COURSE GUIDE

BUS 847
GLOBAL AND ECONOMIC ENVIRONMENT

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INTRODUCTION

BUS 847: Global Economic Environment is a one semester course work having **three credit units**. It is available to students on M.Sc. degree programme in the School of Management Sciences at the National Open University of Nigeria.

The course of made up of 16 units covering essential topics in Global Economic Environment. The topics treated include: global culture and multilateral negotiations, global power and wealth distribution and multilateral negotiations among others.

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 ― Global Economic Environment‖ is to introduce you to the subject of global economic activities. 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 in the third world countries through their subsidiaries. There is therefore the need to understand the economic and cultural implications of operating in the international environment.

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.

COURSE AIMS

The course aims to groom the student in global economics as it affects commerce and industry and to understand the part played by cultural variations in different countries in international business relations. Sooner or later, the student, after his studies, may be involved in one international business or another. The knowledge gained in this course would be instrumental to successful operation.

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:

Explain the meaning and scope of international trade;

Discuss the importance of international trade and highlight its advantages and disadvantages; Discuss the theories/models of international trade;

Explain terms of trade and the meaning and implications of trade barriers; Explain the workings of international business;

Discuss globalization and international economic order; Describe how technology is transferred

Discuss regulation and control of the activities of international institutions

Describe the affairs of international institutions using India as case study

Define the process of negotiation;

Describe the determinants of economic growth; Explain the elements of global economic environment;

Discuss the issues driving import substitution and export industrialization strategies; Discuss the lessons to be learnt from Asian and Mexican financial crises; Define inflation and outline how it affects business operations;

Explain interest rates and discuss how they affect businesses and the economy; and Discuss exchange rate and how its implications for pricing.

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:

Study Units

Module 1

Unit 1 Global Economic Environment
Unit 2 International Trade
Unit 3 Strategic Aspects of International Trade
Unit 4 Terms of Trade and Theories of International Trade
Unit 5 Global Culture and Information Technology

Module 2

Unit 1 International Trade and International Business
Unit 2 International Business Environment I
Unit 3 International Business Environment Il
Unit 4 Globalization & New International Economic Order
Unit 5 Global Power and Wealth Distribution

Module 3

Unit 1 Multilateral Negotiations
Unit 2 Determinants of Economic Growth
Unit 3 Import Substitution Industrialization Strategy
Unit 4 Export Led Industrialization Strategy
UNIT5 Financial Influence on International Business

Module 4

Unit 1 Inflation
Unit 2 Interest Rates

Unit 3	Exchange Rates
Unit 4	Globalization & International Institutions
Unit 5	Lessons from Asian and Mexican Financial Crises

TEXTBOOKS AND REFERENCES

You should use the prepared text for the course made available to you by NOUN. However, in your own interest, do not limit yourself to this study text. Make effort to read the recommended texts to broaden your horizon on the course.

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	
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

With globalization of economic activities and liberalization of trade, organizations are conducting their business in the global environment. Many firms today especially the large ones do their business across national boundaries. Trade liberalization also help firms to source raw materials any where they have cost advantage. The supply chain for raw materials and finished has also gone global. United States firms, for instance, are conducting their businesses in the home country and acquiring firms abroad. Multinational firms acquire raw materials in the third world countries and deliver them to the head office factory for production.

MODULE 1

UNIT 1 GLOBAL ECONOMIC ENVIRONMENT

Unit Structure

1.1 Introduction

The world, as you can understand, 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 that are germane 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.

1.2 Learning Outcomes

By the end of this unit, you will be able to:

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

1.3 Definition 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 at the initial stage we discuss 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.

According to the International Monetary Fund (IMF), in 2022, 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.

But what are the peculiar features of the global economy?

SELF-ASSESSMENT EXERCISE 1

In your own words, describe the term Global Economy.

1.3.1 Characteristics of global economy

A global economy is produced across the world economy characterized by.

The following are a unified market some of the for all characteristics goals of and services the global

1. It gives national producers the opportunity to export their Goods and services to other countries
2. This implies produced to meet that goods international and service standards, across since the buyers globe have would be a choice of other producers.

3. 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.

4. 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.

5. 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.

6. Transfer of learning takes place through the employment of Nationals in the multi-national corporations. Skills are Transferred over time to the local industries.

7. The global economic environment provides the conditions for raising world productivity and consequently, the standards of living at a global scale.

8. 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.

1.4 Economic environment

Now that you understand what Globa 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. What are the components of the economic environment?

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.

SELF ASSSESSMENT EXERCISE 2

Clarify five (5) main components of economic environment.
a) Economic conditions

These 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 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.

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

SELF ASSESSMENT EXERCISE 3

Identify the various types of economic systeme that are found in nations of the world.

1.5 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 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.

1. Summary

This unit is the first part of the discussion on global economic environment. You have learned from it that the ambit of global economy, its characteristics, the components of the economic environment, and the general status of the global economic environment. Relatedly, you have learded that the global economy refers to the economies of all the world nations, and that the 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.

1.7 References/Further Readings/Web Resources

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1.8 Possible Answers to SAEs

Answer to SAE 1

In your own words, describe the term Global Economy.

The global economy that is also referred to as world economy denotes the economies of all the world nations, which implies that the aggregate of national economies makes up the global economy. The global economy is an integrated system of economies of the world with unrestricted and free movement of goods, services and labour.

Answer to SAE 2

Clarify five (5) main components of economic environment.

f. National economic conditions
g. National economic system
h. National economic policies
i. International economic environment
j. National economic legislations.

Answer to SAE 3

Identify the various types of economic system that are found in nations of the world.

1. Capitalism
2. Socialism
3. Democratic Socialism
4. Totalitarian Socialism
5. Mixed Economy

UNIT 2 INTERNATIONAL TRADE

Unit Structure

1.1 Introduction

During the initial unit, you were introduced to the realm of global economic environment and related topics. Globalisation that has brought together all the nations of the world under a global village has enhanced the operations of international trade. In this unit, we shall be discussing the realm of international trade and various models of international trade. This last aspect, as you will invariably appreciate, represent the views of eminent writers on the nature of international trade and ranking countries by total international trade (goods and services). We shall also rank top traded commodities in international trade.

1.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the meaning and scope of international trade;
- Analyse the models of international trade; and
- List the largest countries by total international trade of goods and services.

1.3 Meaning of International Trade

International trade is the exchange of capital, goods, and services across international borders or territories. In most countries, such trade represents a significant share of gross domestic product (GDP). While international trade has been present 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 of production and services.are all having a major impact on the international trade system.

Increasing international trade is crucial to the continuance of globalization. Without international trade, nations would be limited to the goods and services produced within their own borders.

International trade is, in principle, not all that 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 reason is that a border typically imposes additional costs such as tariffs, time costs due to border delays and costs associated with country differences such as language, the legal system or culture.

Another difference between domestic and international trade is that factors of production such as capital and labor 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, labor or other factors of production. Trade in goods and services can serve as a substitute for trade in factors of production.

Instead of importing a factor of production, a country can import goods that make intensive use of that factor of production and thus embody it.

An example is the import of labor-intensive goods by the United States from China. Instead ofimporting Chinese labor, the United States imports goods that were produced with Chinese labor. One report in 2010 suggested that international trade was increased when a country hosted a network of immigrants, but the trade effect was weakened when the immigrants became assimilated into their new country. International trade is also a branch of economics, which, together with international finance, forms the larger branch of international economics.

But what forms the basis of international trade?

SELF ASSESSMENT EXERCISE 1

How will you describe the term International Trade?

1.4 Models of International Trade

The following are noted models of international trade.

I) Adam Smith's model

Adam Smith displays trade taking place on the basis of countries exercising absolute advantage over one another. This is based on the assumptions that there are only two countries and only two products as commodities in trade transactions between such two countries. This model will be well discussed in Unit 4 of this Module of the study material.

II) Ricardian model

The law of comparative advantage was first proposed by David Ricardo.

The Ricardian model focuses on comparative advantage, which arises due to differences in technology or natural resources. The Ricardian model does not directly consider factor endowments, such as the relative amounts of labor and capital within a country.

The Ricardian model makes the following assumptions:

1. Labor is the only primary input to production
2. The relative ratios of labor at which the production of one good can be traded off for another differ between countries and governments

III) Heckscher-Ohlin model

In the early 1900s a theory of international trade was developed by two Swedish economists, Eli Heckscher and Bertil Ohlin. This theory has subsequently been known as the Heckscher-Ohlin model (H-O model). The results of the H-O model are that countries will produce and export goods that require resources (factors) which are relatively abundant and import goods that require resources which are in relative short supply.

In the Heckscher-Ohlin model the pattern of international trade is determined by differences in factor endowments. It predicts that countries will export those goods that make intensive use of locally abundant factors and will import goods that make intensive use of factors that are locally scarce. Empirical problems with the H-O model, such as the Leontief paradox, were noted in empirical tests by Wassily Leontief who found that the United States tended to export labor-intensive goods despite having an abundance of capital.

The H-O model makes the following core assumptions:

1. Labor and capital flow freely between sectors

2. The amount of labor and capital in two countries differ (difference in endowments)
3. Technology is the same among countries (a long-term assumption)
4. Tastes are the same.

Reality and Applicability of the Heckscher-Ohlin Model

In 1953, Wassily Leontief published a study in which he tested the validity of the Heckscher- Ohlin theory. The study showed that the U.S was more abundant in capital compared to other countries; therefore the U.S would export capital-intensive goods and import labor-intensive goods. Leontief found out that the U.S's exports were less capital intensive than its imports.

After the appearance of Leontief's paradox, many researchers tried to save the Heckscher-Ohlin theory, either by new methods of measurement, or by new interpretations. Leamer emphasized that Leontief did not interpret H-O theory properly and claimed that with a right interpretation, the paradox did not occur. Brecher and Choudri found that, if Leamer was right, the American workers' consumption per head should be lower than the workers' world average consumption.

Many textbook writers, including Krugman and Obstfeld and Bowen, Hollander and Viane, are negative about the validity of H-O model. After examining the long history of empirical research, Bowen, Hollander and Viane concluded: "Recent tests of the factor abundance theory [H-O theory and its developed form into many-commodity and many-factor case] that directly examine the H- O-V equations also indicate the rejection of the theory."

In the specific factors model, labor mobility among industries is possible while capital is assumed to be immobile in the short run. Thus, this model can be interpreted as a short-run version of the Heckscher-Ohlin model. The "specific factors" name refers to the assumption that in the short run, specific factors of production such as physical capital are not easily transferable between industries. The theory suggests that if there is an increase in the price of a good, the owners of the factor of production specific to that good will profit in real terms.

Additionally, owners of opposing specific factors of production (i.e., labor and capital) are likely to have opposing agendas when lobbying for controls over immigration of labor. Conversely, both owners of capital and labor profit in real terms from an increase in the capital endowment.

This model is ideal for understanding income distribution but awkward for discussing the pattern of trade.

IV) New Trade Theory

New Trade Theory tries to explain empirical elements of trade that comparative advantage-based models above have difficulty with. These include the fact that most trade is between countries with similar factor endowment and productivity levels, and the large amount of multinational production (i.e. foreign direct investment) that exists. New Trade theories are often based on assumptions such as monopolistic competition and increasing returns to scale. One result of these theories is the home-market effect, which asserts that, if an industry tends to cluster in one location because of returns to scale and if that industry faces high transportation costs, the industry will be located in the country with most of its demand, in order to minimize cost.

Although new trade theory can explain the growing trend of trade volumes of intermediate goods, Krugman's explanation depends too much on the strict assumption that all firms are symmetrical, meaning that they all have the same production coefficients. Shiozawa, based on much more general model, succeeded in giving a new explanation on why the traded volume increases for intermediate goods when the transport cost decreases.

V) Gravity model

The Gravity model of trade presents a more empirical analysis of trading patterns. The gravity model, in its basic form, predicts trade based on the distance between countries and the interaction of the countries' economic sizes. The model mimics the Newtonian law of gravity which also considers distance and physical size between two objects. The model has been proven to be empirically strong through econometric analysis.

VI) Ricardian theory of international trade (modern development)

The Ricardian theory of comparative advantage became a basic constituent of neoclassical trade theory. Any undergraduate course in trade theory includes a presentation of Ricardo's example of a two-commodity, two-country model. A common representation of this model is made using an Edgeworth Box.

This model has been expanded to many-country and many-commodity cases. Major general results were obtained by McKenzie and Jones, including his famous formula. It is a theorem about the possible trade pattern for N-country N-commodity cases.

SELF ASSESSMENT EXERCISE 2

What are the basic assumptions of Heckscher-Ohlin model of international trade?

1.5 Contemporary Theories

Ricardo's idea was even expanded to the case of continuum of goods by Dornbusch, Fischer, and Samuelson. This formulation is employed for example by Matsuyama and others. These theories use a special property that is applicable only for the two-country case.

1. Neo-Ricardian trade theory

Inspired by Piero Sraffa, a new strand of trade theory emerged and was named neo-Ricardian trade theory. The main contributors include Ian Steedman (1941-) and Stanley Metcalfe (1946-).

They have criticized neoclassical international trade theory, namely the Heckscher-Ohlin model on the basis that the notion of capital as primary factor has no method of measuring it before the determination of profit rate (thus trapped in a logical vicious circle). This was a second round of The Cambridge capital controversy, this time in the field of international trade.

The merit of neo-Ricardian trade theory is that input goods are explicitly included.

This is in accordance with Sraffa's idea that any commodity is a product made by means of commodities.

The limitation of their theory is that the analysis is restricted to small-country cases.

2. Traded Intermediate Goods

Ricardian trade theory ordinarily assumes that the labor is the unique input. This is a great deficiency as trade theory, for intermediate goods occupy the major part of the world international trade. Yeats found that 30% of world trade in manufacturing involves intermediate inputs. Bardhan and Jafee found that intermediate inputs occupy 37 to 38% of U.S. imports for the years 1992 and 1997, whereas the percentage of intrafirm trade grew from 43% in 1992 to 52% in 1997.

McKenzie and Jones emphasized the necessity to expand the Ricardian theory to the cases of traded inputs. In a famous comment McKenzie (1954, p. 179) pointed that "A moment's consideration will convince one that Lancashire would be unlikely to produce cotton cloth if the cotton had to be grown in England." Paul Samuelson coined a term Sraffa bonus to name the gains from trade of inputs.

3. Ricardo-Sraffa Trade Theory

John Chipman observed in his survey that McKenzie stumbled upon the questions of intermediate products and discovered that "introduction of trade in intermediate product necessitates a fundamental alteration in classical analysis." It took many years until Y. Shiozawa succeeded in removing this deficiency. The Ricardian trade theory was now constructed in a form to include intermediate input trade for the most general case of many countries and many goods. This new theory is called Ricardo-Sraffa trade theory.

Based on an idea of Takahiro Fujimoto, who is a specialist in automobile industry and a philosopher of the international competitiveness, Fujimoto and Shiozawa developed a discussion in which how the factories of the same multi-national firms compete between them across borders.

International intra-firm competition reflects a really new aspect of international competition in the age of so-called global competition.

