated or traditional bank loans or eurocredits or eu ro loans;

(b) Euro deposits or eurocurrency or euromoney

(c) Foreign bonds,

(d) Eurobonds,

(e) Fixed rate notes (FRNs),

(f) Note issuing facility (NIF)

(g) Euro commercial paper (ECP)

(h) Euro certificates of deposits (ECDs)

(i) Euro equities;

(j) equity-related instruments such as American Depository Receipts (ADRs), Global Depository Receipts (GDRs), and International Depository Receipts (lDRs).

3.7 Types of Financial Instruments/Euro Issues

The word ‘euro’ in the names of many of these instruments needs to be understood well. In 1950s, the erstwhile Soviet Union held the proceeds of its gold sales in the form of US dollars with banks

in UK and France but not in the US because in the days of the Cold War, it did not want to appear to be lending to capitalist America”, and it Was also afraid that its deposits may be confiscated.

These deposits came to be known as euro dollars as they were denominated in dollars and were held in Europe. During the 1960s and 1970s, the volume of these deposits and the market in them expanded because the restrictions such as the ceiling on interest rates and higher CRR imposed by the US authorities on domestic banks had led many US banks to accept dollar deposits at their foreign branches in Europe and to invest dollars so obtained in the US. In the 1970s, the OPEC countries had accumulated massive BOP surpluses which they also preferred to hold in dollars with the banks in Europe.

Finally, the dollar being a widely accepted means of international payments, many European Corporations also preferred to keep their surplus dollars with the European banks. Since 1981, non-US residents have been able to conduct dollar business free of US banking regulations at the International Banking Facilities in the US itself. Earlier, the market for euro was located primarily in Europe, but now it exists in many other countries.

With the passage of time, the progressive extension or the generalization of the concept of euro dollars has occurred in the form of euro currency or euro money, and euro instruments or euro assets. Now the currencies have leapt beyond their traditional boundaries so that it is possible to write cheques in French francs against bank accounts in Tokyo; bank accounts in different currencies exist side by side in many financial centre's; it has become possible to arrange loans in, say US dollars in, say, Bonn or Tokyo. All these are called euro currency deposits and credits; and the markets for them are called euro currency markets. Spearheading the growth of Eurocurrencies was the appearance of euro dollars in the 1950s. Eurodollars are a special case, an example of euro currency; euro yen, euro frank are other euro currencies.

Whether the financial instrument is domestic or foreign or euro depends upon the currency in which it is denominated (the currency of issue), the country in which it is issued (the country of issue), and the location of the issuing entity (the nationality of the issuer).

Let us try to understand further the terminology involved in this context by studying the meaning and nature of some of the instruments mentioned earlier.

As said above, the eurodollars are deposits which are US-dollar-denominated and held at banks located outside the US. Here what matters is the location of the bank, and not the nationality of the bank and the nationality of the deposit holder. A dollar deposit belonging to a US company herd with a US bank's subsidiary abroad is still a eurodollar deposit. A bank deposit is counted as a part of eurocurrency if it is denominated in some currency other than that of the country in which the bank with which it is held is located. As said earlier, eurodeposit or eurocurrency is a generalisation of the eurodollar deposit. Generalising , further, any financial instrument issued or traded in a given country and denominated in the currency other than, that of that country is called an euroinstrument. Eurodeposit is an example Ofeuroinstrument.

Eurocredits or euroloans are loans by banks in international markets. In the case of syndicated eurocredits, a number of banks participate in a loan, each contributing a slice and enabling it to limit its exposure to a single borrower. They have emerged as an important source of external finance for many borrowers, including the corporates.

Eurobonds are the bonds that are denominated in the currency other than that of the country in which they are sold or issued. They are a generalisation of the eurodollar bonds which are the US- dollar-dominated bonds sold outside US. When eurobonds are denominated in more than' one currency, they are called multicurrency bonds. They usually give the lenders the right to request repayment in one or two or more currencies. The amounts of repayment are often set equal in value at the exchange rates in effect when the bonds are issued. Eurobonds are bearer, unsecured bonds, and they are usually listed on the London or Luxemberg exchange. Their variants or types are:

euro-callable bonds, euro-convertible bonds, straight or fixed-rate bonds, floating rate notes of bonds, and equity-linked bonds. The volatility of exchange rates has led to the growing use of a variety of hedging features such as partly paid bonds, warrants to' purchase additional bonds, warrants to buy bonds in different currencies, etc

FRNs Floating Rate Notes (FRNs) and their variants have been important innovations in the eurobonds markets in the recent past. In the case of FRNs, the funds are automatically rolled over every three to six months or so at adjusted interest rates, the new rates are typically set at a fixed margin above a mutually agreed upon interest rate (index) such as the London Interbank Offer Rate (LIBOR). The Capped FRNs, Mismatch Technique FRNs, **Collared Floalers**, (with a floor and cap to the interest rate payable), Inverse Coupon Floaters (in which case the applicable rate of interest is expressed as a given number, say, 12 per cent, less than the LIBOR), and the Perpetual FRNs are some of the variants of this instrument.

Foreign Bonds Foreign bonds are bonds floated in the domestic market and domestic currency by non-resident entities, they are often referred to as Yankee bonds (USA), Bulldog bonds (UK), Samurai bonds (Japan).

They are also bearer, unsecured bonds listed on domestic stock exchanges. They may be subscribed to by the domestic and overseas investors. Foreign Currency Convertible Bonds (FCCBs) are bonds subscribed to by non-residents in foreign currency they are equity-linked unsecured debt instruments carrying a fixed interest rate, and an option of conversion into a fixed number of equity shares or GDRs of the issuing company; Usually, they have a maturity of five years. They are issued with fixed exchange rate clauses, specifying the rates at which they would be converted; interest and principal on them are paid in foreign currency.

Note Issuance Facility Note Issuance Facility (NIF) is a funding arrangement which combines the features of a syndicated bank loan and a FRN issue. It aims at simultaneously satisfying the investor preference for short-term commitments, and the borrower need for medium-term funds.The user of NIF obtains medium-term (5 to 7 years) funding by offering short-term notes called euronotes directly to the investors, and rolling them over repeatedly In order to ensure the success of the roll over NIF has also been called as Revolving Underwriting Facility (RUF), or Short-term Note Issuance facility (SNIF) or Note Purchase Facility (NPF), or Euronote facility (ENF). The variants of NIF die the Traditional Note Issuance Facility described above, Underwritten Multiple Component Facility (UMCF), and Uncommitted Eurocommercial Paper Facility (UEPF) The UMCF enables the borrower to switch between different markets to take the advantage of the cheapest source of funds but by paying front and commitment charges UEPF is not tied to specific back-up lines, it is issued for flexible maturities of any duration from 7 to 365 days. The variants of the strategy for issuing euronotes are sole placing agent, multiple placing agents and tender panel system.

ECCDs Euro Currency Certificates of Deposits (ECCDs) are negotiable, bearer receipts for eurocurrency deposits which could be either fixed-rate or floating-rate deposits. Euro Commercial Paper (ECPs) areeuronotes which are not underwritten. The average maturity of ECPs is about 40 to 50 days, and they are actively traded in the secondary market.

Country Funds, ADRs, IDRs and GDRs Foreign equity investment can be obtained through country funds, FIls investment in the domestic stock market, and the primary issues of equity in markets abroad through the sale of straight equity or convertible bonds or bonds with warrants. The ‘straight equity issues are ma4e through American Depository Receipts (ADRs) International Depository Receipts (IDRs), and Global Depository Receipts (GDRs). ADRs are meant to facilitate public issues and trading in the US IDRs facilitate issues and trading in Europe GDRs are issued and traded in the euromarket as well as in the US. While both individual and institutional investors invest in ADRs only the latter buy GDRs While ADRs can be converted into shares and back into ADRs, GDRs once converted into shares cannot be converted back into GDRs The primary and secondary markets in GDRs are mainly in London and Luxemberg and most of the trading in them is OTC trading.

All the depository receipts including GDRs are essentially equity instruments created or issued abroad not by the companies but by the Overseas Depository Banks (ODBs), which are authorized by the companies in; say, India to issue them to non-resident investors against their shares. These shares are physically held by domestic custodian banks nominated or appointed by the ODBs. In the companies’ books, the ODBs’ names appear as the holders of their shares. The companies’ shares correspond to the GDRs in a fixed ratio, say I GDR = 10 shares.

The GDRs are bearer and negotiable securities; they can be redeemed at the price of the corresponding shares ruling on the date of redemption. They are traded on international markets. They are denominated, quoted, and traded in any freely convertible currency, mainly in US dollars. The shares underlying GDRs, however, are denominated only in the domestic currency (Ruppee).

The GDRs can be listed and traded on any of the overseas stock exchanges or OTCEs. They can be purchased, possessed and freely transferred by the non-residents among themselves. The ODBs get the dividends in the local currency from the company, and it distributes them to the holders of GDRs after converting them into dollars (foreign currencies) at the going exchange rate. While the dividends are taxable (at 10 per cent at source in India), the capital gains are not taxable.