4. International Production Fragmentation Trade Theory

Fragmentation and International Trade Theory widens the scope for "application of Ricardian comparative advantage." In his chapter entitled Li & Fung, Ltd.: An agent of global production (2001), Cheng used Li & Fong Ltd as a case study in the international production fragmentation trade theory through which producers in different countries are allocated a specialized slice or segment of the value chain of the global production. Allocations are determined based on "technical feasibility" and the ability to keep the lowest final price possible for each product. An example of fragmentation theory in international trade is Li & Fung's garment sector network with yarn purchased in South Korea, woven and dyed in Taiwan, the fabric cut in Bangladesh, pieces assembled in Thailand and the final product sold in the United States and Europe to major brands. In 1995 Li & Fung Ltd purchased Inchcape Buying Services, an established British trading company and widely expanded production in Asia. Li & Fung supplies dozens of major retailers, including Wal-Mart Stores, Inc., branded as Walmart.

SELF ASSESSMENT EXERCISE 3

What are the factors responsible for the rise of economic, social, and political importance of International Trade in recent centuries?

1.6 Advantages and Disadvantages of International Trade

1.6.1 Advantages of International Trade

Various advantages are named for the countries entering into trade relations on an international scale such as:

i. A country may import things which it cannot produce
International trade enables a country to consume things which either cannot be produced within its borders or production may cost very high. Therefore it becomes cost cheaper to import from other countries through foreign trade.

ii. Maximum utilization of resources
International trade helps a country to utilize its resources to the maximum limit. If a country does not take up imports and exports then its resources remain unexplored. Thus it helps to eliminate the wastage of resources.

iii. Benefit to consumer

Imports and exports of different countries provide opportunities to the consumer to buy and consume those goods which cannot be produced in their own country.

They therefore get diversity in choices.

iv. Reduces trade fluctuations.
By making the size of the market large with large supplies and extensive demand international trade reduces trade fluctuations. The prices of goods tend to remain more stable.

v. Utilization of Surplus produce
International trade enables different countries to sell their surplus products to other countries and earn foreign exchange.

vi. Fosters peace
International trade fosters peace, goodwill and mutual understanding among nations.

Economic interdependence of countries often leads to close cultural relationship and thus avoid war between them.

1.6.2. Disadvantages of International Trade

International trade does not always amount to blessings. It has certain drawbacks also such as:

i. Import of harmful goods

Foreign trade may lead to import of harmful goods like cigarettes, drugs etc. This may ruin the health of the residents of the country. E.g. the people of China suffered greatly through opium imports.

ii. It may exhaust resources
International trade leads to intensive cultivation of land. Thus it has the operations of law of diminishing returns in agricultural countries. It also makes a nation poor by giving too much burden over the resources.

iii. Over Specialization.
Over Specialization may be disastrous for a country. A substitute may appear and ruin the economic lives of millions.

iv. Danger of Starvation
A country might depend for her food mainly on foreign countries. In times of war there is a serious danger of starvation for such countries.

v. One country may gain at the expensive of another.

One of the serious drawbacks of foreign trade is that one country may gain at the expense of other due to certain accidental advantages. The Industrial revolution in Great Britain ruined Indian handicrafts during the nineteenth century.

vi. It may lead to war
Foreign trade may lead to war different countries compete with each other in finding out new markets and sources of raw material for their industries and frequently come into clash.
This was one of the causes of first and Second World War.

3.2 Largest Countries by Total International Trade

Rank-
Country
World

International Trade of Goods
(Billions of USD)

36,534.0

Date of information 2012 est.

-	European Union	4,468.6	2012 est.
1	United States	3,882.4	2012 est.
2	China	3,866.9	2012 est.
3	Germany	2,575.7	2012 est.
4	Japan	1,684.4	2012 est.
5	Netherlands	1,247.4	2012 est.
6	France	1,243.9	2012 est.
7	United Kingdom	1,149.4	2012 est.
8	South Korea	1,067.5	2012 est.
9	Italy	986.9	2012 est.
10	Hong Kong	947.9	2012 est.
11	Canada	917.3	2012 est.
12	Belgium	882.0	2012 est.
13	Russia	864.7	2012 est.
14	Singapore	788.1	2012 est.
15	India	779.4	2012 est.
16	Mexico	751.4	2012 est.
17	Spain	624.9	2012 est.
18	Taiwan	571.8	2012 est.
19	Saudi Arabia	529.8	2012 est.
20	Australia	518.2	2012 est.

Rank-Country World International Trade of Services (Billions of USD) 8,452.6 Date of information 2012 est.

-	European Union	1,465.8 2012 est.
1	United States	1,019.7 2012 est.
2	Germany	539.72012 est.
3	China	471.02012 est.
4	United Kingdom	453.9 2012 est.
5	France	379.22012 est.
6	Japan	313.42012 est.
7	India	272.8 2012 est.
8	Singapore	250.12012 est.
9	Spain	229.32012 est.
10	South Korea	214.2 2012 est.

Top traded commodities (exports)

Rank Commodity Mineral fuels, oils, distillation products, etc.
Electrical, electronic equipment Machinery, nuclear reactors, boilers, etc.
Vehicles other than railway, tramway Plastics and articles thereof Optical, photo, technical, medical, etc. apparatus Pharmaceutical products Iron and steel Organic chemicals

Pearls, precious stones, metals, coins, etc.

Value in US$('000)

$2,183,079,941
$1,833,534,414
$1,763,371,813
$1,076,830,856
$470,226,676
$465,101,524
$443,596,577
$379,113,147
$377,462,088
$348,155,369

Date of information
2012
2012
2012
2012
2012
2012
2012
2012
2012
2012

Source: International Trade Centre (2022).

1.6 Summary

You have been taken through the realm of international trade and the various models that explain the bais of international trade. Such topic has aided you in appreciating the basis of international trade. The discussion is also helpful in understanding how and why a country should engage in international trade and what goods and services it should be exporting and importing. You have appreciated that international trade has some advantages while there are also disadvantages.

The ranking of countries on the basis of total international traded goods and services will help nations in determining their relative positions and articulating appropriate trade policies if they are to climb on the ladder.

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1.8 Possible Answers to SAEs

Answer to SAE 1

International trade refers to the exchange of and transactions on capital, goods, and services across international borders or territories . In most countries, such trade represents a significant share of gross domestic product (GDP). This form of trade has been enhanced over the years by Industrialization, advanced transportation, globalization, multinational corporations, and outsourcing of production and services.

Answer to SAE 2

Factors responsible for the rise of economic, social, and political importance of International Trade in recent centuries include the following.

i. Industrialization
ii. advanced transportation,
iii. globalisation
iv. multinational corporations
v. outsourcing of production and services

Answer to SAE 3

The H-O model makes the following core assumptions:

5. Labor and capital flow freely between sectors
6. The amount of labor and capital in two countries differ (difference in endowments)
7. Technology is the same among countries (a long-term assumption)
8. Tastes are the same.

UNIT 3 STRATEGIC ASPECTS OF INTERNATIONAL TRADE

Unit Structure

1.1 Introduction

The preceding study unit has been used to discuss international trade. You may be questioning how international trade is inherently beneficial to the various of the world.

This unit closely follows the first one because it deals with the related strategic aspects of international trade. From transfer learning, you have understood that economics deals with the proper allocation and efficient use of scarce resources, the international economics is also concerned with allocation of economic resources among countries. Such allocation is done in the world markets by means of international trade. Under the concept of free trade, the best products are produced and sold in a free competitive market environment. Such benefits of production efficiency like better quality and lower price are available to all peoples of the world through international trade.

3.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the importance of international trade
- Analyse the concept of free trade
- Discuss the advantages and disadvantages of globalization
- Discuss trade barriers and reasons for imposing them in International trade.

3.3 Importance of International Trade

One fundamental principle in international trade is that one should buy goods and services from a country which has the lowest price, and sell his goods and services to a country which has the highest price. This is good for the buyers and for the sellers. Another, with international trade, The less developed countries has the opportunities to accelerate the pace of their economic development.

They can import machines and adapt foreign technology. They can send their scholars and technocrats to more progressive countries to gain more knowledge and skills which are relevant to the particular needs of their developing economies.

In the final analysis, no country in the world can be economically independent without a decline in its economic growth. Even the richest countries buy raw materials for their industries from the poorest countries. If every country produces only for its own needs, then production and consumption of goods would be limited. Clearly, such situation hampers economic progress.

Furthermore, the standard of living of the people all over the world would have no chance to improve. Due to international trade, people with money can acquire goods and services which are not available in their own countries. Hence, satisfaction of consumers can be maximized.

What is the process of ensuring enhanced benefits to nations in international trade?

3.4 Free Trade

Free trade is a policy by which a government does not discriminate against imports or interfere with exports by applying tariffs (to imports) or subsidies (to exports) or quotas.

According to the law of comparative advantage, which you have been introduced to in the previous study unit, the policy permits trading partners‘ mutual gains from trade of goods and services.

Under a free trade policy, prices emerge from the equilibration of supply and demand, and are the sole determinant of resource allocation. 'Free' trade differs from other forms of trade policy where the allocation of goods and services among trading countries are determined by price strategies that may differ from those that would emerge under deregulation. These governed prices are the result of government intervention in the market through price adjustments or supply restrictions, including protectionist policies.

Such government interventions can increase as well as decrease the cost of goods and services to both consumers and producers. Since the mid-20th century, nations have increasingly reduced tariff barriers and currency restrictions on international trade.

Other barriers, however, that may be equally effective in hindering trade include import quotas, taxes, and diverse means of subsidizing domestic industries. Interventions include subsidies, taxes and tariffs, non-tariff barriers, such as regulatory legislation and import quotas, and even inter-government managed trade agreements such as the North American Free Trade Agreement (NAFTA) and Central America Free Trade Agreement (CAFTA) (contrary to their formal titles) and any governmental market intervention resulting in artificial prices. But what are the peculiar features of free trade?

3.4.1 Features of Free Trade

Free trade implies the following features:

- Trade of goods without taxes (including tariffs) or other trade barriers (e.g., quotas on imports or subsidies for producers)
- Trade in services without taxes or other trade barriers
- The absence of "trade-distorting" policies (such as taxes, subsidies, regulations, or laws) that give some firms, households, or factors of production
- an advantage over others Free access to markets
- Free access to market information
- Inability of firms to distort markets through government-imposed monopoly or oligopoly power

SELF ASSESSMENT EXERCISE 1

a) What does the term Free Trade mean to you?
b) What does free trade implies?

1.5 Advantages and Diiisadvantages of Globalization (An Economic View)

1.5.1 Advantages of Globalization

The economic benefits that greater openness to international trade bring are:

♦ Faster growth: economies that have in the past been open to foreign direct investments have developed at a much quicker pace than those economies closed to such investment e.g. communist Russia

♦ Cheaper imports: this is down to the simple fact that if we reduce the barriers imposed on imports (e.g. tariffs, quota, etc.) then the imports will fall in price

♦ New technologies: by having an open economy we can bring in new technology as it happens rather than trying to develop it internally

♦ Spur of foreign competition: foreign competition will encourage domestic producers to increase efficiency. Carbaugh (1998) states that global competitiveness is a bit like golf, you get better by playing against people who are better than you.

♦ Increase consumer income: multination will bring up average wage levels because if the multinationals were not there the domestic companies would pay less.

♦ Increased investment opportunities: with globalization companies can move capital to whatever country offers the most attractive investment opportunity. This prevents capital being trapped in domestic economies earning poor returns.

1.5.2 Disadvantages of Globalization.

The negative drivers of globalization included culture which is a major hold back of globalization.
An example of how culture can negatively affect globalization can be seen in the French film industry. The French are very protective of this part of their culture and provide huge grants to help its development. As well as government barriers market barriers and cultural barriers still exist.

Also a negative aspect to a countries development is war e.g. tourism in Israel fell by 40% due to the latest violence. Corporate strategy can also be a negative driver of globalization as corporation may try to locate in one particular area.

Another negative driver of globalization is ―local focus" or ―localisation" as it is termed in Richard Douthwaite‗s book ―Short Circuit". Douthwaite (1996) believes that globalization can and should be reversed. He also believes that localisation is the way to do this. He defines localisation as ―not meaning everything being produced locally but it means a better a balance between local, regional, national and international markets and thus brings less control to multinational corporations‖. Another step to reverse globalization would be for governments to club together to curb the power of multinational by negotiating new trade and treaties that would remove the subsidies powering globalization and give local production a chance.

Douthwaite also states that the global economy is itself nothing less than a system of structural exploitation that creates hidden slaves on the other side of the world and also

that the North should allow the South to produce for itself and not just for us (North).
So it can be seen that Douthwaite is very opposed to globalization especially that part of it exploited by multinational corporations.

Further arguments put forward against globalization by Mr. Lawton include that it actually destroys jobs in wealthy advanced countries. This is due to the lower costs of wages in developing countries. Multinationals will move to areas of lower wage levels at the drop of a hat, e.g., Fruit of the Loom. Also this ability to relocate has meant that wage levels of unskilled workers in developed countries have actually fallen relatively speaking. This is down to the fact that one now needs skill and knowledge in developed economies to survive.

Also there is the loss of sovereignty that globalization brings. Many anti-globalization believers state that nations are losing their identity and selling their soul.

Then there are environmental factors of globalization as described earlier. These are becoming more and more controversial.

Technology, though usually viewed as a positive aspect of globalization, also has some negative points. Jeffry Sachs (2000) argues that technology is now what divides the world. Sachs states that 15% of the world‘s population account for nearly all the world‘s technological advances. This has to be a concern if developing economies are ever going to catch up. Many countries, almost 30% of the world‘s population, are technologically excluded (this means not only that they do not innovate but also that they cannot adopt new technologies). In recent years some countries, such as Taiwan, South Korea and Israel, have become top rank innovators and with this their economies have flourished. This would indicate that perhaps the best way to tackle world poverty is to provide aid through education and technology.

1.6 Trade barriers

Trade barriers are government-induced restrictions on international trade.

Most trade barriers work on the same principle: the imposition of some sort of cost on trade that raises the price of the traded products. If two or more nations repeatedly use trade barriers against each other, then a trade war results.

Economists generally agree that trade barriers are detrimental and decrease overall economic efficiency, this can be explained by the theory of comparative advantage. In theory, free trade involves the removal of all such barriers, except perhaps those considered necessary for health or national security. In practice, however, even those countries promoting free trade heavily subsidize certain industries, such as agriculture and steel.

Trade barriers are often criticized for the effect they have on the developing world. Because rich-country players call most of the shots and set trade policies, goods such as crops that developing countries are best at producing still face high barriers. Trade barriers such as taxes on food imports or subsidies for farmers in developed economies lead to overproduction and dumping on world markets, thus lowering prices and hurting poor-country farmers. Tariffs also tend to be anti-poor, with low rates for raw commodities and high rates for labor-intensive processed goods. The Commitment to Development Index measures the effect that rich country trade policies actually have on the developing world.

Another negative aspect of trade barriers is that it would cause a limited choice of products and would therefore force customers to pay higher prices and accept inferior quality.

1.6.1 The Basics of Tariffs and Trade Barriers

International trade increases the number of goods that domestic consumers can choose from, decreases the cost of those goods through increased competition, and allows domestic

industries to ship their products abroad. While all of these seem beneficial, free trade isn't widely accepted as completely beneficial to all parties. This article will examine why this is the case, and look at how countries react to the variety of factors that attempt to influence trade.
But what is tariff and why is it being used in international trade?

1.6.2 Tariff and Reasons for using it in international trade

In simplest terms, a tariff is a tax. It adds to the cost of imported goods and is one of several trade policies that a country can enact.

Tariffs are often created to protect infant industries and developing economies, but are also used by more advanced economies with developed industries. Here are five of the top reasons tariffs are used.

i. Protecting Domestic Employment

The levying of tariffs is often highly politicized. The possibility of increased competition from imported goods can threaten domestic industries. These domestic companies may fire workers or shift production abroad to cut costs, which means higher unemployment and a less happy electorate. The unemployment argument often shifts to domestic industries complaining about cheap foreign labor, and how poor working conditions and lack of regulation allow foreign companies to produce goods more cheaply. In economics, however, countries will continue to produce goods until they no longer have a comparative advantage (not to be confused with an absolute advantage).

ii. Protecting Consumers

A government may levy a tariff on products that it feels could endanger its population. For example, South Korea may place a tariff on imported beef from the United States if it thinks that the goods could be tainted with disease.

iii. Infant Industries

The use of tariffs to protect infant industries can be seen by the Import Substitution
Industrialization (ISI) strategy employed by many developing nations. The government of a
developing economy will levy tariffs on imported goods in industries in which it wants to foster
growth. This increases the prices of imported goods and creates a domestic market for

28

domestically produced goods, while protecting those industries from being forced out
by more competitive pricing. It decreases unemployment and allows developing
countries to shift from agricultural products to finished goods.

Criticisms of this sort of protectionist strategy revolve around the cost of subsidizing the
development of infant industries. If an industry develops without competition, it could wind up
producing lower quality goods, and the subsidies required to keep the state-

backed industry afloat could sap economic growth.

iv. National Security

Barriers are also employed by developed countries to protect certain industries that are
deemed strategically important, such as those supporting national security. Defense
industries are often viewed as vital to state interests, and often enjoy significant levels of
protection. For example, while both Western Europe and the United States are
industrialized, both are very protective of defense-oriented companies.

v. Retaliation

Countries may also set tariffs as a retaliation technique if they think that a trading

partner has not played by the rules. For example, if France believes that the United
States has allowed its wine producers to call its domestically produced sparkling wines
"Champagne" (a name specific to the Champagne region of France) for too long, it may
levy a tariff on imported meat from the United States. If the U.S. agrees to crack down
on the improper labeling, France is likely to stop its retaliation. Retaliation can also be
employed if a trading partner goes against the government's foreign policy objectives.

SELF ASSESSMENT EXERCISE 2

What are the five (5) reasons for the imposition of barriers in international trade?

1.6.3 Types of Tariffs and Trade Barriers

There are several types of tariffs and barriers that a government can employ:

a) Specific Tariffs

b) Ad Valorem Tariffs

The Non-tariff barriers to trade include include the following.

i) Licenses

ii) Import Quotas

iii) Voluntary Export Restraints

iv) Local Content Requirements

Specific Tariffs

A fixed fee levied on one unit of an imported good is referred to as a specific tariff. This tariff
can vary according to the type of good imported. For example, a country could levy a $15 tariff

on each pair of shoes imported, but levy a $300 tariff on each computer imported.

Ad Valorem Tariffs

The phrase ad valorem is Latin for "according to value", and this type of tariff is levied on a good
based on a percentage of that good's value. An example of an ad valorem tariff would be a 15%
tariff levied by Japan on U.S. automobiles. The 15% is a price increase on the value of the
automobile, so a $10,000 vehicle now costs $11,500 to Japanese consumers. This price increase

protects domestic producers from being undercut, but also keeps prices artificially
high for Japanese car shoppers.

Non-tariff barriers to trade include:

Licenses

A license is granted to a business by the government, and allows the business to
import a certain type of good into the country. For example, there could be a restriction
on imported cheese, and licenses would be granted to certain companies allowing
them to act as importers. This creates a restriction on competition, and increases
prices faced by consumers.

Import Quotas

An import quota is a restriction placed on the amount of a particular good that can be imported.
This sort of barrier is often associated with the issuance of licenses. For example, a country may
place a quota on the volume of imported citrus fruit that is allowed.

Voluntary Export Restraints (VER)

This type of trade barrier is "voluntary" in that it is created by the exporting country rather than the importing one. A voluntary export restraint is usually levied at the behest of the importing country, and could be accompanied by a reciprocal VER. For example, Brazil could place a VER on the exportation of sugar to Canada, based on a request by Canada. Canada could then place a VER on the exportation of coal to Brazil. This increases the price of both coal and sugar, but protects the domestic industries.

Local Content Requirement

Instead of placing a quota on the number of goods that can be imported, the government can require that a certain percentage of a good be made domestically.

The restriction can be a percentage of the good itself, or a percentage of the value of the good. For example, a restriction on the import of computers might say that 25% of the pieces used to make the computer are made domestically, or can say that 15% of the value of the good must come from domestically produced components.

In the final section we'll examine who benefits from tariffs and how they affect the price of goods.

3.6.4 Who Benefits from Tariffs?

The benefits of tariffs are uneven. Because a tariff is a tax, the government will see increased revenue as imports enter the domestic market. Domestic industries also benefit from a reduction in competition, since import prices are artificially inflated. Unfortunately For consumers - both individual consumers and businesses - higher import prices mean higher prices for goods. If the price of steel is inflated due to tariffs, individual consumers pay more for products using steel, and businesses pay more for steel that they use to make goods. In short, tariffs and trade barriers tend to be pro-producer and anti-consumer.

The effect of tariffs and trade barriers on businesses, consumers and the government shifts over time. In the short run, higher prices for goods can reduce consumption by individual consumers and by businesses. During this time period, businesses will profit and the government will see an increase in revenue from duties. In the long term, businesses may seea decline in efficiency due to a lack of competition, and may also see a reduction in profits due to the emergence of substitutes for their products. For the government, the long- term effect of subsidies is an increase in the demand for public services, since increased prices, especially in foodstuffs, leaves less disposable income.

3.6.5 Tariffs and Modern Trade.

Tariffs increase the prices of imported goods. Because of this, domestic producers are not forced to reduce their prices from increased competition, and domestic consumers are left paying higher prices as a result. Tariffs also reduce efficiencies by allowing companies that would not exist in a more competitive market to remain open.

The role tariffs play in international trade has declined in modern times. One of the primary reasons for the decline is the introduction of international organizations designed to improve free trade, such as the World Trade Organization (WTO). Such organizations make it more difficult for a country to levy tariffs and taxes on imported goods, and can reduce the likelihood of retaliatory taxes. Because of this, countries have shifted to non-tariff barriers, such as quotas and export restraints. Organizations like the WTO attempt to reduce production and consumption distortions created by tariffs. These distortions are the result of domestic producers making goods due to inflated prices, and consumers purchasing fewer goods because prices have increased

Since the 1930s, many developed countries have reduced tariffs and trade barriers, which has improved global integration and brought about globalization. Multilateral agreements between governments increase the likelihood of tariff reduction, while enforcement on binding agreements reduces uncertainty.

SELF-ASSESSMENT EXERCISE 3

In a very brief measure, what is the nature of Nature of from tariff imposition of tariffs in foreign trade?

1.7 Summary

This unit discussed international trade pointing out its importance to both rich and poor countries, importing and exporting countries, domestic and foreign businesses. You have understood that the concept of free trade explains the best circumstances under which international trade can be practiced to best serve the interest of all participants. In a free trade environment, the full advantages and disadvantages of globalization and international trade will be magnified. But international trade is not always free. We therefore had to discuss the various barriers that nations can use in managing international trading relations to serve their identified trading interests.

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1.9 Possible Answers to SAEs

Answer to SAE 1

a) Free Trade

Free trade involves a policy by which a government of a nation does not discriminate against imports or interfere with exports by applying tariffs (to imports) or subsidies (to exports) or quotas.

According to the law of comparative advantage, the policy permits trading partners' mutual gains from trade of goods and services.

Under a free trade policy, prices emerge from the equilibration of supply and demand, and are the sole determinant of resource allocation. 'Free' trade differs from other forms of trade policy where the allocation of goods and services among trading countries are determined by price strategies that may differ from those that would emerge under deregulation.

b) Free trade implies the following features:

Trade of goods without taxes (including tariffs) or other trade barriers (e.g., quotas on imports or subsidies for producers)

Trade in services without taxes or other trade barriers

The absence of "trade-distorting" policies (such as taxes, subsidies, regulations, or laws) that give some firms, households, or factors of production an advantage over others Free access to markets Free access to market information Inability of firms to distort markets through government-imposed monopoly or oligopoly power.

Answer to SAE 2

Reasons for using tariff in international trade

i. Protecting Domestic Employment
ii. National security
iii. Protecting Consumers
iv. Infant Industries
v. Retaliation

Answer to SAE 3

Nature of from tariff imposition in foreign trade.

The effect of tariffs and trade barriers on businesses, consumers and the government shift over time. In the short run, businesses will profit and the government will see an increase in revenue from duties while In the long run, in the long term, businesses may see a decline in efficiency due to a lack of competition and government will be under pressure for provision of subsidies for socio-economic goods.

UNIT 4 TERMS OF TRADE AND THEORIES OF INTERNATIONAL TRADE

Unit Structure

4.1 Introduction

The preceding study exposed you to the intricacies of international tarde in terms of its importance, free trade, importance of globalisation and trade barriers such as tariffs. In continuation of such discussion, this study unit will introduce to you terms of trade, balance of trade, and theories of international trade. You can appreciate that the buying and selling of goods and services across national border is known as international trade.

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 the pricing of goods and services which brings about terms of trade.

4.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss terms of trade and its features;
- Analyse the techniques and economic effects of international trade restrictions;
- Evaluate the theories of International Trade.

4.3 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.

But how is terms of trade can be examined?

4.3.1 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, e.g., choice of base period, the choice of weights, the method of averaging, and so on.

How is the terms of trade measured?

4.3.2 Measures of Terms of Trade

Change in a country‘s terms of trade has some direct and 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.

a) 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 = (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.

b) Gross Barter terms of trade

This is a measure introduced by F.W. Taussig. It is the relative change in a country‘s volume of exports and imports as agains6t0the 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.

SELF ASSESSMENT EXER CISE 1

Differentiate between an average and a Derivative in relation to Terms of trade.

4.4 Balance of Trade

This is the difference between visible imports and visible exports. It visible imports are greater than visible exports; balance of payments is said to be unfavourable. Where visible exports are 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.

4.5 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 6e1xtent of these gains.

Doubts however, began to emerge after the Second World War when issues relating to economic development and welfare began 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.

4.5.1 Immiserising Growth

The concept immiserising growth refers to the situation where an increase in a country‘s export commodity leads to such deterioration in its 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 characterized 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.

4.5.2 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 industrial country starts exploiting a natural Product which it was previously importing. In the process, its exchange rate appreciates 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 2

How does the Dutch Disease affect Nigerian economy?

4.6 Theories of International Trade

These are also known as the bases of international trade.

4.6.1 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 prod7u3ction 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 Lac of e 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.

4.6.2 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.

4.6.3 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 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 since necessarily compromising the production of food crops which enter into the domestic market.

4.6.4 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 the two countries involved, with no on one worth, hence, perfect competition having market power over the other ensured between

c. Third assumption says, increase in the production of a product can experience diminish in 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 the factors of production used (Labour & capital) are cheaper.

4.6.5 Competitive Advantage of Nations

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

Porter points out the importance of country factors which he categorized into four major component. They are:

To grow of
i) Factor conditions
ii) Demand conditions
iii) Related and supporting industries
iv) 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:

Determinants of National Competitiveness

Firm strategy, structure and rivalry factor conditions demand Conditions Firm Strategy

Source: Adapted.form Porter, M. E. (1990).

SELF ASSESSMENT EXERCISE 3

Highlight the four components of a nation's competitiveness.

1.7 Summary

This unit has exposed you to the broad and complex nature of international trade. You have learnt about the in-depth explanation of the terms of trade, its related terms and the measurement. You have also learnt about balance of trade concept, negative effects of international trade, the various bases (theories) of international trade, and the components of nation's competitiveness as provided by Michael Porter.

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1.8 Possible Answers to SAEs

Answer to SAE 1

Differentiate between an average and a Derivative in relation to 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, e.g., choice of base period, the choice of weights, the method of averaging, and so on.

How does the Dutch Disease affect Nigerian economy?
Answer to SAE 2

The crude oil was discovered in 1957 when the country depended on only cash crops from the various regions of the country. But the output became appreciably high due to demand in the world market in the 1970s. The foreign earnings generated was wasted without the country getting any development to show for it while plunging into huge amount of foreign debts in subsequent years.

Relatedly, the government and farmers abandoned the cash crops being produced before the oil windfall.

SELF ASSESSMENT EXERCISE 3

Highlight the four components of a nation's competitiveness.

Answer to SAE 3

i) Factor conditions
ii) Demand conditions
iii) Related and supporting industries
iv) Firm strategy, structure and rivalry.

UNIT 5 GLOBAL CULTURE AND INFORMATION TECHNOLOGY

Unit Structure

5.1 Introduction

The preceding study unit exposed you to the intricacies of international trade. You learnt from the discussion that an important aspect of trade interaction at international level is the issue of international competitiveness. Each national depends on the operations of the domestic industries to compete at international level against other nations. Relatedly, in this unit, you will be exposed to the discussion of issue of technology that is apotentcatalyst in enhancing international competitive edge of some nations over other nations. This study unit is all information technology and the global cultural environment.

5.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the origin and workings of various gadgets of information technology;
- Analayze the trend of information technology in local firms and global businesses; and
- Evaluate the position of local and foreign firms in the current information technology age

5.3 Emergence of Information Technology

Information technology as we know it today touches the life of businesses and individuals on daily basis. Nothing happens without the use one information and computer technology in offices and in homes. Information technology boosts commerce and industry, it makes life easy for people in the society, it has transformed the way human beings relate with each other in society. It facilitates messages, transactions and contacts at both the national and global levels.

5.3.1 The pre-history of Information Technology

Multinational companies which have been operating for many years in their mother countries abroad are used to carrying out their business transactions with the aid of cutting-edge information technology gadgets and equipment. Such companies have been instrumental to the introduction of sophisticated information technology into business in the developing world through their branches and subsidiaries in the third world countries.

In some instances, information technology entered a firm through its accounting department, the director of finance and the firm's audit partner. The first computer, after all, had been built to deal with particular complex problem of calculation, having to do with census data, and audit firms were quick to realize that the computer offered firms (especially publicly quoted firms) the following advantages in their business:

- Increase in the accuracy of accounting and finance functions
- Reduction in the time required to complete formal reportage
- Reduction in the number of people required to perform tasks

The use of information technology (IT) was justifiable in both its target the accuracy in counting money and dealing with other accounting issues, and in its use – the saving of time and money.