The GDRs are exchangeable with underlying shares either at any time or after the Iapse of a particular time period. In India for example, an investor can cancel and convert GDRs into equity shares without any “lock-in period”, but after a “cooling period” of 45 days. The exchanged shares can then be traded on the local stock markets. The issue price of GDRs depends upon the market price of the underlying shares at the time of the issue. The services of the underwriters can he used for issuing GDRs. The settlements of trading in GDRs are done through the clearing organizations namely, CEDEL and EUROCLEAR.

GDRs facilitate greater awareness and enhanced image of the company in global markets. Their holders do not have the voting rights, and depositories usually relinquish their voting rights. However, once GDRs are cancelled and the underlying shares are released, the persons who come to hold those shares have the voting rights. This is said to be beneficial to the companies The Indian companies can issue GDRs only -as per the guidelines in force at different points of time.

The holders of GDRs are entitled to dividend bonus, and right issues, hut they cannot sell or pledge or transfer them to domestic residents (in India). The process of cancellation of GDR involves the following steps: The holder informs the about his intention and then cancels the GDRs. The depository then directs the custodian release underlying shares into the domestic market for sale on behalf of the nonresidents. The custodian then releases shares to the counterparty broker who sells them and remits the proceeds to the custodian, who remits them to the depository, who in his turn remits them to the non-residents.

4.0 CONCLUSION

International financial institutions (IFIs) are financial institutions that have been established (or chartered) by more than one country, and hence are subjects of international law. Their owners or shareholders are generally national governments, although other international institutions and other organizations occasionally figure as shareholders. Financial Instruments can be thought of as easily tradeable packages of capital, each having their own unique characteristics and structure.

5.0 SUMMARY

International financial institutions (IFIs) are financial institutions that have been established (or chartered) by more than one country, and hence are subjects of international law. The basic objective includes interpretation of international financial institution, its classification, and thorough explanations international financial instruments.

6.0 TUTOR-MARKED ASSIGNMENT

‘Discuss various international financial instruments?

7.0 REFERENCES/FURTHER READING

M L BHOLE: Financial Institutions and Market, Structure, Growth and Innovation. Fourth Edition: Tata McGraw-Hill Publishing Company Limited.
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UNIT 17: INTERNAL AND EXTERNAL DEBT

CONTENT

1.0 INTRODUCTION

The history of debt can be traced to some 5,000 years of human history. But it remains a serious and complex issue. Many wars have been fought over indebtedness. Nations and economies have been grounded on account of debts, while many companies are driven into bankruptcy due to poor handling of their debts. David Graeber, in his 2011 award-winning book Debt: The First 5,000 Years even argues that debt has often driven revolutions and social and political changes. The "Occupy" Wall Street uprising in the US recently may readily come to mind.

Borrowing money, accessing credit facilities and eventually being in debt are all part and parcel of the modern economy and way of living. It is as true of individuals as of nations. Borrowing in itself is not a problem when it enables individuals and nations to acquire what they desperately need without having to wait till they can save the amount. Borrowing only becomes an issue when people or nations take on too much or have trouble meeting their commitments or there is mismanagement of the borrowed funds due to personal indiscipline or corruption in high places at the national level. Therefore, what individuals and nations need is proper management of their debt profiles.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- give detail analysis on debt background
- explain the meaning of internal and external debt .
- explain importance of internal debt.
- consider the Overview of the Nigerian Debt Management Office

3.0 MAIN CONTENT

3.1 Internal debt

This is a class of national debt that has to do with the money owed by the government to lenders based in that same country. The debt encompasses any obligation that is taken on by any agency of the national government, including funds that are borrowed in lieu of printing additional currency. While many nations carry at least some internal debt, there is usually some effort to balance this portion of the overall country debt with obligations that are owed to lenders outside the nation.

Along with internal debt, countries are also likely to carry at least some external debt. This form of financial obligation encompasses any and all funds borrowed from lenders that are based outside the borders of the country. Debt of this type may be assumed in order to stabilize the economy within a nation, with the effort sometimes helping to protect the value of that nation's currency on the world market. Both internal and external debt may be taken on as a means of dealing with some sort of emerging economic crisis, such as rapidly growing inflation or a period of recession.

3.2 External debt

Debts contracted in foreign currency often mean that local interest rates are high. External debt also means that the borrower is in thrall to foreign powers, since foreign interest rates will directly affect the economy of the borrower. Internal borrowing means the country maintains more of its economic sovereignty. The distinction between internal and external debt is important only in the sense that the currency in which the debt is contracted is the main variable. Local currency is easier for local banks and governments to control than foreign currency.

3.3 Managing both external and internal debt

Managing both external and internal debt is something that is important to any nation. Typically, the idea is to retire certain debts as soon as possible, often before the actual settlement date for the obligation arrives. By structuring a viable debt management plan, governments can control the total amount of debt as well as retire certain obligations even as new debts are created. When managed properly, the turnaround on debt is such that the total national debt decreases over time without creating any type of hardship for the internal economy or any of its citizens.

3.4 Benefits of Internal Debt

There are benefits to utilizing internal debt versus simply printing more currency for the government to use. Taking into consideration some of the basics of macroeconomics, going with this strategy can often allow the government to at least partially avoid the increase in inflation that is more likely to occur when more money is printed and released into circulation. In addition, the internal debt incurred does not necessarily have to be used for the purchase of goods and services. One strategy is to borrow the money from private lenders as a means of creating securities that can in turn be purchased with the potential of a certain level of returns to investors. The government is then able to generate funds from the purchases and over time retire the debt while using this process to allow investors to stimulate the economy.

While there are positive aspects of carrying a certain amount of internal debt, nations tend to monitor the activity closely. Should the debt increase beyond a certain point, steps are usually taken to restore more of a balance between external and internal debt, usually by settling obligations and reducing the overall country debt. Doing so ultimately helps to keep the economy stable while also protecting the value of the nation’s currency on the open market. SELF ASSESSMENTS EXERCISE

What are the differences between internal and external debt
Discuss the benefits of internal debt.

3.5 Overview of the Nigerian Debt Management Office

However with the establishment of the DMO to centrally coordinate the management of the country’s debt a path to sanity, the path of professionalism and efficiency was being boldly taken. The functions DMO are clearly are spelt out in detail in Sections 6 and 7 of the DMO Act, 2003 (as recently amended). They include advising the Government on Terms and Conditions of Loans, Restructuring and Refinancing; maintaining a complete and accurate database of all FGN Borrowings (Domestic and External) including contingent liabilities (guarantees) and Preparing and submitting to the Government, annually, a forecast of debt service and borrowing capacity.

Other functions are efficient management of Nigeria’s Domestic and External Debt Stocks, including the financial and currency risks; managing relationships with local and international creditors and investors issue; issuing and managing FGN securities issued publicly and publishing Debt Data.

In order to achieve its mandate and objectives, the Debt Management Office (Establishment, etc) Act 2003, gives the Office a wide range of functions. These functions are provided for under Section 6 of the Act. These functions give us a glimpse into the activities of the DMO. The functions are as follows, to:

(a) maintain a reliable database of all loans taken or guaranteed by the Federal or State Governments or any of their agencies;

(b) prepare and submit to Federal Government a forecast of loan service obligations for each financial year;

(c) prepare and implement a plan for the efficient management of Nigeria's external and domestic debt obligations at sustainable levels compatible with desired economic activities for growth and development; and participate in negotiations aimed at realising those objectives;

(d) verify and service external debts guaranteed or directly taken by the Federal Government;

(e) on agency basis, service external debts taken by State Governments and any of their agencies: where such debts are guaranteed by the Federal Government;

(f) set guidelines for managing Federal Government financial risks and currency exposure with respect to all loans;

(g) advise the Federal Government on the re-structuring and re-financing of all debt obligations;

(h) advise the Minister on the terms and conditions on which monies, whether in the currency of Nigeria or in any other currency, are to be borrowed;

(i) submit to the Federal government, for consideration in the annual budget, a forecast of borrowing capacity in local and foreign currencies;

(j) prepare a schedule of any other Federal Government obligations such as trade debts and other contingent liabilities, both explicit and implicit, and provide advice on policies and procedures for their management;

(k) establish and maintain relationships with international and local financial institutions, creditors and institutional investors in Government debts;

(l) collect, collate, disseminate information, data and forecasts on debt management with the approval of the Board

(m) carry out such other function, which may be delegated to it by the Minister or by an Act of the National Assembly; and

(n) perform such other functions which in the opinion of the Office are required for the effective implementation of its functions under this Act.

In carrying out its function under Section 6 (1)(c) the DMO has designed and developed three strategic plans since its inception.

Already it has implemented the first two and it is currently riding on the wings of the third strategic plan which covers the period from 2013-2017. It also formulated the National Debt Management Framework which is meant to guide the policy and strategy for external borrowing by the Federal and States Governments.