SELF ASSESSMENT EXERCISE 1

Clarify five (5) benefits of information technology.

5.3.2 Transaction processing using Information Technology

Information technology has demonstrated its usefulness in aiding businesses to function more efficiently. In both international and local firms, it plays a prominent role in accountancy, money counting, product-making and product distributi8on across the country. It is used in transaction processing, batch-oriented management and later as the pace of the economy increased it found its way into production and production scheduling.

But what about the environment of information technology?

5.4 The Technological Environment

Technology is a term that ignites passionate debates in many circles these days. Some blame technology for environmental destruction and cultural fragmentation. Others view technology as the key to economic and social progress. No doubt there are important messages in both extremes.

For our purpose, technology is defined as all the tools and ideas available for extending the natural physical and mental reach of humankind (Kreitner, 2009). A central theme in technology is the practical application of new ideas, a theme3 that is clarified by the following distinction between science and technology:

Science is the quest for more or less abstract knowledge, whereas technology is the application of organized knowledge to help solve problems in our society. According to the following historical perspective, technology facilitates the evolution of the industrial age into the information age, just as it once enabled the agricultural age to evolve into the industrial age.

Consequently, information has become a valuable strategic resource. Organizations that use appropriate information technologies to get the right information to the right people at the right time will enjoy a competitive advantage.

5.4.1 The Innovation Process

Technology comes into being through the innovation process, the systematic development and practical application of a new idea. According to a recent survey of about 250 executives, they All agreed that this important area needs urgent improvement. Nearly all of them cited innovation as top priority and said they plan to increase their budget on Research and Development (R & D).

A great deal of time-consuming work is necessary to develop a new idea into a marketable product or service. And many otherwise good ideas do not become technologically feasible, let alone marketable and profitable. According to one innovation expert, only one out of every 25 new ideas ever becomes a successful product and of every 15 new products, only one becomes a hit.

There is a Three-Step Process of Innovation such as espoused below.

The innovation process has three steps. First is the conceptualization step, which is when a new idea occurs to someone. Development of a working prototype is the next step, and this is called Product technology. This involves actually creating a product that will work as intended. The third and final step is developing production process to create a profitable relationship among quality, quantity, and price. The third step is labeled production technology.‖ Successful innovation depends on the right combination of new ideas, product technology, and production technology. A missing or deficient step can ruin the innovation process.

SELF ASSESSMENT EXERCISE 2

How can IT innovation be promoted through entrepreurship?

Identify the three stages of technological innovation

5.4.2 Promoting Technological Innovation through Entrepreneurship

When someone is called an entrepreneur, you could assume that he or she is a vey creative individual who has risked everything while starting his or her own business. Indeed, the entrepreneurs are a vital innovative force in the economy.

A less-known but not less important type of entrepreneur is the so called intrapreneur.

Gifford Pinchot (2009) defined intrapreneur as an employee who takes personal interest and hands-on responsibility for pushing any type of innovative idea, product or process through an organization. This being that a new innovation requires some tending and refinement to bring it to perfection.

If today‘s large companies are to achieve a competitive edge through innovation, they need to foster a supportive climate for intrapreneurs. According to experts on the subject, an organization can foster intrapreneurship if it does four things:

- Focuses on results and teamwork
- Rewards innovation and risk taking

- Tolerates and learns from mistakes
- Remains flexible and change-oriented

SELF ASSESSMENT EXERCISE 3

What are the various steps to be taken to encourage intrapreneurship in organization?

5.5 Global Awareness and Cross-Cultural Effectiveness

Americans in general and American business students and manager in particular are often considered too narrowly focused for the global stage. You can appreciate that this is unlike European and Asian managers, who grow up expecting to see international service, the U.S. executives are required to prepare only for domestic experience, with English as their only language. This state of affair is slowly changing amid growth of international business and economic globalization. To compete successfully in a dynamic global economy, present and future managers need to develop their international and cross-cultural awareness.

Successful global managers possess a characteristic called cultural intelligence (CQ), the ability of an outsider to read individual behavior, group dynamics, and situations in a foreign culture as well as the locals do. (The initials CQ are a variation of the familiar label IQ, for intelligence quotient). Just as a chameleon changes colour to blend in with its surroundings, a person with high CQ quickly analyzes an unfamiliar cultural situation and then acts appropriately and confidently. In short, CQ involves seeing the world as someone else sees it.

While noting that only 5% of managers studied possess high CQ, a pair of researchers shared this cautionary tale of a manager with low CQ.

Consider the example of the French manager transferred to the USA. After meeting his secretary (a woman) the first time, he greeted her with European hello‘ (an effusive and personal cheek-to-cheek kiss greeting). This greeting was, however, met with obvious discomfort. His secretary later filed a complaint for harassment.

You can personally boost your cultural intelligence by mastering the nine cross-cultural competencies listed below:

The cross-cultural competency cluster knowledge or skill required

1. Building relationships: Ability to gain access to and maintain relationship with members of host culture.

2. Valuing people of different cultures: Empathy for difference; sensitivity to diversity
3. Listening and observation: Know cultural history and reasons for Certain cultural actions and customs.
4. Coping with ambiguity: Recognizes and interprets implicit behavior, non-verbal cues.
5. Translating complex information: Knowledge of local language, symbols or other forms of verbal language and written language.
6. Taking action and initiative: Understands intended and potential Unintended consequences of actions.
7. Managing others: Ability to manage details of a job including maintaining cohesion in a group.
8. Adaptability and flexibility: Views change from multiple perspectives
9. Managing stress: Understands own and other‘s mood, emotions, and personality.

5.5.1 Contrasting Attitude towards International Operations

Can a firm‘s degree of internationalization be measure? Some observers believe it can, and they claim a true global company must have subsidiaries in at least six nations.

Others say that to qualify as a multinational or global company, a firm must have a certain percentage of its capital or operations in foreign countries. However, many people are of the view that these measurable guidelines tell only part of the story and suggest that it is management‘s attitude towards its foreign operations that really counts.

The more one penetrates into the living reality of an international firm, the more one finds it is necessary to give serious weight to the way executives think about doing business around the world.

The orientation toward ―foreign people, ideas, and resources in headquarters and in subsidiaries, and in host and home environments, becomes crucial in estimating the multinationality of a firm.

The managerial attitudes toward international operations are identifiable. These are:

1. Ethnocentric attitude: This is the view that the home country‘s personnel and ways of doing things are the best.

Polycentric attitude: The view that local managers in host countries know best how to run their own operations.

Geocentric attitude: This is a world-oriented view that draws on the best talent from around the globe.

5.5.2 The Cultural Imperative

Culture is defined as the pattern of ―taken-for-granted assumptions about how a given collection of peop9l1e should think, act, and feel as they go about their d9a1ily affairs. Culture has a powerful impact on people‘s behavior. For example, consider the activity of negotiating business contract on frequent basis.

What about business negotiations under cross-cultural situation?

Cross-cultural business negotiators who ignore or defy cultural traditions do so at their own peril.

The risk is the possibility of losing a contract or failing to negotiate a favourable deal.

Therefore, sensitivity to cross-cultural differences is imperative for people who do business in other countries.

How then does culture affects contract deal?

To Americans, a contract signals the conclusion of negotiations; its terms establish the rights, responsibilities, and obligations of the parties involved. However, in respect of the the Japanese, a company is not forever bound to the terms of the contract. In fact, it can be re-negotiated whenever there is a significant shift in the company‘s circumstances.

For instance, a sudden change in governmental tax policy, or a change in the competitive environment, is considered a legitimate reason for contract re-negotiation. To the Chinese, a signatory to an agreement is a partner with whom they can work, so to them the signing of a contract is just the beginning of negotiations.

5.6 Summary

The explosion in the use of information technology in businesses can be traced to the multinational companies which have been operating for many years in their mother countries abroad. They establish subsidiaries in the third world countries and subsequently bring the technology of the advanced countries into the developing world. All kinds of business transactions are now carried out with the aid of cutting-edge information technology facilities .

In some instances, information technology entered a firm through its accounting department and then spread to other functional areas. Information technology is ruling the world of commerce and industry in the present generation.

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1.8 Possible Answers to SAEs

Answer to SAE 2

Five (5) benefits of information technology.

i. It enhances the speed and accuracy in transaction.
ii. It ensures that business operations in service industry is efficient and effective.
iii. It creates job opportunities for the youth segment of the populace.
iv. It has made some nations to be above other nations in technological operations.
v. It aids in modernization of modern operations and production.

Answer to SAE 2

The three stages of technological innovation

First step —Conceptualization step, which is when a new idea occurs to someone.
Second step – Development of a working prototype which is called Product technology. This involves actually creating a product that will work as intended.

Developing production process to create a profitable relationship among quality, quantity, and price.

Third step — production technology. Successful innovation depends on the right combination of new ideas, product technology, and production technology.

Answer to SAE 3

The various steps to be taken to encourage intrapreneurship in organization include the following.

i. Focuses on results and teamwork.
ii. Rewards innovation and risk taking.
iii. Tolerates and learns from mistakes.
iv. Remains flexible and change-oriented.

MODULE 2

UNIT 1 INTERNATIONAL TRADE AND INTERNATIONAL BUSINESS

Unit Structure

1.1 Introduction

From the preceding study unit, you have understood the role of information technology in world economy. In relation to it, the phenomenon of IT also affect the international trade and business.

This unit will look 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 represents 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 so also some risks.

1.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss international trade;
- Analyze the basic concepts and reasons for international trade;
- Examine the various forms of international trade;
- Evaluate the issues surrounding the establishment of world trade organization (WTO).

1.3 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.

1.3.3 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 favored 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.

Forms of International Trade

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

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.

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 1

What do you understand by the term international trade?

1.4 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-related10subject 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 made by govern international trade relations which was 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 basically applicable to international trade in goods was for years was modified to include new provisions particularly to deal with the trade problems of developing countries.

1.4.1 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 increase 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).

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

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

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.

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 theseagreements.

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 make life more efficient
j. Government are shielded

SELF ASSESSMENT 2

Mention five (5) benefits of the World Trade Organization.

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.

The Dynamic Nature of GATT Members to World Trade Organization

It is of greater important to examine any change in a1tt0itude of GATT membership and how GATT rules applied to issues. Such issues do not position whether a certain policy is environmentally correct or not. GATT rules if members.

They suggest that the US policy could be made compatible with agreed on amendments or reached 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 market-oriented policies in most countries communism has led to the gradual adoption of Where Production and international trade had been state controlled. These countries, Which in the past traded primarily among them 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.

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 Urugua Round 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 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 favored 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 product and domestically produced like goods, both in 10the matter of the of internal taxes and in the application of internal taxes.
levy

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) WTO and another country objects. Should the GATT under dispute an environment be handled under agreement outside the WTO or the under 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.

1.4.7 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-fiber 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 Quality Customs arrangements. A good example is the 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 said to be dumped when they are sold for export at less than their normal value.

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).

1.4.8 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 Remained into international law on January 1, 1948, GATT 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.

1.4.9 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 3

Demonstrate that WTO is different from GATT.

1.6 Summary

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 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 to regulate international trade 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.

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1.8 Possible Answers to SAEs

Answer to SAE 1

The major forms of International trade include:

- Direct exporting and importing
- Foreign licensing and franchising.

Answer to SAE 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.

Answer to SAE 3 51

The WTO is a multinational institution set 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 treaty created in 1945 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 after the war. The main objective of GATT was to reduce the barriers of international trade through reduction of tariffs, quotas, andsubsidies. It Agreement was into law in1948. It was replaced by WTO in January, 1995.

UNIT 2 INTERNATIONAL BUSINESS ENVIRONMENT I

Unit Structure

1.1 Introduction

Domestic market, also known as home market, as you know, is affected by some environmental variables known as uncontrollable variables that are external to the business.
You can also understand that international market is not an exception to the environmental forces that shape business operations generally. Thus, an international businessman must critically study these variables before going abroad. The effects of such forces or variables on international business activities can be very devastating or colossal. This unit examines the nature of such variables and their impact on international business activities.

1.2 Learning Outcomes

By the end of this unit, you will be able to:

- Analyze the international uncontrollable forces
- Discuss the economic variables
- Evaluate the physical and environmental forces
- Discuss the socio-cultural variables
- Analyze the legal and political variables.

1.3 The Nature of International Business Environments

You have understood from previous study units that international environment is diverse with varied forces at are distinct from the domestic business environment. Therefore, going abroad for business, you are bound to face varied problems that are different from that of your home country. For instance, Nigeria and Brazil are engaged in international business; the economic, physical, political, and other environmental factors in Nigeria differ from that of Brazil. Thus, you need to critically study Brazil's environmental variables/factors before you go into her market. But what are forces that are not favourable to the business operations at international level? Hence, we shall consider the following factors.

SELF ASSESSMENT EXERCISE 1

Give five (5) ways through which international environment affects business.

1.3.1 Economic and Socio-Cultural Forces Economic Aspect

Once you have decided on the economy or country which you want to explore, the following are the factors to investigate under the economic aspect.

i) GNP, GNP/capita and GDP/capita, income distribution, private consumption, gross domestic investment, private and government consumption and unit labour cost.

ii) GNP: - Is gross national product, it is the total value of all goods and services produced domestically not including net factor income from abroad. The United States GNP is about $80 trillion while Sao Tome and Principe is 44 Million.

iii) GNP/capita and GDP/capita: - GDP is the measured access to a country 's wealth by individuals within a nation. Per capita of Nigeria is less than a dollar.

iv) Income Distribution: - It is a measure of how a nation's income is apportioned among its people, commonly reported as the percentage of income received by population quintiles.

v) Private Income: - This is described as discretionary income i.e. how much is left for individuals after paying taxes and spending on necessities. Business men are interested in this before they enter a market, because this determines the purchasing power of such market.

vi) Gross Domestic Investment: - Amount of private investment.

vii) Private and Government Consumption: - The total amount of money spent in provision of goods and services. In most countries it rises.

viii) Unit Labour Cost: - This is the total production labour costs divided by units produced. This is done to know whether it will be favorable to go into a particular market.

But what are socio-economic dimensions of the environment?

The Socio-economic Dimensions include the following:

i) Total population: - The total population of the market abroad should be critically examined. It is believed that if a country's population is high, the market is likely going to be high.

ii) Age Distribution: - In Nigeria, the youth have the highest percentage, followed by the adults, children and the aged.

iii) Population Density and Distribution: - Population density is a measure of the number of inhabitants per area units, while population distribution is a measure of how inhabitants are distributed over a nation's area.

iv) Rural Urban Drift: - Movement of individuals from rural settlement to urban settlement. In Nigeria, it is rising daily.

SELF ASSESSMENT EXERCISE 2

Give five (5) ways through which Nigeria's high population csn be an advantage to international business man.

1.3.2 Physical and Environmental Forces

What are the dimentsions of the physical environment?

You can appreciate that the physical environment such as the nature of land can also affect business operations in foreign countries. In considering physical and environmental forces, it is important to examine the following:

i) Topography: - If a businessman is to come into Nigeria from Australia, he should be interes1te1d in the following physical landscape of Nigeria.

ii) Mountains and plains. Because in countries like Spain, Switzerland, China, Colombia, mountains divide markets; it equally has an implication on population concentration.

iii) Deserts. This naturally would indicate scanty population which would affect markets.

iv) Bodies of water. This could help in transportation like inland waterways.

v) Climate and development. The climatic implication to business is great, because it influences the type of goods we trade in. Natural resources must equally be studied because they affect business. These resources may include:

vi) Energy - These include petroleum, local and nuclear power, non-fuel minerals. In OPEC, presently the output is less and the prices are rising, because of this, international businessmen must study or monitor changes because they are necessary and may affect business.

The study and close observation of natural resources in a country is very important. In fact, effective environmental management is a global issue nowadays.

But what are the socio-cultural factors affecting international business?

1.3.3 Socio-Cultural Forces

Culture: - You understand from transfer learning that culture implies the sum total of beliefs, rules, techniques, institutions and artifacts that characterise human population.

You do appreciate that culture being part of the environment also affects all business functions as far as marketing, human resource management, production and finance are concerned. An international businessman needs to study these socio-cultural variables of the international market because they are the pivot of business activities. To a certain degree, they influence the success or failure of international business activities.

There are communities that believe in the superiority of their own ethnic group, you must appreciate this to succeed in this type of community market. But what are those components of culture in any given country. Such socio-cultural components that a businessman should critically study before going international include the following among others.

i. Aesthetics: - A country's sense of beauty and good tastes.
ii. Attitude and beliefs.

iii. Religion: - In Nigeria, the major religions are Christianity, Islam and Traditional religion.

iv. Material culture: It refers to all human made objects and thus concerned with how people make things (technology) and who makes what and why (economics).

v. Education: People's literacy influences the type and mode of business they engage in.

vi. Language: In Nigeria, we have over 360 languages. It does not mean that an international businessman must speak them all, but he/she must appreciate them.

vii. Societal organisation: This includes cultural festivals which may involve legal and/or political structures.

SELF ASSESSMENT EXERCISE 3

Identify five (5) socio-cultural forces that can affect the international businessman.

1.3.4 Political forces

In the world, there are four different types of ideological forces.

i. Communism- It was propounded by Karl Max to mean a classless society. It was developed by his successor (Lenin) into a control of society by the communist party and the attempted worldwide spread of the ideology.

ii. Capitalism- It is an economic system in which the means of production and distribution are for the most part privately owned.

iii. Socialism: - Public, collective ownership of the basic means of production and distribution and operating for use rather than profit.

iv. Conservative or liberal: -This refers to a person who wishes to minimize government activities and maximise private ownership and business. It is equally referred to as right wing liberal: It is popular in America. Conservatives are particular about greater government investment in most aspects of human activities.

The country in which you want to do business must be studied to know which mode of government it operates. Other areas to study in terms of political forces are the following.

i) The government ownership of business.

ii) The privatisation system. That this, to some extent, is in practice in Nigeria.

iii) Nationalism - The level of one's devotion to one's nation. For instance, Americans are believed to be more nationalistic than Nigerians.

iv) Government protection- American government is good at this, it unapologetically fights for its interests when they are threatened.

v) Government stability- some nations are stable while some are not.

Traditional hostilities: The long-standing enmities between tribes, races, religion, ideologies or countries.

International organisations: - Must be contended with if you go international in your business.

1.4 Summary

In this study unit, you have acquired knowledge about the international environment which is not different from the domestics in terms of their dimensions. The components of such environment include; political forces, socio-cultural forces, physical and environmental forces, economic and socio-economic forces. From the discussion in this unit, you have come to understand that there are serious forces that an international businessman must study carefully before venturing into a market. A lot of businesses have been wrecked at the international level as these forces were not taken into consideration at the onset.

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1.6 Possible Answers to SAEs

Answer to SAE 1

Five (5) ways through which international environment affects business include:

i. Currency depreciation
ii. Political instability
iii. Social uprising
iv. Ban or embargo on importation
v. Government policy on industrialization

Answer to SAE 2

Five (5) ways through which Nigeria's high population csn be an advantage to international
business man include:

i. Availability of cheap labour;

ii. Savings in labour cost;
iii. Enhances corporate diversity; and
iv. Enhances sales volume of products services turnover.

Answer to SAE 3

Five (5) socio-cultural forces that can affect the international businessman include:

i. Attitude and beliefs.
ii. Language
iii. Religion.
iv. Material culture.
v. Education.

UNIT 3 INTERNATIONAL BUSINESS ENVIRONMENT II

Unit Structure

1.1 Introduction

As you have understood from the discussion in the preceeding units, there are many forces in the environment of international arena. Such forces include legal forces, labour forces and competitive forces, which have to be critically examined. You can appreciate that their effect must be studied before proceeding into an international business just like other forces discussed in the previous unit. Thus, this unit examines the impact of legal, labour and competitive elements on international business operations.

1.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the legal forces affecting international business
- Analyse the nature labour forces in
- Evaluate the competitive forces as they affect international business.

1.3 International Business Environment

From this previous study unit, you will recall that the international business environment is so complex for prospective and potential businessmen due to the its complex nature largely because of the various forces affecting its operations. Therefore, such forces like legal, labour and competition variables, as they affect business activities must be critically examined.

1.3.1 Legal Forces

Do all countries have different laws regulating the economic operations such as business activities? Of course, they do. Hence, for a foreign firm to operate in Nigeria, it has to understudy those laws that are formulated into regulations of Nigerian business environment. For instance, the following are good examples of regulatory laws and agencies in Nigeria for domestic business, and once you want to operate in Nigeria from a foreign country, they must equally apply to you and so also those firms that are coming to operate in the country.

1. Standard Organisation of Nigeria (SON)

The Nigeria Standard Organisation Act of 1971 establishes SON as an integral part of the Federal Ministry of Industries. The SON is to carry out the following functions among other things.

i) To designate, establish and approve standards in respect of meteorological materials, commodity structures and process for the certification of products in commerce and industry throughout Nigeria.

ii) To provide necessary measures for quality control of raw materials and products in conformity with the standard specification.

iii) To ensure compliance with designated standard.

iv) To establish a quality assurance system including certificate for factories, products and laboratories.

v) To develop methods of testing materials, supplies equipment and items purchased for use of public and private establishment.

vi) To establish and maintain laboratories necessary for the performance of their functions.

2. National Agency for Food and Drug Administration and Control (NAFDAC)

NAFDAC was established in 1993 with such functions as to:

i) regulate and control the importation, exportation;
ii) manufacturing, advertisement, distribution, sales and use of food, drugs, cosmetics, medical services, bottled water and chemicals.

3. Drugs and Related Productions

Non-drug products like cosmetics or medical devices shall be manufactured, imported, advertised, sold or distributed in Nigeria unless it is registered in accordance with the provisions and regulations of 1993

Act.

4. Environmental Impact Regulation

Similar to what obtains in several other countries, environmental protection is accorded a lot of prominence in Nigeria. The Federal Environmental Protection Agency (FEPA) is charged with overall responsibility of monitoring, supervising and coordination of environmental impact assessment procedure for Nigeria, as well as environmental assessment guideline for various industrial sectors of the country.

5. Trade Malpractice (Miscellaneous Offences Decree 1992)

This law provides punishable offences relating to trade malpractice and could set up a special trade malpractice investigation panel to investigate such offences. The law provides against any person who:

i) falsely labels, packages, sells, offers for sale or advertises any product so as to mislead as to its quality, character, brand name, value, composition, merit or safety.

ii) contracts or deals, uses or intends to use any weight measure which is false or unjust for the purpose of sale

iii) sells any product by weight measure or number less than is purported to be sold.

iv) advertises or invites subscription for any product which does not exist.

The following are some laws and regulations governing the establishment and operations of business in Nigeria.

i. Nigeria Investment Promotion Commission Decree No 16 of 1995.
ii. Foreign Exchange (Monitoring and Miscellaneous Provisions) Decree No 17 of 1995.

iii. Immigration Acts of 1963.
iv. Dumped or Subsidised Goods Act No 9 of 1958.
v. Custom Duty Drawback Regulation No 70 of 1958.
vi. Securities and Exchange Commission Act of 1979.
vii. Privatisation and Commercialisation Decree No 75 of 1988

SELF ASSESSMENT EXERCISE 1

What areas of operations are affected by the operations of NAFDAC to international business?

1.3.2 Labour Forces

From transfer learning, you can recall that labour is very necessary for productive activities in any business. But can any firm just get labour force without any encumbrance or considering the nature of the labour market? To star with labour, in economics, is an effort necessary made to satisfy human needs. As one of the three leading elements in production, they are subject to regulatory laws in any country. You will recall that the other two factors of production being land (natural objects) and capital.

Labour forces have the following factors that affect international business.

i) Labour mobility
ii) Guest workers and labour shortages
iii) Composition of labour force
iv) The role of social status, sexism, racism, traditional society or minorities in employment policies
v) Employer-employee relationship.

I. Labour Mobility

It means the movement of people from one country or area-to-area to another in order to get jobs. In the US, say 10.4 percent of the populations are foreigners working in different sectors of the economy. The labour mobility could be as a result of influx of refugees/asylum seekers (ILO, 2022).

II. Guest Workers and Labour Shortages

These are people who are in another country legally to perform certain jobs;

countries like France, Germany etc. have low birth rate, people go there as guest workers because of shortage in employable population (ILO, 2022).

III. Composition of Labour Force

It is the combination of all that are employable in a given country and region. It involves age, skill, gender, race and religion. In Nigeria, the number of Northern women in employment scale has risen; before, they were excluded.

IV. Consideration in Employment Policies

The social variables for consideration in employment policies are sex, race, tribe, club membership etc.

V. Employer-Employee Relationship

Ball et al (2002) opined that labour market is the pool of available potential employees with the necessary skills within countries. The employer could be an individual, corporate or a government. A businessman must study the rules and regulations guiding employer-employee relationship in a country. For international businessman, it is very important to diligently study these guiding rules before venturing into the international arena. A country with a high rate of labour unrest is not profitable for business (ILO, 2022).

What does the competitive environment portend for operations in international business?

1.4 Competition Environment

To start with, is it possible for an economic environment to be devoid of competition?
Competitive forces are present in any industry operating in a country and they are many and varied. You can appreciate the competitive nature of business from the following considerations:

1. Marketing Point of View

Businessmen must constantly keep an eye on competitors that may invade their markets and erode their market share. Competition comes in many forms. Any alternative satisfier of a need or want is a competitor. Marketers must know the number and size of their competitors as well as the tools they use in competition. Marketers must also pay attention to competition from abroad (foreign countries) as some of these foreign competitors are gaining a growing advantage over the domestic marketers. Example is in the area of telecommunication, where MTN, 9Mobile, etc, have advantages over landline company.

2. Competition within a Region

This is a competition within a particular region, for instance, ECOWAS countries could come together to compete with other groups.

Sometimes, competition could be from between two or more countries. The US for example is competing in all aspects of economy with Japan, Asia, and Hong Kong, etc.

Competition is a healthy development for business, because it compels the competitors to adequately satisfy the target markets otherwise sales/patronage would drop.

For business to be able to compete there is need for analysis of business competitive forces, which include:

i. competitor analysis
ii. competitor intelligence system (CIS)

SELF ASSESSMENT EXERCISE 2

Identify five areas in which firms compete in a given environment.

1.5 Competitive Analysis

You can appreciate that analyze the environment of competition is germane in business environment. Hence the analysis is a situation where principal competitors are identified, and their objectives, strengths, weaknesses and product lines are assessed. Sources of information for competitors analysis are obtained from:

i. Within the firm
ii. Published materials
iii. Suppliers/customers
iv. Competitors employees
v. Direct observation or analysing physical evidence.

There is issue of Competitive Intelligence System (CIS) This consists of the procedures for gathering, analysing and disseminating information about a firms' competitors.

SELF ASSESSMENT EXERCISE 3

It is assumed that your line of business falls under communication industry; name four major competitors.

1.6 Summary

You have acquired knowledge from this unit that legal forces, labour forces and competitive forces are also variables that affect business operations in international business environment be studied carefully so that an international businessman does not underestimate the market potentials.

These forces must be studied well, if not, they will have negative effect on international business activities.

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1.8 Possible Answers to SAEs

Answer to SAE 1

Areas of operations of NAFDAC affecting international business include:

i. Food
ii. Drugs
iii. Production of food and drugs
iv. Consumption of food and drugs
v. Production and consumption of table and pure water

Answer to SAE 2

Five areas in which firms compete in a given business environment include:

i. Production of commodities
ii. Marketing of products and services
iii. Pricing of commodities
iv. Promotion of products and services
v. Product line enhancement

Answer to SAE 3

Four major competitors in communication industry in Nigeria include:.

i. MTN
ii. GLO
iii. Airtel
iv. 9Mobile

UNIT 4 GLOBALIZATION & NEW INTERNATIONAL ECONOMIC ORDER

Unit Structure

1.1 Introduction

You have been exposed to the intricacies of international business environment. Corporate 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.

Therefore, the trend 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.

1.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss ten new international economic order (NIEO)
- Analyse international trade in the context of NIEO
- Evaluate regulation & control of the activities of international institutions
- Analyze global business in the context of
- Discuss interdependence and cooperation in context of NIEO.

1.3 Globalisation and New International Economic Order

Large corporations particularly, have been gingered to be conducting their business operates in the global environment due to remarkable developments around the world.. The other business entities are not left out in the fray due to the fact that they engage in sourcing their production inputs overseas. The overseas firms started producing their products in foreign countries and outsourcing while the supply chain for many commodities are being handled on global basis. Some firms in Nigeria, for instance, have become multinationals while acquiring other firms abroad, thus expanding into international market. The main intent is to acquire as much market shares as possible. Relatedly, such tendency of international business and globalization operate at the behest of trade liberalization among nations and the removal of all trade impudent. This facilitates establishment of commerce and industry that can flourish smoothly around the world without hitches and obstacles.

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. What are these phenomena? Such occurrences include the following:

(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.

What are the proposals put forward by the LDCs gave birth to the New International Economic Order?

Specific proposals for the NIEO 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.

SELF ASSESSMENT EXERCKISE 1

Identify the five (5) phenomena that gave impetus to the demand for New International Economic Order in the early 1970s.

What is the nature of international trade in the context of NIEO?

1.3.1 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 through:

(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. the U.S. can trade its goods for goods and services produced cheaply by other countries. Then 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.

Since the LDCs lack modern technological knowhow, what is the policy on transfer of technology to them?

SELF ASSESSMENT EXERCISE 2

Mention any five (5) measures established for improving the terms of trade of LDCs and removing their chronic trade deficits.

1.3.2 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 technology; and
(iv) adoption of commercial practices governing transfer of technology to the requirements of LDCs.

What about the regulation and control of the operations of the companies

1.4 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 such as to:

(i) regulate their activities in host countries so as to remove restrictive business practices in LDCs;
(ii) bring about assistance, transfer or technology and management skills to LDCs. On equitable and favourable terms;
(iii) regulate the repatriation of their profits; and
(iv) promote reinvestment of their profits in LDCs.