When the DMO advises the Minister pursuant to section 6(1)(h), the Minister must comply with Sections 21(1) and 27(1) of the DMO before any loans can be taken. These sections have to do with laying the terms and conditions for borrowing before the National Assembly.

One function of the DMO (which is not contained in Section 6) is contained in Section 19 of the Act. The Section provides that:

The Office shall annually advise the Federal Government on the financing gap for the succeeding financial year and the amounts to be borrowed for bridging the gap both internally and externally.

The DMO should advise the Federal Government every year about the financial gap for the next year and also advise on how to bridge that gap from internal or external sources. This advice would ordinarily not extend to state governments' financing gap.

Achievements Of The DMO Since Inception

In the pre-DMO era, Nigeria had had to contend with a myriad of challenges in managing her debts and was plunged into a debt trap such that it was becoming practically impossible to source for credit from international creditors to meet the country's public sector funding requirements.

During its ten years of statutory existence, it has made some strides on the nation's debt profile.

The most remarkable to date is its engineering of Nigeria's exit from the Paris Club of creditor nations and the London Club of commercial creditors in 2006. This the office achieved working in tandem with the Minister of Finance.

The DMO, through its data gathering and dissemination activities have made information on Nigeria's debt profile more readily available. Unlike in the past, where even in the corridors of government there was no reliable data on the country's outstanding debts.

It is worthy of note, that other countries have established their own debt management institutions. For example, the UK has its DMO which is an agency under the UK Treasury Department. In the US there are a few but then the two main bodies are the Bureau of Public Debt and the Office of Debt Management. While the Bureau is responsible for obtaining the loans, the Office of the Debt Management is in charge of debt management policy and issuance of government related securities.

However, no modern nation can avoid incurring public debt. The free market economy that drives the world is a debt-based economy. True, in the past, debt was often issued to finance wars and other extraordinary events, but most recently Public Debts have been used for more peaceful ends, such as real investments, health care, education and communication systems and the establishment of a social security system.

Debt is an important component of fiscal policy of any country and, therefore, has implications for its economic growth and development. Governments of both emerging and developed economies will continue to borrow. And this will have implications for the future cash flows of Government Debt Service and on their domestic financial market. What is imperative is not a panic due to rising debt profile of domestic and foreign nature but a prudent debt management strategy to meet government's borrowing needs at minimal costs and a degree of risks in funding the nation's budget deficit in a non-inflationary manner, without recourse to monetary financing. All of these strategies have already found their proud place in Dr. Nwankwo's governance of the Nigeria's Debt Management Office.

4.0 CONCLUSION

While there are positive aspects of carrying a certain amount of internal debt, nations tend to monitor the activity closely. Should the debt increase beyond a certain point, steps are usually taken to restore more of a balance between external and internal debt, usually by settling obligations and reducing the overall country debt. Doing so ultimately helps to keep the economy stable while also protecting the value of the nation's currency on the open market.

The DMO is a very crucial body in Nigeria's economic fabric. If Nigeria is to achieve Vision 20:2020, the role of the DMO must remain strategic in that pursuit.

To reach its potential, the DMO must be given financial and operational autonomy. It should not be subject to the caprices of politicians. The DMO must ensure that it data provision is up-to-date and responsive. This is why the quality of its staff needs to be improved upon so that they could remain above board to discharge their duties within the legislative setup of the Office.

5.0SUMMARY

Borrowing in itself is not a problem when it enables individuals and nations to acquire what they desperately need without having to wait till they can save the amount. Borrowing only becomes an issue when people or nations take on too much or have trouble meeting their commitments or there is mismanagement of the borrowed funds due to personal indiscipline or corruption in high places at the national level. External debt means that the borrower is in thrall to foreign powers, since foreign interest rates will directly affect the economy of the borrower. The unit point on benefits of internal debt.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the achievements of the DMO since inception?

7.0 REFERENCES/FURTHER READING

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Nigeria's debt guardian February 14, 2014 | Filed under: The Executives | Author: Phillip Isakpa

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UNIT 18 DEBT FINANCING PORTFOLIOS

CONTENT

1.0 INTRODUCTION

Debt management thus plays an important part in today's world and there are various forms of investments that could be availed to help the individuals with the payment of these debts. An example could be furnished to substantiate what is being said. If a family or an individual takes a loan for any purpose from a certain bank it means that the party needs to pay the monthly installments for certain period of time. In order to pay the loans the party can take recourse to investing in options whose returns are tax free. The mutual funds are the types of investment option whose returns are not taxable.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- give meaning to debt management
- identify the debt portfolio benchmarks and targets .
- explain importance of portfolio benchmarking and principles for the benchmark.
- identifyingimportant risk related benchmark indicators.

3.0 MAIN CONTENT

3.1 Debt Portfolio

A debt portfolio is primarily a list of the financial necessities of a certain company. The investments in these cases are normally meant for longer periods of time. A debt portfolio also takes into account the inconsistencies in working capitals. Proper management is an important part of the debt portfolios. In the present world there are many people who have been taking loans of several kinds for a variety of purposes. This entails the payment of installments at certain points of time.

The various debt management companies have been providing exceptional service to people who need to manage their debt portfolios in a proper way. These companies normally focus on long term strategies to help their clients with debt portfolio management.

People have often employed loans, mortgages or re-mortgages as possible debt portfolio management options. On certain occasions the debt management companies also provide their clients with educational sessions on how to look after their debt portfolios.

By combining all the various liabilities into one, the debt portfolio management companies offer the clients the scope of cutting down on their payments. This makes it more convenient for the payer to plan the payments.

3.2 DEBT PORTFOLIO BENCHMARKS AND TARGETS

The aim of the debt management office is to manage sovereign debt in a manner that is consistent with key pre-determined objectives, designed to guard against any potential debt servicing difficulties. Although the primary objective of the debt management office has been to meet the ongoing financing needs of the Government, minimizing the cost of financing subject to an acceptable level of risk is also considered important in all debt management functions. The objectives of debt management also include developing efficient and deep markets in government securities, facilitating the domestic financing of Government.

In an attempt to manage costs and risks, the debt manager often uses benchmarks to guide the debt office towards achieving debt targets. Suitably identified benchmarks can also trigger early warning signals of potential debt servicing problems, and at the same time provide information to market participants regarding the consistency of national debt policy objectives and the ability to achieve medium and long-term macroeconomic stability. There exists, however, key trade-offs while implementing benchmarks for debt management and, therefore, the role of debt managers becomes an important determining factor in benchmark implementations.

3.3 IMPORTANCE OF PORTFOLIO BENCHMARKING

The importance of portfolio benchmarking: The design of portfolio benchmarks and targets is a significant component in the debt management function, which is supposed to assist in identifying risk tolerance levels and facilitate the following:

(i) Decision making on the composition of the debt portfolio with regards to various parameters, such as currency, maturity, interest rate, and instruments choice;

(ii) Active management of the debt portfolio by allowing the debt manager to make adjustments in response to changing market conditions;

(iii) Decisions regarding the use of risk management instruments such as financial derivatives;

(iv) Imposing significant discipline for the debt management officials; and

(v) Enhancing transparency and accountability in Government debt management.

SELF ASSESSMENTS EXERCISE

What are the various importance of portfolio benchmarking**.**
Discuss the role of debt management in Business environment.

3.4 PRINCIPLES FOR THE BENCHMARK

In defining portfolio benchmarks, the debt manager should have a thorough knowledge of the country's overall macroeconomic situation interfacing with the Government's debt management objectives.

While international benchmarks can serve as the starting point, country specific characteristics and interaction of macroeconomic variables in the given context become important considerations in setting portfolio benchmarks. The benchmarks and targets should limit risks and also provide the debt manager with a robust measurement of performance. For practical implementations and operational convenience, the benchmarks should have certain key attributes, as follows:

• First, the benchmark should be robust enough to act as a reliable measure of performance with as little as possible reliance on assumptions about the future economic and financial environment. Debt managers need to constantly review the selected benchmarks and targets in response to changing domestic and external environment.

• Second, the outcome of the benchmark implementation should be evaluated over the lifetime of the debt portfolio. Key benchmark indicators are subject to change in the short run from their desired levels due to temporary shocks. However if such deviation persist, a change in debt portfolio becomes imminent, for example, due to shifts in creditor composition or interest variations or changes in policy regime.

• Third, the benchmarks should provide the lowest cost to government for the chosen level of risk. The costs of maintaining benchmarks and the associated policy trade-offs should not outweigh the realizable benefits of the targeted portfolio selection.

• Fourth, to the extent possible the benchmarks should be simple, transparent and highly achievable. Selection of benchmarks based on such criteria as optimality or efficiency might appear technically sound, but would lack practical implementation, particularly in small country environment that are characterized by market inefficiency.

• Fifth, the benchmark must be achievable over the desired time as otherwise very optimistic targets can jeopardize the credibility of the debt.