1.4.1 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; and
xi) investment in industrial and development projects on favourable terms.

SELF ASSESSMENT EXERCISE 3

Mention five (5) Areas of reform in international monetary system from NIEO in favour of LDCs.

1.4.2 Interdependence and Cooperation

Above all, the New International Economic Order declaration lays emphasis on more efficient and equitable 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.

1.5 Summary

This unit is used to expose you to the fact that 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 posture has 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 in relation to their GDP.

You have also learned that given globalization scenario, trade liberalization among nations and the removal of all trade barriers, many firms have moved out of their nations t foreign markets. Trade liberalization tends to ensure that commerce and industry can flourish smoothly around the world without hitches and hazards. From the discussion, you have realized that International operations go with cultural differences, which must serve international firms and businessmen for success in the international markets.

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1.7 Possible Answers to SAEs

Answer to SAE 1

Five (5) phenomena that gave impetus to the demand for New International Economic Order in the early 1970s.include:

i. A severe energy crisis;
ii. The breakdown of the Bretton Woods System in 1973;
iii. The disappointment with development aid from advanced nations;
iv. The formation of OPEC in 1973 and its success in raising oil price; and
v. The existence of high rates of inflation and unemployment in LDCs

Answer to SAE 2

Measures as aimed at improving the terms of trade of LDCs

and removing their chronic trade deficits by the new international economic order.

(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) implying access to markets in developed countries through progressive removal of tariff and non-tariff barriers and restrictive trade practices.

Answer to SAE 3

Five (5) Areas of reform in international monetary system from NIEO in favour of LDCs include:

(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; and

(v) debt re-negotiation on a case-by-case basis with a view to concluding agreements on debt- cancellation, moratorium or rescheduling.

UNIT 5 GLOBAL POWER AND WEALTH DISTRIBUTION

Unit Structure

5.1 Introduction

The proceeding study unit has been used to discuss the issues of globalisation and new international economic order. You have gained knowledge on what about the crave for a new international economic Order by the less developed nations. The international scene particularly in the 1970s which has made the world to be a global village results in making firms to move massively into foreign operations and markets. This also came on the hills of trade liberalization in many countries. Relatedly, this unit is intended to discuss issues of global power structures emanating from groupings of advanced countries and formation of alliances.

You can understand from previous study unit that the wealth of the world is concentrated mainly in advanced nations at the expense of the less developed countries (LDCs). Hence, such unhealthy situation gives rise to the agitation for equitable distribution of the global wealth between the Global North and the Global south; the so called First World and Third World countries.

5.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss global power and wealth distribution;
- Analyse instrument for Wealth Distribution; and
- Evaluate problem of power distribution.

5.3 Global Power and Wealth Distribution

There are many strategies in the hands of state in the global political economy, as regards wealth distribution in modern diplomacy. Emergence of globalization began as an attempt to examine the way in which states or global powers responds to and attempted to manage the process of globalization and wealth distribution. The instrument of competitive strategies, did not favour less developed nations. The role of less developed nations in the global political economy in wealth distribution is in decline, and Omnipotent Globalization had become a mysterious, somehow and incontrollable force, rendering wreathing in its wake powerless. (Ronew Palan 2009).

In the word of Francis Balle (2009 p. 207) In technological and economic terms, The world is a village, nevertheless, the world remains a mechanism for cultural, economic and political difference. Under the combined effect of the globalization of the economy and distribution of wealth revolution, have led to Americanization or the balkanization of culture as regards wealth distribution has promoted forced standardization. This was also queried by Charles Ziagber (2007) great power are not the avatar of development but a new stage in resource allocation. The danger of the 21st century is not of a forced march towards Americanization, but rivalry between economic powers and the globalization of markets and distribution of economic resources.

The global power has attempted and still attempting to distribute wealth in the society.

The wealth of nations is not evenly distributed. Some nations are rich in natural resources. Others are rich in both human and natural resources, but lacked technological expertise. The global powers like the USA, Britain, France, Russia, Germany have formed a cartel or grouping as regards use of wealth and how it is distributed across the globe.
Most third world nations have resources, e.g. Nigeria has oil or crude but cannot exploit them because she depends on advanced nations to use its natural resources.

SELF ASSESSMENT EXERCISE 1

Mention five (5) reasons for the push towards wealth redistribution between developed nations and less developed countries?

5.4 Instrument for Wealth Distribution

Although much of the wealth of nations naturally sited, but its distribution are centrally controlled. The wealth owners can hardly have effective control of its wealth because the global powers have signed agreements, given aids as way of controlling natural resources or wealth of less developed nations.

The use of Multinational Corporation. The global power have used and still using multinational corporation as a means of distributing wealth, because they have link with their home government to repatriate dividends and export both finished and raw material to anywhere deemed appropriate by the global powers.

We have experienced numerous conflicts and violence, as a result of the use of multinational corporations as engine of growth and for wealth distribution.

Another instrument for wealth distribution is through cartel and use of threat and loan deal to deal with less developed nations where natural resources are endowed.

For example, less the super power has used threat assassination and coup to deal with developed nations to bow to their whims and caprices. David Allende of Chile was destooled because he refused USA and its allies control their natural resources.

Besides, the global powers also uses joint ventures, and technical exports as a way of distributing wealth to area where not located. The joint venture enables poor nations to be assisted in her wealth exploration and distribution. Most of the Arabia wealth is found in USA and its allied super power, because they use joint ventures to entice poor nations to inviting them.

Increase globalization. Another instrument for wealth distribution is through globalization where the world is a global village, where transaction is concluded through internet, e-market and so on. Globalization has provided ways for making wealth distribution easy. The super have used their technical known how to improve the distribution of wealth of nations.

Besides, the above, through the Instrument Of regional bodies. The great Power has formed NATO, WARSAW, European, Unions a way of maximizing advantages in wealth utilization and distribution. Regional bodies have assisted in distribution wealth across the globe.

The applicable strategies for redistribution of wealth include: technology transfer; bilateral agreements; signing of economic pacts; use of multinational corporations; and gifts, among others.

SELF ASSESSMENT EXERCISE 2

Identify five (5) strategies for wealth redistribution around the world.

1.5 Problems of Global Power in Wealth Distribution

The Place of global powers in wealth distribution has continued to generate Confusion and conflicts among great power that have technological expertise and power, than those nations who possessed resources without technological advantage. Political instability, violence and war have resulted from wealth distribution in modern world diplomacy and economic relations.

One of these problems is the problem of financial insecurity experienced by the majority of developing countries. The problems are three factors, namely hasty and disorganized financial liberation, excessive debt and lack of capital flow into underdeveloped nations liberalization of financial markets without the slightest examining countries in transaction. IMF orders the liberalization of financial markets without evidence that stimulate growth and economic development in countries adopting it. This was the case of Nigeria and Russia (Neijib Mekache 2007).

An influx of capital into economic With an immature and insufficiently regulated financial system can do more harm than good. The influx and sudden withdrawal of capital in South East Asia and Latin America brought 1999 – 1998 crisis and uprising in Arab world recently. Joseph Stiglitz clearly explained, ―It is unfair to demand that developing countries with a scarcely functioning backin0g system should risk apenus up their market operation rules, it is bad economic decision because speculative capital whose elob and flow leaves chaos in its wake. The small developing country are like small boats, rapid liberalization of financial markets by IMF force them to take to sea in high wind before they are able to plug the hoes in the bull‖ reviewed from the above, the possibility of developing getting financial ship reck is high.

There is the need to free developing countries from the Anglo-Saxon financial model based on the free circulation of capital.

Another problem resulting from great power wealth distribution is increased debtedness that of less developed countries to have natural resources, without adequate technical knowhow and expertise to distribute the wealth. Many nations have van into debts, which crippled their economy. G8 initiative adopted at the Gleneagles summit in June 2005 for the cancellation, in full, of the debt of countries benefiting from the programme for payments of transfer (PPT) with respect to the IMF. G8 initiative should be extended to non PPT countries with similar level of revenue and poverty.

Many nations have suffered and are still suffering from debt they incurred due to wealth distribution.

Furthermore, political instability has come into the purview of nation for example have experienced and still experiencing violence, bomb blast due to resource distribution and power acquisition. Political hegemony Remained the last resort to wealth distribution.

The global power through IMF introduced privatization and commercial of public enterprise, the only access to wealth is through political office. Many rested interest, who could not reach corridor of power used violence to change things.
The Nigerian State gradually bleeding slowly into death.

SELF ASSESSMENT EXERCISE 3

What are the problems associated with global power in wealth distribution? look at global power and distribution across the Comity nations.

Britain, France Russia. Other great powers, emerging after The cold war include, Germany, Asian

Tigers' and other colonize which have reached their human and technological ebbs and A flow. Global powers depends on their military might's, technological superiority and the Use of loans, and other instruments to Intimidate less developed nations with Natural wealth. We have been that global power uses, globalization and financial institutions to get their ascendance as a resources and wealth distributor. They have formed economic blocks; use IMF as a tool, and multinational corporations as a tool to entrench themselves avatar of wealth distribution. The politics of wealth distribution as authoritative allocation of values rest In the hands of global powers. This has created pockets of resistance and violence on its wake.

1.6 Summary

In this unit, we Instrument examined the globalization and wealth Distribution between the First World and Third World.

The unit also discuss Global power play and the used to pursue wealth distribution. We also examined some of the problems inherent in wealth distribution based on the focus and locus of global powers.

This tendency has resulted into social violence, financial crisis, indebtedness of third world nations, and lack of even development across the globe.

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1.8 Possible Answers to SAEs

Answer to SAE 1

Five (5) reasons for the push towards wealth redistribution between developed nations and less developed countries include:

i. Globalisation of international markets;
ii. Global politics and rivalry;
iii. Skewed wealth structure in favour of developed nations;
iv. Advanced technological means of production in advanced nations; and
v. Lack of transfer of technology to the LDCs for exploiting their natural endowments.

Answer to SAE 2

The strategies for wealth redistribution around the world include:

i. technology transfer;
ii. bilateral agreements;
iii. signing of economic pacts;
iv. use of multinational corporations; and
v. gifts

Answer to SAE 3

The problems associated with global power in wealth distribution include:

i. Financial insecurity experienced by the majority of developing countries.
ii. Problem of weak financial systems in LDCs.
iii. LDCs still attached to developed world financial models based on free circulation of capital.
iv. Increased indebtedness of LDCs.
v. Political instability in LDCs.
vi. Inimical pills of IMF regarding SAP, commercialization and privatization.

MODULE 3

Unit 1 Multilateral Negotiations

Unit Structure

1.1 Introduction

In the previous study unit , you have been exposed to globalisation and wealth distribution between the developed countries and less developed countries. This unit is used to discuss negotiation in business whether it is multilateral (between nations) or local (between groups and individuals within a country). You should understand that such discussion for defined business relationship is guided by the same principles. In essence, our negotiating skills are tested when we new relationships. Basically, managers have even more opportunities to negotiate. Sales people, employees, labour unions, other managers, and customers all have wishes that the organization may not be able to grant without some give-and-take discussion. Sadly to say that most of us are rather poor negotiators. Negotiation skills, like any other crucial communication skills, need to be developed through diligent study and regular practice. Hence you are being exposed to acknowledge and skills for effective negotiations in this unit. The required tactic with which to negotiate more favourable outcomes than did those with no such training are explored herein.

1.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the connotation of negotiation & its purpose;
- Analyze the elements of negotiation;
- Evaluate the process of negotiation; and
- Demonstrate what it takes to achieve effective negotiation.

1.3 Negotiation: Meaning and Purpose

Negotiation can be defined as a decision-making process among interdependent parties who do not share identical preferences. It is through negotiation that the parties decide what each will give and take in their relationship. The scope of negotiations spans all levels of human interaction, from individuals to organizations to nations. But what are the main types of negation?

There are two common types of negotiation are ―two-party and ―third-party negotiation. This distinction is evident or common real estate transactions. If you sell your home directly to a buyer after settling on a mutually agreeable price, that is a two-party negotiation. It becomes a third-party negotiation when a real estate broker acts as a go-between for seller and buyer.

Regardless of the type of negotiation, the same basic negotiating concepts apply.

Negotiation can also be seen as any form of verbal communication in which the participants seek to exploit their relative competitive advantages and needs to achieve explicit or implicit objectives within the overall purpose of seeking to resolve problems which are barriers to agreement.

This latter definition stresses three elements in negotiation such as identify as follows:

(1) Negotiation involves communication, that is, the exchange of information;

(2) Negotiation takes place in a context in which the participants use their comparative and competitive advantages and perceived

needs of the other party to influence the outcome of the negotiation process;

(3) Each participant has implicit as well as explicit objectives which determine their negotiating strategies, e.g. a supplier will explicitly wish to obtain the best price but implicitly will be seeking a contribution to fixed overheads and endeavoring to keep the plant and work force employed.

What are necessary ingredients of negotiations?

SELF ASSESSMENT EXERCISE 1

Define negotiation based on your own understanding of the word.

1.3.1 Elements of Effective Negotiation

A good way to learn about proper negotiation is to start from zero. This means confronting and neutralizing one‘s biases and faulty assumptions. Sports and military metaphors, for example, are usually inappropriate in negotiations because effective negotiators are not bent on beating the opponent or wiping out the enemy. They have a much broader agenda. For instance, effective negotiators not only satisfy their own needs, they also enhance the other party‘s readiness to negotiate again. You should understand that rust is important in this regard. Using this ―clean slate approach to learning, let us explore three common elements of effective negotiation. These are:

(i) Adopting a win-win attitude
(ii) Knowing your BATNA (Best Alternative to a Negotiated Agreement)
(iii) Identifying the bargaining zone

Adopting a win-win attitude towards Negotiation: Culture has a powerful influence on individual behavior. In America, for example, the prevailing culture places a high value on winning and never losing. American cultural preoccupation with winning is an admirable trait but sometimes it can be a major barrier to effective negotiation. A win-win attitude is preferable.

Replacing a culturally based win-lose attitude with a win-win attitude is quite difficult.

Deeply ingrained habits are hard to change. But they must be changed if American managers are to be more effective negotiators in today‘s global market place.

Knowing your BATNA (Best Alternative to a Negotiated Agreement): This old-sounding label represents the anchor point of effective negotiations. BATNA is an abbreviation for ―best alternative to a negotiated agreement. In other words, what will you settle for if negotiations do not produce your desired outcome(s). Members of the Harvard Negotiation Project, which is responsible for this BATNA concept, call it ―the standard against which any proposed agreement should be measured. That is the only standard which can protect you both from accepting terms that are too unfavourable and from rejecting terms which would have been in your best interest to accept. In today‗s popular language, it means ―what is your bottom line?

Identifying the Bargaining Zone:

Negotiation is useless if the parties involved have no common ground. At the other extreme, negotiation is unnecessary if both parties are satisfied with the same outcome. Midway, negotiation is necessary when there is a degree of overlap in the ranges of acceptable outcomes. Hence, ―bargaining zone" can be described as the gap between the two BATNA‗s – the area of overlapping interests where agreement is possible. Because negotiators keep their BATNAs secret, each party needs to estimate the other‗s BATNA when identifying the likely bargaining zone.

1.3.2 Added Value Negotiation

Win-win negotiation is great idea that can be difficult to implement on a daily basis. Managers and others tend to stumble when they discover that a win-win attitude, though necessary, is not all they need to get through a touch round of negotiations. A step-by-step process is also essential.

Karl and Steve added value negotiating process that bridges the gap between win-win theory and practice. Added value negotiating (AVN) is five-step process involving the development of multiple deals that add value to the negotiating process. This approach is quite different from traditional ―single-outcome negotiating that involves ―taking something from the other party.
Added value negotiating comprises the following five steps:

1. Clarify interests: Both subjective (judgmental) and objective (observable and measurable) interests are jointly identified and clarified by the two parties. The goal is to find some common ground as a basis for negotiation.

2. Identify options: What sort of value, in terms of money, property, actions, rights, and risk reduction can each party offer the other? This step creates a market place of value for the negotiators.

3. Design alternative deal packages: Rather than tying the success of the negotiation to a single win-win offer, create a number of alternatives from various combinations of value items.

   This vital step, which distinguishes added value negotiating from other negotiation strategies, fosters creative agreement.

4. Select a deal: Each party tests the various deal packages for value, balance, and fit. Feasible deals are then discussed jointly, and a mutually acceptable deal is selected.

5. Perfect the deal: Unresolved details are hammered out by the negotiators.

Agreements are put in writing. Relationships are strengthened for future negotiations. Added value negotiating is based on openness, flexibility, and mutual search for the successful exchange of value. It allows you to build strong relationships with people over time.

SELF ASSESSMENT EXERCISE 2

Mention the five-step process in added value approach to negotiation.

1.4 Approaches to Negotiation

Approaches to negotiation can be classified as adversarial and partnership:

1.4.1 Adversarial negotiation

This is also referred to as distributive or win-lose negotiation, is an approach in which the focus is on ‗positions' stakes out by the participants in which the assumption is that every time one party wins the other loses. As a result, the other party is regarded as an adversary.

1.4.2 Partnership negotiation

Partnership negotiation is also called integrative or win-win negotiation, and it is an approach in which the focus is on the merits of the issues identified by the participants on which the assumption is that through creative problem solving one or both parties can gain without the other having to lose. Since the other party is regarded as a partner rather than an adversary, the participants may be more willing to share concerns, ideas and expectations.

1.5 The Content of Negotiation

In any negotiation, two goals or objectives should receive consideration. These may be referred to as substance goals and relationship goals.

(a) Substance goals: These are concerned with the ‗content issues' of the negotiation. The possible content issues are legion and depend on the requirements relating to a specific situation. Most negotiations will take place in respect of high-value-usage items, that is, the 15-20% that constitute the major portion of inventory investment. Negotiation usually relates to non-standard items although a large user will seek, if possible, to negotiate preferential terms for standard supplies. Most negotiation topics affect price either directly or indirectly.

(b) Relationship goals: These are concerned with outcomes relating to how well those involved in the negotiation are able to work together once the process is concluded and how well their respective organizations or constituencies may work together. Some
areas for relationship goals include:

- Partnership sourcing
- Preferred supplier status
- Supplier involvement in design and development and value
- analysis Sharing of technology.

1.5.1 What is an Effective Negotiation?

Effective negotiation may be said to take place when:

(i) Substance issues are satisfactorily resolved and
(ii) Working relationships are preserved or even enhanced.

There are three criteria for effective negotiation. These are:

(a) The negotiation produces a ―wise agreement."

That is an agreement that is acceptable to both sides.

(b) The negotiation is ―efficient."

An efficient negotiation is one that does not consume much time or involve too much cost.

(c) The negotiation is ―harmonious."

Harmonious negotiation fosters rather than inhibits good interpersonal relationships.

1.5.2 The Process of Negotiation

Negotiation falls into three distinct phases: pre-negotiation, the actual negotiation and post-negotiation.

(a) Pre-negotiation

Cases are won in chambers‖ is the guiding principle in pre-negotiation, that is, legal victories are often the outcome of the preceding research and planning of strategy on the part of counsel.

Executives can learn much by studying the strategies and tactics of legal, diplomatic and industrial relations and applying them to business negotiations. The matters to be determined at the pre-negotiation stage are as follows:

Who is to negotiate?

(i) Individual approach: When negotiations are to be between two individuals, both should normally have sufficient status to settle unconditionally without reference back to higher authority. The majority of purchasing and production negotiations are conducted on an interpersonal basis.

(ii) Team approach: For important negotiations, especially where complex technical, legal, Financial, etc. issues are involved a team approach is usually more commonly employed since. An individual negotiator is rarely qualified to act as sole negotiator for a company.

(b) The Actual Negotiation

Even with a philosophy of partnership negotiation, the activities of the participants will change at each stage of the negotiation process. These activities alternate between competition and co- operation. It is useful for a negotiator to recognize this pattern of interaction and to recognize the stage that has been reached in a particular negotiation.

Special book on negotiation usually list a number of techniques available to negotiators. It is not possible to detail these in this course material but some general findings include the following:

(i) In framing an agenda, the more difficult issues should appear later, thus enabling some agreement on less controversial matters to be reached early in the negotiation.

(ii) Questions are a means both of eliciting information and keeping pressure on an opponent. Questions can also be used to control the pattern and progress of the negotiation.

(iii) Concessions are a means of securing movement when negotiations are deadlocked.

Research findings show that losers tend to make the first concession and that each concession tends to raise the expectation level of the opponent. Buyers should avoid a pattern of concession in which, through inadequate preparation, they are forced to concede more and more. The convention is that concession should be reciprocal. While flexibility is essential, there is no compulsion to make a counter-concession and the aim should be to concede less than has been obtained. The outcome tends to be more favourable when the concessions made are small rather than large.

(iv) Negotiation is between people. It is essential to be able to weigh up the personalities ofone‘s opponents and the drives that motivate them, e.g. achievement, fear, etc.

(c) Post-Negotiation

Post-negotiation involves:

(i) Drafting a statement detailing as clearly as possible the agreement reached and circulating it to all parties for comment and signature.

(ii) Selling the agreement to the constituents of both parties, that it, what has been agreed upon,why it is the best possible agreement, what benefits will accrue.

(iii) Implementing the agreement, example, placing contracts, setting up joint implementation team, etc.

(iv) Establishing procedures for monitoring the implementation of the agreements and dealing with any problems that may arise.

SELF ASSESSMENT EXERCISE 3

Mention the essential stages of negotiation.

1.5.3 Global Negotiation

The growth of global business has highlighted the importance of global negotiating skills.
These include:

(i) A knowledge of the language of the country in which the other party to the negotiation is located.

(ii). A recognition of cultural influences on the negotiation process. For example, Japanese negotiations are characterized by politeness, a non-revealing manner, a non- confrontational approach and persistence. In contrast, negotiators in the USA and Canada appeal to reason, adduce objective facts to counter subjective statement, take a moderate initial position and place great emphasis on the meeting of deadlines

1.6 Summary

This study unit has been used to discuss the realm of negotiation. You have gain the knowledge that negotiation national or international has the same objective, and parties negotiate to get advantages or leverage or fair price or value. You also have known that a party's negotiating skills are tested a product is being bought and managers have even more opportunities to negotiate. Sales people, employees, labour unions, other managers, and customers all have wishes that the organization may not be able to gain advantages without some kind of negotiation in business dealings. In addition, negotiation skills like any other crucial communication skills, as you can understand, need to be developed through diligent study and regular practice, which lends credence to the cliché that practice makes perfect.

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1.8 Possible Answers to SAEs

Answer to SAE 1

Negotiation can be viewed as a process of making decision between interdependent parties who share divergent preferences regarding the subject matter at stake.

Answer to SAE 2

Five-step process in added value approach to negotiation involves:

1. Clarify interest
2. Identify options
3. Design alternative deal packages
4. Select a deal
5. Perfect the deal

Answer to SAE 3

Mention the essential stages of negotiation.

i. Pre-Negotiation
ii. Actual Negation
iii. Post-Negotiation

UNIT 2 DETERMINANTS OF ECONOMIC GROWTH

Unit Structure

2.1 Introduction

The preceding study unit has been used to discuss negotiation, which is very important in our personal business transactions and the operations of the corporate entities. In this unit, you will be taken through the determinants of economic growth. You will recall from transfer earning regarding earlier study units in this study material that international trade has been used in many ways, through transfer of technology, exchange of other productive resources, etc., to enhance economic growth in many nations of the world. The activities of the multinational corporations, as you have learned form our earlier discussions in this study material, have been very useful in aiding economic growth and development of the less developed counties. The globalization, trade liberalization and international business have played and still playing no less role in aiding nations' quest for economic development around the world. You will learn more about the predictors of economic growth in this unit.

2.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the term Economic Growth;
- Discuss the variables that influence the definition of economic growth and development;
- Analyze the factors that influence or the determinants economic growth
- Discuss how social indices like poverty, inequality and land use influence growth and development in third world nations like Nigeria.

2.3 Meaning of Economic Growth

Growth in general terms could be defined as an increase in output. This indicates an increase in the rate of output per unit of input. Development implies increase in output with a change in technical and institutional arrangement by which production takes places. In regard to less developed countries it implies change over from traditional techniques Which keep output at subsistence level to modern techniques, which carry the output above the subsistence level (Olajide 2007).

Zogbe (2008) conceptualized growth as an expansion of the system in one or more dimensions without a change In its structure and development as an innovative process leading to the structural transformation of social system. In examining focus and focus of the definition of Economic growth and development, we need to examine traditional economic measure and new economic view of development.

In economic terms, development meant the capacity of a national economy whose initial economic condition has been move or less static for a long time, to generate and sustain an annual increase in its gross national income (GND) at rates of 5% or more. A common alternative economic index of development has been the use of rates of growth of income per capital to take into account the ability of a nation to expand its population.

Growth Levels and Rate of the ability of income per capita to take into account nation To expand its output at a rate of growth of GNI per capita minus the Rate of inflation are normally used to measure the overall economic well-being of a population – how much of real goods and services is available to the average citizen for consumption and investment.

Economic development in the past has been typically seen in terms of – how much of real goods and services is available to the average citizen for consumption and investment.

Economic development in the past has been typically seen in terms of the planned alteration of the structure of production and employment so that agriculture share of both declines and that of manufacturing and service industries increases. The economic strategies focused on rapid industrialization at the expense of agricultural and rural development. Besides the above there are new economic views of development targeted at examining the levels of the living of the masses of the people. The new epoch, attempt to look how poverty of the people are to be dealt with. A number of developing countries experienced relatively high rates of growth of per capital income during 1960s to 1970s economic development came to be redefined in term of the reduction or elimination of poverty, inequality, and unemployment within the context of a growing economy. ―Redistribution from growth‖ becomes a common slogan. Based on above, we Can insinuate that economic development Can Be conceived ad multidimensional process involving major changes in social structures, popular attitudes, and national institutions, as Well as the acceleration of economic growth, the reduction of inequality and the eradication of poverty. Development and growth must include the whole gamut of change by which an entire social system turned to the diverse basic needs and desires of individual and social groups within that system.

But what influence economic growth and development in any nation?

SELF ASSESSMENT EXERCISE 1

Show how economic growth is different from economic development.

2.4 Determinants of Economic Growth.

It must be observed that, the less developed and developing nations are aware of factor inhibiting their development and growth. We can now discuss some of these factors as follows:-

1. Resource Endowment

The pace of economic growth of a country depends on natural endowment the nation is blessed with. This includes both physical and human resources. They have significant role to play in the process of economic development of a country.

Examples

include, black gold, gold, copper, fertile land, water resources. These resources can go nowhere if they are not properly harnessed and utilized by man. The quality of labour force is critical in determining the productive capacity of a country. The human sizes, resources include the size of labour force and the managerial and the technical skills acquired by the labour force. What about the capital factor in relation to economic growth?

2. Capital Accumulation

Another factor that can stimulate economic growth is the rate of capital formation that is the rate of investment in human and physical capital in the political economy. The rate at and human which both physical resources is growing can have effects on economic Growth. capital accumulation; can stimulate economic growth through modern methods in technological growth and skills available in the society. Capital accumulation Is important in stimulating economic growth because modern production methods involve the use of modern technology, a physical capital and human skill to manage it.

Therefore, the ability of less developed countries to use these modern methods in terms of technology and skill will go a long way to determine their growth and largely depend on the level of capital accumulated in its equality.

3. Capital – output Ratio

Another factor that can determine economic growth is capital-output ratio in an economy.
This means the amount of capital used to produce certain level of output. It measures the efficiency of capital, i.e., the rate at which output grows as a result of a given volume of capital investment. In less develop countries; capital output ratio is very high because appropriate investment in both social and economic sector has not been made.

We must observe that There is always more investment in economic sector than social sector, thereby, resulting in used capacity in the Economic sector especially in the industries. The rate at which national output grows is determined by the capital – output ratio. The lower it is, this lower the capital output ratio will be.

What role does the technology play in economic growth?

4. Technological progress

There is a symbiotic relationship between capital formation and technological progress.

The two help in stimulating growth of an economy. The source of their relationship can be highlighted by referring to the sources of technical changes, which requires capital as their prerequisite. An improved technology cannot be concretized except in the shape of capital equipment so also increase in capital must accompany technical change so that it becomes increasingly more fruitful.

Technological progress refers to the development of new and improved method of doing traditional task. When there is technological progress, there will be an effective use of the stock of resources in an economy; new ones could also be discovered. The so called Industrial and Agricultural revolutions in the present developed countries were as a result of technological innovations cum progress. So the less developed countries should find a way of developing their technology.

Importing foreign technology in its entirety may not do the trick but ability to adapt it to local environment. This brings in the importance of skilled manpower to fix the technology. Japan immediately after the Second World War adapted technology from Africa, to their Environment through skilled man-power and today Japan is a force to reckon with technologically. So less developed countries should find ways of developing their own technology if they find adapting imported ones expensive so as to have a long lasting growth. This is because technological progress has direct impact on productivity of factors of production. Does the appropriateness of population policy affect the economic growth of a nation?

5. Population Policy

Less developed countries in order to grow need an appropriate population policy. This is borne out of the dire consequences of rapid population growth. Though, it is not a crime to have a high population growth, as it will create necessary market in the economy that would also stimulate growth. A rapid population growth will require a much higher rate of growth of national output in order to raise per capita output hence this will be falling thereby signaling poor economic situation.

With recent improved health facilities in most less developed countries (courtesy WHO of and UNICEF), there is increased survival rate of children at birth, this results in large proportion of children in the population of third world countries.

This large proportion raises the dependency ratio which registers its effect on the productive capacity of the economy. Having the right disposition in the population composition is what will help the less developed countries to grow. Thus, the essence of appropriate population policy, which the country can develop, that will be beneficial to their growth should be embraced.

For example, more vigorous efforts are required to reduce population growth in the developing nations, especially Africa and South Asia, urgent need to strengthen programmes of family planning, female illiteracy, fertility reduction, maternal and child health care. This is more important now than ever going by the world demographic report which shows that the Share of the developing nations world population has grown From 69% in 1960 to 78% by 2000 and it is expected to reach 84% by 2025. While developed nation population is shrinking from 31% to 22% in 2000 and expected to shrink to 16% by 2025.