3.5 Framework for Portfolio Benchmarks

Framework for Portfolio Benchmarks Drawing from the international best practices, the following broad areas can be suggested for undertaking the debt portfolio benchmarks and establishing targets:

a) **Sustainability Benchmarks** One of the key aspects of benchmarking is to ensure that the level of debt is sustainablein the medium run. Although debt sustainability has been defined in several ways, two simple definitions are as follows: economic debt sustainability, which means that the debt service does not inhibit growth and the overall economic policy, and, financial debt sustainability, which means that a country is able to service its outstanding level of debt.

A wide range of quantitative indicators could be used to assess both economic as well as financial debt sustainability: stocks versus flows (debt service) for the numerator, and GDP, exports, and fiscal revenues for the denominator. In addition, public domestic debt should be taken into account because in countries with high public domestic debt, this is a factor that significantly affects sustainability of budget balance. Similarly, private sector debt should be given consideration if it also plays an important role. The Asian financial crisis of 1997 indicated that a high level of private debt can also accentuate debt servicing problems, with defaults by such entities and creating moral hazard problems for the system.

It is therefore prudent for the debt office to identify a set of benchmarks or targets which would ensure debt sustainability in the medium run, keeping in view the macroeconomic targets. In broader terms this would imply that the level of debt at any point of time is consistent with the overall macroeconomic targets such as maintaining stable debt-to- GDP ratio, by promoting investments and growth, and maintaining external viability.

Although there is no rule of thumb that would determine the thresholds for debt sustainability, this can be measured and assessed simultaneously using a set of ratios such as follows:

Debt Service Ratio: In terms of sustainability indicators, the ratio of debt service payments (principal and interest service) to the value of exports of goods and services indicates how much Interest Service ratio: Ratio of interest payments to earning in exports of goods and services indicates the terms of external debt burden. It also indicates how much the current earnings are needed in order that the debtor remains current in servicing debt.

External Debt/Exports: External debt to exports (of goods and services) ratio can be measured as an indicator of sustainability, since an increasing debt to exports ratio indicates that the country may have problems meeting its obligations in future.

External Debt/GDP: The ratio of total outstanding external debt to national income, which provides an indication of the potential to service external debt, by switching resources from production of domestic goods to the production of exports.

NPV of Debt/Exports: Net Present Values (NPV) of debt to current exports compares the debt burden with repayment capacity.

A number of emerging and developing country governments attempt to maintain the aggregate debt target ratio below 50 percent of GDP in the medium run. This includes both external as well as domestic debt. Under the HIPC Initiative key indicators of external debt sustainability have included the Net Present Value (NPV) of debt-export ratio, which should be below 150%; or the NPV of debt-to-fiscal revenue ratio which should be below 250%. Under this scheme, a country's debt level is considered unsustainable if debt-to-export levels are above a fixed ratio of 150 percent; or, countries that have very open economies where the exclusive reliance on external indicators may not adequately reflect the fiscal burden of external debt, the debt-to-government revenues above of 250 percent are considered unsustainable. The debt-to-government revenues would represent a country’s capacity to repay if the exports were on the private accounts, and this way it implied that the debt service relevant to social spending by considering relationship with the total government revenues.

It is to be recognized here that the indicators of sustainability over time would depend upon the interaction of several important variables such as economic growth, development in the country's external sector, as well as the way the current account deficits are being financed. The later raises important issues as regards the sources of external finance, whether from multilateral or bilateral sources, or such other forms of external inflows as portfolio flows, other invisibles from tourism or remittances, or from non-debt creating flows such as foreign investments.

B) Liquidity Benchmarks:

Even though the debt indicators may portray a sustainable trend there are times when these would be under stress, primarily affected by short term liquidity factors. Temporary liquidity problems can intensify debt servicing difficulties, which can be triggered by factors such as a sharp drop in export earnings, increase in international interest rates, appreciation of the loan currency or increase in prices of imports such as oil. Some of the liquidity specific benchmarks can be identified as follows:

Reserves/Imports: The ratio of foreign exchange reserves to imports serves as an important indicator of liquidity, requiring that a country should maintain at least reserves to cover at least 3 months of imports. Depending on the type of exchange rate regimes and controls the reserve requirements can be quite large.

Short Term Debt/Reserves: This ratio assesses the vulnerability to liquidity situation in the event of capital flight or repayments on account of short term debt or due to such other forms of speculative capital outflows.

Interest Payments/Reserves: Measures the interest payments on all external debt which could be covered by usable reserves. Short Term Debt/Total Debt: The ratio of short term external debt (all debt with residual maturity of less than a year) in total external financing measures the extent of vulnerability in the event of liquidity crisis.

The structure of debt as regards its composition (official versus private), maturity (short versus long term), and the degree of concessionality (grant elements), and interest rates (fixed versus floating) are considered as important indicators affecting liquidity. The recent financial crises in Mexico (1994), Southeast Asia (1997) and Russia (1998) brought to the forefront situations of liquidity problems as the governments of these economies were forced to refinance maturing short term foreign currency denominated debt under severely deteriorating economic conditions (with higher interest rates, depreciated domestic currencies, and fiscal vulnerability). Maintenance of a set of liquidity specific indicators at their desired level would prevent governments from fiscal vulnerability in response to shocks.

c) Fiscal Benchmarks:

High debt level, both domestic as well as external, typically causes concern to Governments as there occurs shifts in resources away from development towards debt servicing. High level of domestic debt in particular can contribute to fiscal vulnerability in the medium run. Policy makers need to monitor certain fiscal indicators of debt vulnerability such as follows:

Debt service/Fiscal Revenue: This ratio serves as an indicator of how much budgetary resources are utilized for government debt servicing, on account of external as well as domestic.

NPV of Debt/Fiscal Revenue: This ratio measures the debt servicing obligations in relations to government revenues, which actually affects social spending.

The debt management office should consider the fiscal strategies of the government while designing portfolio benchmarks and setting debt targets. For instance, during a period of budget deficits, the primary consideration is making government securities more attractive to potential investors and deciding whether to introduce new instruments. On the other hand, during a period of budget surpluses, governments may decide to decrease the level of debt which would reduce the availability of established benchmarks.

Similarly a given budgetary target such as a cap on debt-to-GDP ratio would limit flexibility to benchmark selection. It is in this context the importance to maintain the debt market to facilitate potentially higher levels of government borrowings in the future is being recognized.

In some situations, trade-offs between minimizing financing costs and supporting domestic markets may become more apparent. Governments at times aiming at lowering of the annual budget costs of debt servicing or its volatility might concentrate on specific maturity sector of the bond markets. Thus shortening of the maturity under a steeply rising yield curve although may reduce interest costs in the short run, it might increase refinancing risk eventually, or the lengthening of maturity would create bunching of debt serving in the future if the debt manager does not create a smooth redemption profile.

Similarly, diversification to foreign borrowing in a low interest currency to achieve lower interest cost may increase currency risks. It is therefore necessary for the debt manager to recognize that portfolio benchmarks and debt targets would depend jointly on a set of variables such as fiscal position, debt management objectives, government risk preferences and debt market conditions.

d) Aggregate Portfolio Benchmark

One way of looking at the aggregate debt portfolio is in terms of its composition as regards external and domestic debt. A higher level of external debt is understood to have a higher risk element in the debt portfolio, as well as remaining susceptible to exogenous factors. A higher composition of external debt in the aggregate debt portfolio can exacerbate the impact of uncertain exogenous factors, such as volatility of exchange rates and interest rates. Therefore, governments need to maintain an optimal composition of domestic and external debt in the aggregate debt portfolio. Two indicators can be considered relevant in this context:

Portfolio Duration: Setting an appropriate duration of debt portfolio in order that the portfolio is neutral to the changes in interest rates.

Domestic Debt/Total Debt: This ratio measures the dependency on external borrowings for development. There should a fare balance between securing long term financing from external sources and domestic securities markets.

The aim of debt management strategy should be to attain an optimum maturity structure of the debt portfolio, as the exposure to changes in interest rates inherent in the maturity profile of the debt stock can impact debt costs. Typically the target debt structure should not be based on a particular interest rate outlook, rather be based on an overall strategy to achieve an optimum duration of the portfolio, with an appropriate mix of short term treasury bills and medium to long term bonds. Government should structure the debt portfolio to provide reasonable cost stability under a range of potential interest rate environment and achieve a balanced maturity profile.

There is no single optimal solution to the government financing mix, as regards domestic versus external sources. It would depend on the availability of financing alternatives at any given time, the depth of the government securities market, and the country's creditworthiness and accessibility in international markets.

e) Risk Management Benchmarks

An important aspect of debt management function is concerned with the identification as well as management of risks in a debt portfolio. In a world of floating exchange rates and interest rates, the debt servicing costs fluctuate significantly due to fluctuations in market prices. Exchange risk arises not only due to the changes in local currency against the loan currency, but also due to cross-currency movements in the global markets. The later can have significant impact on debt servicing; for instance, the appreciation of the Japanese yen against the US dollar can cause a rise in the dollar value of the external debt contracted in Japanese yen. The risk would be accentuated when debt is contracted at variable interest rates, such as LIBOR based loans. Debt contracted at variable interest rates is subject to risk as market interest rates rise, or debt contracted at fixed interest rates can have risk in the presence of substantial decline in market rates. The portion of debt contracted at variable interest rates should be controlled, and its exposure to rising interest rates be monitored and managed.

Three important risk related benchmark indicators can be suggested:

Budgeted Debt Service/Actual: This ratio measures the risk of public debt portfolio on a cash flow basis, in terms of its impact on the actual debt service as against the budgeted debt service.
Floating rate debt/Total Debt: Measures the component of debt that is affected by a rise in market interest rates, particularly for foreign currency loans with floating rates.
Risk Tolerance Level: This type of risk is being measured in a forward looking framework, in terms of the potential absorptive capacity of the government of the increase in future debt servicing, that are due to changes in the underlying variables such as exchange rates and interest rates.

The currency and interest rate composition of debt as well as its maturity structure are important determinants of risk in a debt portfolio. For example, a typical benchmark would specify the currency composition of the debt, and for each currency, the duration, the proportion of fixed and floating rate instruments and the types of instruments (bank loans versus bonds). It is in this context benchmarking government debt to some optimum currency portfolio (resembling the currency composition of reserves and exports earnings) or an international interest rate benchmark (which may be some kind of weighted average interest rate, OECD consensus rate or the World Bank lending rate) should be considered important.

Debt management policy should lay emphasis on stabilizing the debt service costs, by maintaining an optimal combination of fixed/floating rate debt as well as maintaining an optimal currency composition of debt portfolio. The examples of Columbia and New Zealand given below provide indications of how currency and interest rate benchmarks are selected, with differing compositions of debt portfolio. Periodic review of external debt portfolio should be undertaken, in response to major swings in exchange rates and interest rates, thereby identifying expensive foreign currency debt and undertaking risk management strategies. Debt managers should also take advantage of the favorable exchange rate and interest rate environment, and negotiate with the lenders for their prepayment, with due consideration to the penalty of such actions. It needs to be noted here that the risk related benchmarks have to be determined given the risk tolerance for the Government. It would depend on how much volatility that the Government financial position can sustain without jeopardizing the budget targets and macroeconomic policies.

4.0 CONCLUSION

In concluding, it is necessary to realize that the indicators as explained in this paper need to be assessed simultaneously with due consideration of their interactions. While setting portfolio benchmarks and targets, it is necessary to recognize the environment within which the debt management function is undertaken, considering the country specific factors such as the borrowing history, sovereign ratings, and development of the financial sector, monetary conditions and the climate of external resources. The selection of optimum debt portfolio benchmarks and debt targets require careful analysis of several macroeconomic variables. The debt management function needs not only to focus on the long run outcome of its policy targets on the macroeconomic variables, and but also at the same time minimizing any short run difficulties in debt servicing.

The debt managers should also recognize that there exists significant trade-offs in setting portfolio benchmarks, which constrain their ability to conduct effective debt management. Also important is the existing framework of debt management supporting the effectiveness and credibility of policy strategies. The quality of institutions and the transparency of governance system also matter much in managing debt and ensuring its sustainability. Benchmark indicators can serve merely as the early warning signals, and solutions would require undertaking suitable macroeconomic policies or responding proactively to changes in financial environment. The ratios and targets provided in the paper are merely indicative, which are expected to serve as medium term indicators of debt management functions, and that they should be constantly reviewed with changing situations.

5.0 SUMMARY

The selection of optimum debt portfolio benchmarks and debt targets require careful analysis of several macroeconomic variables. The debt management function needs not only to focus on the long run outcome of its policy targets on the macroeconomic variables, and but also at the same time minimizing any short run difficulties in debt servicing. The unit had considered scope behind debt portfolio management. The next unit shall focused further explanations on internal and external debt.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the principles for debt benchmark?

7.0 REFERENCES/FURTHER READING

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UNIT 19 THEORY AND PRACTICE OF DEVALUATION

CONTENTS

1.0 INTRODUCTION

Currency devaluation is one of the most dramatic-even traumatic-measures of economic policy that a government may undertake. It almost always generates cries of outrage and calls for the responsible officials to resign. For these reasons alone, governments are reluctant to devalue their currencies. Yet under the present rules of the international monetary system, laid down in the Articles of Agreement of the International Monetary Fund, devaluation is encouraged whenever a country's international payments position is in "fundamental disequilibrium," whether that disequilibrium is brought about by factors outside the country or by indigenous developments. Because of the associated trauma, which arises because so many economic adjustments to a discrete change in the exchange rate are crowded into a relatively short period, currency devaluation has come to be regarded as a measure of last resort, with countless partial substitutes adopted before devaluation is finally undertaken.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Define Devaluation
- Discuss the three Approaches to the Analysis of Devaluation theory
- State the different Types of Devaluation Packages
- Discuss the effect of devaluation in developing economies
- State the Consequences of Devaluation

3.0 MAIN CONTENT

3.1 What is Devaluation?

Devaluation is the process whereby the government /monetary authority deliberately reduces the foreign exchange value of the national currency. Devaluation and Depreciation are often used interchangeably in that both refer to a reduction in the foreign exchange value of a national currency. However there exists a difference between the two concepts. Devaluation refers to the official reduction of the external values of a currency while depreciation means an automatic fall in the external value of the currency by the market forces. The difference between devaluation and depreciation is that while devaluation means the lowering of external value of a currency by the government, depreciation means an automatic fall in the external value of the currency by the market forces. The former is arbitrary and the latter is the result of market mechanism. Thus, devaluation serves only as an alternative method to depreciation.

By convention, changes in the value of a currency are measured against the American dollar, so a devaluation means a reduction in the dollar price of a unit of foreign currency or, what is the same thing, an increase in the number of units of the foreign currency that can be purchased for a dollar.

3.2 The Theory of Devaluation

In analyzing devaluation, the exact nature of the initial disequilibrium is important, and, much analysis misleads by its focus on economies are assumed to be in equilibrium at the moment of devaluation. To set the stage precisely, suppose we have a country which for reasons past has money costs that are too high to permit it to balance its international payments at a level of domestic economic activity that is both desired and sustainable, and as a result it must finance a continuing payment deficit out of its reserves, a process that obviously cannot continue indefinitely. Thus by assumption we are not dealing with a case in which domestic demand is pressing against productive capacity to an extent that is regarded as undesirable ("inflationary"), although under the circumstances domestic expenditure does exceed domestic output, a necessity to maintain full employment. Correction of the payments imbalance by reducing aggregate demand (the rate of money spending) would lead to unwanted unemployment because of the rigidity of factors incomes in money terms, especially wages. Perhaps ultimately the pressure on costs and prices of a 'depression in activity would restore an equilibrium level of costs and prices that would lead to payments balance at full employment, but the transitional depression might have to be long and painful. The recommended alternative is devaluation of the currency, which at the stroke of a pen lowers the country's costs and prices when measured in foreign currency. Analysis of the effects of devaluation on the country's economy and of the mechanism whereby it eliminates the payments deficit has proceeded under three quite different and apparently contrasting approaches: the elasticities approach, the absorption approach, and the monetary approach.

3.3 Three Approaches to Analysis of Devaluation theory

3.3.1 The Elasticities Approach Focuses

The elasticities approach focuses on the substitution among commodities, both in consumption and in production, induced by the relative price changes wrought by the devaluation. For an open economy such as the one we are considering here, the principal relative-price change is between goods, whether imported or exported, whose price is strongly influenced by conditions in the world market, and those home goods and services that are not readily traded. For a small country, we can assume that the prices in domestic currency of foreign-trade goods-exports, imports, and goods in close competition with imports-will rise by the amount of devaluation (the larger of the two percentages mentioned above is the relevant one here). This rise will divert purchases out of existing income to nontraded goods and services, thereby reducing domestic demand for imports and for export goods, releasing the latter for sale abroad. When the country is large enough to influence world prices, domestic prices may rise by less than the amount of the devaluation, since prices in foreign currency will fall somewhat in response to the reduction in our country's demand for imports or to the increase in its supply of exports. There is some presumption that most countries will have a greater influence on their export prices than on the prices at which they import, so the rise in local prices of exports will be less, and the terms of trade will deteriorate.

i. The shift in relative prices operates both on consumption and on production. Consumption will be diverted to lower-priced non traded goods and services, releasing some existing output for export and cutting demand for imports. At the same time, increased profitability in the foreign-trade sector, arising from the fact that prices in domestic currency have risen more than domestic costs, will stimulate new production of export and import-competing goods, and will draw resources into these industries. If excess capacity happens to exist in these industries, the resources drawn in will be variable ones-labor and materials otherwise new investment will be required; in agriculture, land may have to be re-cropped or herds rebuilt.

ii. The elasticities approach gives rise to the celebrated Marshall-Lerner condition for an improvement in the trade balance following a devaluation: that the elasticity of demand for imports plus the foreign elasticity of demand for the country's exports must exceed unity, which is to say that the change in the quantity of imports and exports demanded together must be sufficiently great to offset the loss in foreign earnings consequent upon lowering the price of exports in foreign currency. This condition assumes initially balanced trade, finished goods, and elastic supply of exports both at home and broad, but may be modified to allow for initial trade imbalance, for less than perfectly elastic supplies of export, and for intermediate products.

3.3.2 The Absorption Approach Shifts

The absorption approach shifts attention from individual sectors to the overall economy. Its basic proposition is that any improvement in the balance on goods and services must, in logic, require some increase in the gap between total output and total domestic expenditure. It starts from the identity $E \pm X = Y \pm M$, where E is total domestic expenditure on goods and services and X is total foreign expenditure on our country's goods and services (exports), the sum of the two representing total "absorption" of the goods and services available to the country, which derive from its own aggregate output, Y, and imports from the rest of the world, M. Rearranging the terms yields $X-M = Y-E$, which shows that any trade surplus reflects an excess of output over domestic expenditure, and vice versa for a deficit It follows that to reduce a deficit requires a corresponding reduction in the gap between output and expenditure. Excess capacity and unemployment will permit an increase in output; otherwise expenditure must be reduced. Without such a reduction, there can be no improvement in the balance, regardless of the elasticities. This analysis points to the policy prescription that devaluation must be accompanied by deflationary monetary and fiscal policy to "make room" for improvement in the balance, a prescription to which we shall return below.

3.3.3 The Monetary Approach to Devaluation

The monetary approach to devaluation & cases on the demand for money balances and the fact that an excess demand for goods, services and securities, resulting in a payments deficit, reflects an excess supply of money. It draws attention to the analytical parallel between a devaluation and a reduction in the supply of money that affects all holders in equal proportion. Devaluation is equivalent to a decline in the money supply and in the value of other financial assets denominated in local currency, when measured in foreign currency. Put another way, the real value' of the-money supply -will be reduced by devaluation, because the local prices of traded goods and services, and, secondarily, those of non-traded goods and services to which demand is diverted, will rise. The public will accordingly reduce its spending in order to restore the real value of its holdings of money and other financial assets, which reduction in expenditure will produce the required improvement in the balance of payments. For a country in initial deficit, the right devaluation will achieve just the right reduction in the real value of the money supply, and the deficit will cease. To restore lost reserves the country must devalue by more than that amount, in order to achieve a surplus. But once the public has reattained its desired financial holdings, expenditure will rise again and the new surplus will be eliminated. On this view, a devaluation beyond the equilibrium point has only a once-for-all effect. A key implication of this approach is that if the monetary authorities expand domestic credit following devaluation to satisfy the new demand for money, the effects of the devaluation on international payments will be undermined. (The money supply may of course increase in response to the inflow of reserves; indeed, if it does not, the surplus will continue until some other country takes steps to curtail it).

3.4 Interrelatedness of the Approaches

These three approaches are complementary rather than competitive-they represent different ways of looking at the same phenomenon, and each has its strengths and weaknesses. The first has its roots in Marshallian, partial-equilibrium analysis, and is most suitable when the foreign-trade sector-like Marshall's strawberry market-is small relative to the total economy, or when there are ample unemployed resources-and even in the latter case it offers only a part of the story. The absorption approach is “Keynesian” in its focus on total output and expenditure, not differentiating among sectors and neglecting monetary effects. But it draws attention to the impact of changes in exchange rates on overall income and expenditure, which the elasticities approach fails to do. The third approach is the international counterpart of the revived monetary school of thought propagated by the Chicago-London School of Economics, but its intellectual roots go back to David Hume, where stock adjustments in the real value of money balances were all important.

It is tempting to think of these three approaches in temporal sequence, with the first stage of the elasticity approach representing the short run, the absorption (income-expenditure) approach applying to the medium run,, and the monetary approach applying to the long run, on the grounds that asset portfolios take a long time to adjust following a major dislocation. But this would oversimplify the matter. All factors are present to some degree even immediately following devaluation.

3.5 Type of Devaluation Packages

1. Straight devaluation involving a discrete change m e principal exchange rate, as opposed to a freely depreciating rate or an administered "slide" in the rate, such as was adopted by Brazil, Chile, and Colombia in the late sixties, whereby the rate was depredated by a small amount every two to eight weeks.
2. devaluation with a stabilization program of contractionary monetary and fiscal policy aimed at reducing the level aggregate demand, or at least the rate of increase of demand.
3. devaluation accompanied by liberalization, whereby imports and other international payments that were previously prohibited or subject to quota are allowed to take place under much less restraint than before the devaluation.
4. devaluation accompanied by partial or full unification of exchange rates, whereby a pre-existing diversity of exchange rates is collapsed into a single, unified rate, or at most two rates, the lower one applying to traditional exports of primary products and in effect amounting to a tax on these exports.

It is obvious that these categories are not mutually exclusive. Devaluation may involve simultaneously a stabilization program, liberalization and exchange-rate unification, and in fact at least some elements of often resent in developing countries.

3.6 Effect of Devaluation in Developing Countries

The external sector, however, is only one component of demand. It is necessary also to ask how devaluation may after the level of total domestic expenditure, E. Refined analysis is necessary to discuss the possible effects satisfactorily, but here it will be sufficient.

Speculative effect: There is first the speculative effect, which is also important in devaluations from open deficits. If devaluation has been anticipated and is expected to lead to a general increase in prices there will be anticipatory buying before the devaluation and the post-devaluation period will therefore commence with larger-than-usual holdings of goods. Total expenditure by the public may therefore drop in the period immediately following devaluation, until these inventories are worked off. (This effect would also lead to a rise in imports before and a drop after the devaluation, insofar as this is permitted by the system of licensing or other controls.) While the speculative effect will normally lead to a drop in expenditure, however, it may lead to an increase if the price increases following devaluation are expected to lead to general inflation, or if another devaluation is in prospect, as it did immediately following Britain's devaluation in 1967.

Distributive effect: Devaluation will generally lead to a redistribution of income, and-this distributive effect, while present for any devaluation, is likely to be especially important in developing countries with heavy reliance on primary products for export. Unless checked by special export taxes, a devaluation will lead to a sharp increase in rewards to those in the export industry, who are often landowners. Whether large or small, landowners are likely to have different saving and consumption patterns from urban dwellers, generally saving more out of marginal changes in income, at least in the short run. Thus, a redistribution of real income from workers to businessmen and from urban to rural dwellers is likely, in the first instance, to lead to a drop in total expenditure out of a given aggregate income, and this drop will be deflationary. But of course the redistributional effect could also go the other way, if as a result of devaluation the real income of those with a low marginal propensity to save is increased at the expense of others. The redistributional effect will also affect the level of imports out of a given total income, since consumption pattern of those who gain may differ from that of losers. But this effect is likely to be less marked than the total expenditure effect, partly because much of the import bill of developing countries represents inputs into domestically produced goods and services, so they are somewhat more widely diffused throughout the economy than would be the case for direct imports of manufactured consumer goods. Diaz-Alejandro has documented well the dominating importance of the redistributive effect following the Argentine devaluation of 1959, where the shift of income to the landowners led to a sharp drop in domestic spending and therefore to a secondary drop in imports.

External debt service effect: Devaluation will lead to a rise in the domestic costs of servicing external debt denominated in foreign currency. Where the liabilities are those of businessmen who do not benefit much from the devaluation, it may lead to bankruptcy and an attendant decline in business activity, even when businesses are otherwise sound. This factor allegedly figured in the decline in investment following the Argentine devaluation of 1962. Even where the debt is held officially, the problem of raising the local currency counterpart of external servicing charges often poses a serious problem, and sometimes represents a serious inhibition to devaluation.

Domestic credit squeeze : When the balance of goods and services has turned adverse in terms of domestic currency-as we have seen above may frequently be expected-then in the absence of countervailing monetary action a domestic credit squeeze may result, since importers and others will be paying more into the central bank for foreign exchange than exporters are receiving. This in turn may lead to a reduction in domestic expenditure.

Domestic and foreign investment effect: On the other hand, the improved earning opportunities in the export industries may (if they are expected to last) induce both domestic and foreign investment in the country. Foreign investors bring their funds with them, as it were, and increase local credit by converting foreign exchange into domestic currency at the central bank. Domestic investors must either activate idle balances or find banks willing and able to lend, in the second instance leading to domestic credit expansion.

Of course, the incentives to invest in import-competing industries will be reduced by the devaluation (in sharp contrast to the case of devaluation from a position of open deficit, where they will be stimulated by devaluation); but the stimulus to investment may on balance be positive, partly because there are limits to the rate at which disinvestment can take place. For reasons given earlier, however, the extent of new investment will depend on expectations about the durability of the new regime, and investors may wait awhile to see how things are going.

Money-demand effect: In the monetary approach to devaluation from an open deficit, attention was drawn to the reduction in the real value of money holdings and reliance was placed on a desire to reconstitute these holdings to reduce expenditure. In the case of devaluation from a suppressed deficit, however, this money-demand effect is more complicated, and may not be present at all. If devaluation simply displaces other instruments of policy, with no effect on domestic prices, the real value of money balances will not be altered. If, as is more typically the case, devaluation displaces some other limits on imports but raises the local prices of exports, the effect on the real value of money holdings will depend upon the importance of export products in local expenditure. When export products are extensively purchased by residents, the monetary effect will tend to reduce domestic spending. Import liberalization, on the other hand, cuts the other way insofar as import prices actually fall. Moreover, in the long run another factor comes into play: to the extent that devaluation displaces measures that led to a less efficient use of resources, the devaluation package will lead (after the necessary reallocation of resources has taken place) to an increase in real income, and this in turn will require a supporting increase in money holdings. Unless it is supplied by the monetary authorities, this demand will depress expenditure relative to potential income.

3.7 Consequences of Devaluation

(1) Devaluation, it is feared, will not achieve the desired improvement in the balance of payments, because neither imports nor exports are sufficiently sensitive to relative price changes within the acceptable range of such changes-in a phrase, elasticity pessimism.

(2) Devaluation will worsen the terms of trade of the country and thus will impose real costs on it.

(3) By raising domestic prices, devaluation will set in motion a wage-price spiral that will rapidly undercut the improved competitiveness that the devaluation is designed to achieve.

(4) Whatever its economic effects, it is thought that devaluation will be politically disastrous for those officials responsible for it.

4.0 CONCLUSION

The upshot of these various considerations is that devaluation in developing countries is likely to be deflationary in the first instance, and thus may "make room" for any improvement in the balance on goods and services, without active reinforcement from monetary and fiscal policy. Indeed, for reasons given below, it may sometimes be desirable to accompany devaluation with modestly expansionary policies.

5.0 SUMMARY

In this unit, you have learnt the meaning of Devaluation and how it differs from the concept of Depreciation, the three Approaches to the Analysis of Devaluation theory, the different types of Devaluation Packages, the effect of devaluation in developing economies as well as the consequences of Devaluation

6.0 TUTOR-MARKED ASSIGNMENT

- What do you understand by the concept of Devaluation?
- State five effects of devaluation on developing economies

7.0 REFERENCES/FURTHER READINGS

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UNIT 20 FOREIGN DIRECT INVESTMENT AND PORTFOLIO

CONTENTS

1.0 INTRODUCTION

This unit explores the meaning of Foreign Direct Investment and portfolio, the theories of Foreign direct investment, their benefits , the relationships between portfolio and direct investment, and their differences under the assumption that the difference between the two is whether the investor has control over the investment, or not. It will also look at the benefits of each type of investment: how those benefits differ and how they are complementary.

2.0 OBJECTIVES

At the end of this unit, you should be able to discuss the following

- The meaning of Foreign Direct Investment
- State clearly how Foreign Direct Investment differs from Foreign portfolio investment
- Discuss the theories of Foreign Direct Investments

- Discuss the benefits of both foreign direct investment and Foreign portfolio investment to the host country

3.0 MAIN CONTENT

3.1 Meaning of Foreign Direct Investment(FDI)

Foreign Direct Investment (FDI) is an investment that is made to acquire a lasting management interest (usually 10% of voting stock) in an enterprise and operated in a country other than that of the investors. According to the IMF and OECD definitions, Foreign Direct Investment reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise). The “lasting interest” implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter. Direct investment involves both the initial transaction establishing the relationship between the investor and the enterprise and all subsequent capital transactions between them and among affiliated enterprises both incorporated and unincorporated.

Foreign Direct Investment (FDI) is the category of international investment in which a resident entity in one country obtains a lasting interest in an enterprise resident in another country. A lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. The criteria used to distinguish direct investment from other types of investment is that “a direct investment is established when a resident in one economy owns 10 percent or more of the ordinary shares or voting power, for an incorporated enterprise, or the equivalent, for an unincorporated enterprise”.

All subsequent transactions between affiliated enterprises, both incorporated and unincorporated, are also classified as direct investment transactions. Direct investment is divided into equity capital, reinvested earnings, and other capital. Equity capital comprises equity in branches, all shares in subsidiaries and associates (except non participating, preferred shares that are treated as debt securities), and other capital contributions. Reverse investment or cross-participation transactions are recorded as direct investment claims and liabilities. Reinvested earnings consist of the direct investor’s share of earnings not distributed as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor. Other direct investment capital (or intercompany debt transactions) covers the borrowing and lending of funds between direct investors and subsidiaries, branches, and associates.

3.2 Objectives of Foreign Direct Investment (FDI)

The major objective of FDI is to provide the investing company the opportunity to actively manage and control the host nation's activities.
The following are the identified reasons for FDI

- Increase sales and profit: most of the largest and best-known multinationals earn millions of dollars each year through overseas sales, for example General Electric a US MNE held $448.9 billion dollars in foreign assets in 2010 (World Investment Report 2011). Small and medium scale enterprises (SMEs) also benefit from the growth of operation of large MNEs in the aspect of local suppliers; if their productivity is high there is a possibility that the MNE will extend the contract and allow them supply other world-wide locations. SMEs are interested in FDI because it helps them increase their sales and profits.

- Reduction in Cost: An MNE can achieve lower cost of production by going abroad to operate than by producing in its home country. Some cost to be considered are; transportation cost, cost of energy, access to raw materials and labour cost. However some critics argued that this can have an adverse effect as the case of US top sport brand NIKE in 1992, their business model was to outsource all manufacturing to low cost areas in the world such as Indonesia which had a labour cost of 4% of those prevailing in US and re-invest the money saved into R&D and marketing. Nike was accused of using child labourers, sexually abusing female workers and also unreasonable working hours for their workers. This had a dent on their public image and in 1999 they recorded a sales loss of $67.7 million (Barboza 2006).

- Protect domestic markets: a major reason the domestic market. Some MNEs enter international markets in order to bout out potential competitors and thus prevent them from expanding their operations overseas. For example, Airtel Nigeria overtook Glo Mobile as the second largest player in the mobile market after its rebranding exercise in 2008.

- To enter emerging markets: some foreign economies have a faster economic growth pace than others and FDI provides MNCs a possibility to take advantage of this opportunity.

3.3 Theories of Foreign Direct Investment

The theories are classified into three as discussed below:

The Dependency School did not believe on assumption that FDI is vital for the economic growth of developing countries. The theory posits that FDI strangulate development by displacement of indigenous production and perpetuates dominance of the weaker countries by keeping them in a position of constant dependence on the economies of the developed countries. The dependency school sees the cause of underdevelopment primarily in the exploitation by the industrialized nations. The school focuses on the consequences of FDI in developing countries and its critical analysis of western development paradigms that regard FDI as explicitly positive.

The Modernization School: The modernization school is reflected in the perfect market approach as represented by the neoclassical theories. This school of thought proclaims that there is a natural order through which countries ascend to what is seen as developmental stages. The theorists recommend barriers to exogenously motivated development through industrialization, liberalization, and opening up of their economy. Their ability to overcome these barriers will depend on how endowed the country is with production factors such as labour, capital, and natural resources. The modernization school views foreign direct investment as a prerequisite and catalyst for economic growth and development of the host countries.

Integrative School calls for mixture of both the dependency and modernization theories. It cautions against too much openness and too much regulation or intervention. The integrative school is represented by the diverse FDI and negotiation paradigm and its attempts to transform the thinking of FDI by analyzing it from the perspectives of host countries as well as investors. An integrative FDI considers both micro and macro economic variables. The macro-level envelops the entire economy while micro level denotes firms and institutions that link the two. What distinguishes the integrative theory from its predecessors is that it accords more importance to the micro-level, the sphere where macro and micro variables meet and public and private sectors interact. It is the arena that public policies are established and implemented. The micro level is thus pivotal to the successful implementation of public policies. Although the integrative school is beginning to gain relevance yet it suffers some setback because it has not been thoroughly analyzed due to the difficulty in quantifying them.

3.4 Benefits of FDI to host country

- Trade and investment: Studies have revealed that FDI has a trade related benefits as it integrates the host countries more closely into the outside world. Inward investment has been generally identified to be involved in the development of host countries resources (UNCTAD 2011). An example is the development of the Nigerian oil and gas industry by the world renowned MNCs (Shell Petroleum, Mobil, Chevron and Agip Petroleum). The Nigerian economy is being integrated with the world as the country benefits from international trade flows through the exportation of crude oil.

- FDI as a means of transferring knowledge, assets and technology. According to OECD (2009), technology transfer is the most important outlet through which foreign corporate presence may produce positive externalities in the host developing economy. MNCs are regarded as important sources of research and development (R&D) activity, and they generally possess better technology than those used in the developing countries like Nigeria. MNC investing in the developing countries have the potential of generating considerable technology spillovers.
- FDI increases productivity beyond what domestic firms would trigger and it facilitates the creation of jobs in the host countries. The transfer of management know-how is also valuable to the development of indigenous firms with organization learning through knowledge sharing

- FDI stimulates competition among firms and within industries. The increase in competition motivates local and domestic firms to increase service delivery to their customers with the aim of contending with the big multinational corporations. The impact leads to economic growth, lower prices and more efficient resource allocation

- Human capital enhancement: OECD report (2009), argued that the impact of FDI on human capital in developing countries appears to be indirect, occurring not through the efforts of the multinationals but through government policies seeking to attract FDI via enhanced human capital. The skills of individuals employed by MNCs are further developed through on-the job learning and training. The demand for skilled labour by the MNC provides a demonstrating effect as the government of the host countries are provided with an early indication of what skills are in demand.

- Enterprise development: FDI spurs enterprise development in host countries through the formation of synergies with the local firms or in the case of mergers and acquisitions, a situation whereby MNCs controls the activities of the domestic company with the aim of raising the efficiency and reducing costs in the targeted enterprise. According to OECD (2006) efficiency gains may also occur in unrelated enterprise through demonstration effects and other spillovers that are related to technology and human capital spillovers.

3.5 Adverse effects of FDI to host country

- The major cost of FDI to host countries is the repatriation of future dividends. Experts have argued that some inward FDI lead to asset stripping and inflows, which will eventually cause an outflow as investments are liquidated. Firms often repatriate earnings back to the home country and this may likely continue for a long time except the government of host country intervenes.

- Home countries suffer from loss of economic sovereignty. Most of the crucial decisions to invest produce and market product and services are taken by the home countries.

- FDI leads to degradation of environments of the host countries. One of the worst oil pollution in the 21st century was caused by the British Petroleum and the impact was identified to have caused damages, worth billions of dollars to the seashore and the North American environment. In Nigeria, oil spillage caused by multinationals remains the major threat to the Nigerian Niger Delta environment.

- Transfer Pricing: Multinational organizations may seek to evade taxes or engage in creative accounting by adjusting profits and prices at which transfers are made. Oil companies in Nigeria were accused of ripping off the Nigerian government in excess of $2billion, an amount identified as tax deductions and royalties.

- Adverse impact on domestic firms: Having confirmed that FDI initiates competition among firms and within industries of the host countries, the impact of competition can either be positive as it increases service delivery or negative in terms of effect on the local firms. In the case of natural resource-based investments, FDI may deny opportunities to the local producers. Foreign investors may also compete with scarce local inputs such as skilled labour.

- Monopolistic power: It is argued that because MNC have skills, knowledge and capital that domestic firms cannot match, the presence of multinational companies can force local firms out of business, leading to market dominance by the MNCs. Once and MNC becomes a monopoly, it has the power to influence prices and extract excessive profits, potentially reducing the gains of FDI. An example is the case of Intel, the world largest producer of chip, which was accused of using its monopoly power to stifle competitors.

- Social disorder: experts have argued that public protest may occur if a multinational exerts too much power on public goods such as water, electricity and roads or if a multinational is involved in the pollution of environment. The crisis in the Niger Delta part of Nigeria erupted after the various stakeholders started protesting against pollution caused by oil and gas multinationals in the area.

- Undue influence on the shaping of policy: It is argued that whenever large scale FDI is being experienced by a country, policies are constrained to avoid efforts that could deter constant FDI flow into the country. Foreign investors and MNCs in general may influence policies that would favour their operations and boost their gains.

3.6 Definition of Foreign Portfolio Investment (FPI): FPI includes investments by a resident entity in one country in the equity and debt securities of an enterprise resident in another country which seek primarily capital gains and do not necessarily reflect a significant and lasting interest in the enterprise. The category includes investments in bonds, notes, money market instruments and financial derivatives other than those included under direct investment, or in other words, investments which are both below the ten per cent rule and do not involve affiliated enterprises. In addition to securities issued by enterprises, foreigners can also purchase sovereign bonds issued by governments.

3.7 Benefits of Foreign Portfolio Investment

Foreign portfolio investment increases the liquidity of domestic capital markets, and can help develop market efficiency as well. As markets become more liquid, as they become deeper and broader, a wider range of investments can be financed. New enterprises, for example, have a greater chance of receiving start-up financing. Savers have more opportunity to invest with the assurance that they will be able to manage their portfolio, or sell their financial securities quickly if they need access to their savings. In this way, liquid markets can also make longer-term investment more attractive.

Foreign portfolio investment can also bring discipline and know-how into the domestic capital markets. In a deeper, broader market, investors will have greater incentives to expend resources in researching new or emerging investment opportunities. As enterprises compete for financing, they will face demands for better information, both in terms of quantity and quality. This press for fuller disclosure will promote transparency, which can have positive spill-over into other economic sectors. Foreign portfolio investors, without the advantage of an insider's knowledge of the investment opportunities, are especially likely to demand a higher level of information disclosure and accounting standards, and bring with them experience utilizing these standards and a knowledge of how they function.

Foreign portfolio investment can also help to promote development of equity markets and the

Shareholders' voice in corporate governance. As companies compete for finance the market will reward better performance, better prospects for future performance, and better corporate governance. As the market's liquidity and functionality improves, equity prices will increasingly reflect the underlying values of the firms, enhancing the more efficient allocation of capital flows. Well functioning equity markets will also facilitate takeovers, a point where portfolio and direct investment overlap. Takeovers can turn a poorly functioning firm into an efficient and more profitable firm, strengthening the firm, the financial return to its investors, and the domestic economy.

Foreign portfolio investors may also help the domestic capital markets by introducing more sophisticated instruments and technology for managing portfolios. For instance, they may bring with them a facility in using futures, options, swaps and other hedging instruments to manage portfolio risk. Increased demand for these instruments would be conducive to developing this function in domestic markets, improving risk management opportunities for both foreign and domestic investors.

In the various ways outlined above, foreign portfolio investment can help to strengthen domestic capital markets and improve their functioning. This will lead to a better allocation of capital and resources in the domestic economy, and thus a healthier economy. Open capital markets also contribute to worldwide economic development by improving the worldwide allocation of savings and resources. Open markets give foreign investors the opportunity to diversify their portfolios, improving risk management and possibly fostering a higher level of savings and investment

3.8 Shared attributes and complementarity of the benefits

Many of the benefits mentioned above for either type of investment will not be immediately apparent. A foreign direct investor's relations with the domestic economy, with suppliers, users, and sellers of its products, will develop over time. Likewise, the portfolio investor's relationship to the domestic capital markets and effect on the markets' efficiency will evolve over time. Few, if any, of these benefits are guaranteed. For both direct and portfolio investment, having an adequate policy and regulatory structure is necessary to reap the potential benefits. Both types of investment, each in their own way, also reward transparency and good corporate and public governance – thus providing an incentive to improve in those areas.

A healthy domestic economy also enhances the benefits that foreign direct investment can provide, and a sound financial sector is a prerequisite for economic health. As shown below, the benefits of foreign portfolio investment require a suitable prudential regulatory system, but prudential regulation is also necessary for a sound domestic financial sector and overall economic health. The contribution of foreign portfolio investment to strengthening domestic capital markets and their infrastructure, which enhances the domestic allocation of capital, can help to boost the benefits of foreign direct investment.

Therefore, the two are also complementary in that their benefits are enhanced when both are present.

3.9 Policy differences and complements

Complementarity, however, does not mean that the two types of investments are the same, or that they should receive the same policy responses. Although the benefits of foreign portfolio and direct investment are often shared or complementary, there are also marked differences between them.

Differences between portfolio and direct investors stem from the differences in motivation and expectation for these two types of investment. For the foreign direct investor, the purpose is control and operation of an enterprise. Just as it will be slower and more costly for such an investor to commit to the host economy, it will be slower and more costly to divest. In the medium to long term, he expects a profitable operation. The portfolio investor, on the other hand, is interested in putting his funds where they get the maximum return for a given level of risk. Portfolio investment will be faster to move in search of higher returns and/or lower risk, and have a shorter time horizon. Therefore, it will tend to be more volatile. Volatility can be useful in providing opportunities for profit, or arbitrage, which will attract investors and encourage market efficiency. Volatility also indicates that the market is seeking the best allocation of capital for the current economic opportunities. But, portfolio investment, with its volatility, can also experience system-wide movements of capital which can have broad economic repercussions. These differences in motivation and attributes necessitate differences in policy approach for the two types of investment.

4.0 Conclusion

We have seen in this unit that although the benefits of foreign portfolio and direct investment are often shared or complementary, there are also marked differences between them.

5.0 SUMMARY

In this unit, you have learnt the Meaning of Foreign Direct Investment, Objectives of Foreign Direct Investment (FDI), the different theories of Foreign Direct Investment, the Benefits of FDI to host country, the adverse effects of FDI to host country, the definition of Foreign Portfolio Investment (FPI), the benefits of Foreign Portfolio Investment , the Shared attributes and complementarity of the benefits as well as the Policy differences and complements

6.0 TUTOR-MARKED ASSIGNMENT

- What do you understand by Foreign Direct Investment?

- How does Foreign Portfolio Investment differ from Foreign Direct Investment?
- Discuss the different benefits of Foreign Direct investment to the host country.

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