6. Creative and Dynamic Entrepreneurship (Risk Bearers)

Dynamic entrepreneurs who can take risk in productive industries rather than commence will also play a major role in promoting economic growth. Besides their traditional roles of coordinating, organizing, planning and directing function as a factor of production, a creative entrepreneur should try new method of production to increase his profit share.

As a result these entrepreneurs will have to take new risk and be pace setters with the hope of maximizing profit. The extent he can risk, the higher the profit and this will equally reflect in growth of National output.

SELF ASSESSMENT EXERCISE 2

Mention five (5) factors influencing economic growth.

Appropriate Institutions and attitudes Besides the aforementioned factors, it is also a matter of necessity that there is the availability of appropriate institutions, such as banks that could mobilize available savings and change it into investments. The land holding methods where the whole land ownership is fragmented needs be looked into. The attitude of not allowing women to work or seen outside their domain which is common mostly with the Muslim sect should be revisited and reviewed. Everybody has what he or she can contribute to the development of the country. Development should be seen as a collective responsibility.

People‘s attitude to getting rich at all cost should be changed.

In conclusion, apart from those economic factors that were mentioned above, it has also been observed by writers that economic development has much to do with human endowments, social attitudes, political conditions and historical accidents, in less developed countries, political and administrative framework. If these could be addressed i.e. giving room for political stability, efficient and effective, upright and good governance, economic development will be ensured. Retrogressive culture, social attitudes, values, virtues and over sentimentality of religion that predominate less developed countries should be equally addressed, to give room for growth.

SELF ASSESSMENT EXERCISE 3

Why are appropriate Institutions and attitudes important in economic growth?

2.5 Summary

We endeavored to discuss the issue of economic growth and the factors that determined economic growth. Defined economic development, however, goes beyond economic growth because the later is only a means to the former. It is instructive to note that there cannot be economic development without economic growth. It is the former that triggers the latter. You have also been made to become accustomed with the modern conceptualsation of economic development. You have also understood from the discussions in this study unit the difference between economic growth and economic development. You have also come to terms that neither economic growth nor economic development can be achieved without the necessary influential factors, which serve to determine their pace in any nation around the world.

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2.7 Possible Answers to SAEs

Answer to SAE 1

Growth in general terms could be defined as an increase in output in goods and services of a country while development implies an increase in output with a change in technical and institutional arrangement by which production takes place.

Alternatively, growth can be conceptualized as an expansion of the system in one or more dimensions without a change in its structure and development as an innovative process leading to structural transformation of social system. Economic development implies the capacity of a national economy whose initial economic condition has been more or less static for a long time, to generate and sustain an increase in its gross national income at a rate of 5% or more.

Answer to SAE 2

Five (5) factors influencing economic growth include:

i) Resource endowment
ii) Capital accumulation
iii) Capital-output ratio
iv) Technological progress
v) Population policy

Answer to SAE 3

Appropriate Institutions and attitudes play crucial role in economic growth because such institutions like banks are required towards mobilizing funds through savings from the people to fund industrial growth and survival in any economy while encouraging investments in the economy. Furthermore, economic development has much to do with human endowments, social attitudes political conditions and historical antecedents.

UNIT 3 IMPORT SUBSTITUTION INDUSTRIALIZATION STRATEGY

Unit Structure

3.1 Introduction

The preceding study has been used to discussed the issue of economic growth. You have been made to get acquitained with the definitions of economic growth as well the conceptualization of economic development. You also derived the knowledge about the fact that economic growth serves as the springboard for economic development and the predictors of both in any country. In related terms, industrialization is necessary for both economic growth and economic growth . The import substitution industrialization (ISI) is a trade and economic policy that advocates replacing foreign imports with domestic production that serves as catalyst for both economic growth and economic development. This study unit will be used to discuss this industrialization and economic catalyst.

3.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the basis of import substitution industrialization strategy;
- Analyze the historic background of Import Substitution Industrialization;
- Demonstarte how some theories motivated LDCs to engage in using Import substitution industrialization as policy; and
- Analyze the Latin America experience drawing on advantages and disadvantages of ISI.

1.3 Basis of import substitution industrialization (ISI)

The import substitution industrialization (ISI) is based on the premise that a country should attempt to reduce its foreign dependency through the local production of industrialized products. The term primarily refers to 20th-century development economics policies, although it has been advocated since the 18th century by economists such as Friedrich List.

ISI policies were enacted by countries within the Global South with the intention of producing development and self-sufficiency through the creation of an internal market.

ISI works by having the state lead economic development through nationalization, subsidization of vital industries (including agriculture, power generation, etc.), increased taxation, and highly protectionist trade policies.

Import substitution industrialization was gradually abandoned by developing countries in the 1980s and 1990s due to structural indebtedness from ISI related policies on the insistence of the IMF and World Bank through their structural adjustment programs of market-driven liberalization aimed at the Global South. In the context of Latin America development, the term Latin American structuralism refers to the era of import substitution industrialization in many Latin American countries from the 1950s until the 1980s.

The theories behind Latin American structuralism and ISI were organized in the works of Raúl Prebisch, Hans Singer, Celso Furtado, and other structural economic thinkers, and gained prominence with the creation of the United Nations Economic Commission for Latin America and the Caribbean (UNECLAC or CEPAL).

While the theorists behind ISI or Latin American structuralism were not homogeneous and did not belong to one particular school of economic thought, ISI and Latin American structuralism and the theorists who developed its economic framework shared a basic common belief in a state-directed, centrally planned form of economic development. In promoting state-induced industrialization through governmental spending through the infant industry argument, ISI and Latin American structuralist approaches to development are largely influenced by a wide range of Keynesian, communitarian and socialist economic thought.

ISI is often associated and linked with dependency theory, although the latter has traditionally adopted a much broader Marxist sociological framework in addressing what they perceive to be the cultural origins of underdevelopment through the historical effects of colonialism, Eurocentrism, and neoliberalism.

SELF ASSESSMENT EXERCISE 1

What is the basis of import substitution industrialization?

1.4 History Background of Import Substitution Industrialization (ISI)

Even though ISI is a development theory, its political implementation and theoretical rationale are rooted in trade theory: it has been argued that all or virtually all nations that have industrialized have followed ISI.

Import substitution was heavily practiced during the mid-20th century as a form of developmental theory that advocated increased productivity and economic gains within a country. This was an inward-looking economic theory practiced by developing nations after WW2.

Many economists at the time considered the ISI approach as a remedy to mass poverty: bringing a third-world country to first-world status through national industrialization. Mass poverty is defined thusly: "the dominance of agricultural and mineral activities -- in the low-income countries, and in their inability, because of their structure, to profit from international trade," (Bruton, 2002).

Mercantilist economic theory and practices of the 16th, 17th, and 18th centuries frequently advocated building up domestic manufacturing and import substitution. In the early United States, the Hamiltonian economic program, specifically the third report and the magnum opus of Alexander Hamilton, the Report on Manufactures, advocated for the U.S. to become self-sufficient in manufactured goods. This formed the basis of the American School, which was an influential force in the United States during its 19th century industrialization.

Werner Baer contends that all countries that have industrialized after the United Kingdom went through a stage of ISI, in which the large part of investment in industry was directed to replace imports (Baer, 1972).

Going farther, in his book Kicking Away the Ladder, Korean economist Ha-Joon Chang also argues, based on economic history, that all major developed countries, including the United Kingdom, used interventionist economic policies to promote industrialization and protected national companies until they had reached a level of development in which they were able to compete in the global market, after which those countries adopted free market discourses directed at other countries to obtain two objectives: open their markets to local products and prevent them from adopting the same development strategies that led to the developed nations' industrialization.

SELF ASSESSMENT EXERCISE 2

Briefly trace the background of import substitution industrialization.

1.5 Theoretical basis of Import Substitution Industrialization (ISI)

As a set of development policies, ISI policies are theoretically grounded on the Singer-Prebisch thesis, on the infant industry argument, and on Keynesian economics. From these postulates, it derives a body of practices, which are commonly: an active industrial policy to subsidize and orchestrate production of strategic substitutes, protective barriers to trade (such as tariffs), an overvalued currency to help manufacturers import capital goods (heavy machinery), and discouragement of foreign direct investment.

Due to the exploitation indirectly performed by the laissez-faire market, third-world countries started to become self-reliant. To fight mass poverty in any given country, ISI was an implement for the infant-industry argument. To compete in the world market against first-world countries, third-world and/or developing countries would protect their "infant" new industries until a sufficient amounts of knowledge, capital, and comparative advantage are accumulated.

Henry J. Burton in his paper ‗A Reconsideration of Import Substitution' stated: "The very idea of import substitution implied this: keep out that which is now imported from the North and produce it at home," (Bruton 910). Consequently, the North's developed and industrialized markets will not be a factor or a source of resources for the undeveloped and developing South.

By placing high tariffs on imports and other protectionist, inward-looking trade policies, the citizens of any given country, using a simple supply-and-demand rationale, will substitute the less-expensive good for the more expensive. The primary industry of importance would gather its resources, such as labor from other industries in this situation; the industrial industry would use resources, capital, and labor from the agricultural sector.

In time, a third-world country would look and behave similar to a first-world country, and with a new accumulation of capital and comparative advantage and an increase of TFP (total factor productivity) the nation's industry will be capable of trading internationally and competing in the world market.

Bishwanath Goldar, in his paper ‗Import Substitution, Industrial Concentration and Productivity Growth in Indian Manufacturing' wrote: "Earlier studies on productivity for the industrial sector of developing countries have indicated that increases in total factor productivity, (TFP) are an important source of industrial growth," (Goldar 143).

He continued: "a higher growth rate in output, other things remaining the same, would enable the industry to attain a higher rate of technological progress (since more investment would be made) and create a situation in which the constituent firms could take greater advantage of scale economies;" it is believed that ISI will allow this (Goldar 148).

In many cases, however, these assertions did not apply. On several occasions, the Brazilian ISI process, which occurred from 1930 until the end of the 1980s, involved currency devaluation as a means of boosting exports and discouraging imports (thus promoting the consumption of locally manufactured products), as well as the adoption of different exchange rates for importing capital goods and for importing consumer goods.

Moreover, government policies toward investment were not always opposed to foreign capital: the Brazilian industrialization process was based on a tripod which involved governmental, private, and foreign capital, the first being directed to infrastructure and heavy industry, the second to manufacturing consumer goods, and the third, to the production of durable goods (such as automobiles). Volkswagen, Ford, GM, and Mercedes all established production facilities in Brazil in the 1950s and 1960s.

The principal concept underlying ISI can thus be described as an attempt to reduce foreign dependency of a country's economy through local production of industrialized products, whether through national or foreign investment, for domestic or foreign consumption. It should be noted, as well, that import substitution does not mean import elimination: as a country industrializes.

A nation implementing ISI begins to import new materials that become necessary for its industries, such as petroleum, chemicals, and other raw materials it may have formerly lacked. The real objective of import substitution is therefore not to eliminate trade but to lift a nation to higher stage, that of exporting value-added products not as susceptible to economic fluctuations as are raw materials, according to the Singer-Prebisch thesis.

1.6 Latin America Experience

Import substitution policies were adopted by most nations in Latin America from the 1930s until the late 1980s. The initial date is largely attributed to the impact of the Great Depression of the 1930s, when Latin American countries, which exported primary products and imported almost all of the industrialized goods they consumed, were prevented from importing due to a sharp decline in their foreign sales. This served as an incentive for the domestic production of the goods they needed.

The first steps in import substitution were less theoretical and more pragmatic choices on how to face the limitations imposed by recession, even though the governments in Argentina (Juan Domingo Perón) and Brazil (Getúlio Vargas) had the precedent of Fascist Italy (and, to some extent, the Soviet Union) as inspirations of state-induced industrialization. Positivist thinking, which sought a "strong government" to "modernize" society, played a major influence on Latin American military thinking in the 20th century.

Among the officials, many of whom rose to power, like Perón and Vargas, industrialization (especially steel production) was synonymous with "progress" and was naturally placed as a priority.

ISI gained a theoretical foundation only in the 1950s, when Argentine economist and UNECLAC head Raúl Prebisch was a visible proponent of the idea, as well as Brazilian economist Celso Furtado. Prebisch believed that developing countries needed to create local vertical linkages, and they could only succeed by creating industries that used the primary products already being produced domestically. The tariffs were designed to allow domestic infant industries to prosper.

ISI was most successful in countries with large populations and income levels which allowed for the consumption of locally produced products. Latin American countries such as Argentina, Brazil, Mexico, and (to a lesser extent) Chile, Uruguay and Venezuela, had the most success with ISI.

This is so because while the investment to produce cheap consumer products may pay off in a small consumer market, the same cannot be said for capital-intensive industries, such as automobiles and heavy machinery, which depend on larger consumer markets to survive.

Thus, smaller and poorer countries, such as Ecuador, Honduras, and the Dominican Republic, could implement ISI only to a limited extent. Peru implemented ISI in 1961, and the policy lasted through to the end of the decade in some form.

To overcome the difficulties of implementing ISI in small-scale economies, proponents of this economic policy, some within UNECLAC, suggested two alternatives to enlarge consumer markets: income redistribution within each country, through agrarian reform and other initiatives aimed at bringing Latin America's enormous marginalized population into the consumer market, and regional integration through initiatives such as the Latin American Free Trade Association (ALALC), which would allow for the products of one country to be sold in another.

In Latin American countries in which ISI was most successful, it was accompanied by structural changes to the government. Old neocolonial governments were replaced by more-or-less democratic governments. Banks and utilities and certain foreign-owned companies were nationalized or had their ownership transferred to local businesspeople.

Many economists contend that ISI failed in Latin America and was one of many factors leading to the so-called lost decade of Latin American economics, while others contend that ISI led to the "Mexican Miracle," the period from 1940 to 1975, in which annual economic growth stood at 6% or higher.

As noted by one historian, ISI was successful in fostering a great deal of social and economic development in Latin America:

―By the early 1960s, domestic industry supplied 95% of Mexico‘s and 98% of Brazil‘s consumer goods. Between 1950 and 1980, Latin America‘s industrial output went up six times, keeping well ahead of population growth. Infant mortality fell from 107 per 1,000 live births in 1960 to 69 per 1,000 in 1980, [and] life expectancy rose from 52 to 64 years. In the mid 1950s, Latin America‘s economies were growing faster than those of the industrialized West.‖

1.7 Advantages and disadvantages of ISI

The major advantages claimed for ISI include the following.

(1) increases in domestic employment, i.e., reducing dependence on non-labor- intensive industries such as raw resource extraction and export,

(2) resilience in the face of a global economic shocks, such as recessions and depressions, and

(3) less long-distance transportation of goods and less concomitant fuel consumption and greenhouse gas and other emissions.

Disadvantages claimed for ISI are that

(1) the industries it creates are inefficient and obsolete, as they are not exposed to
internationally competitive industries, which constitute their rivals, and

(2) the focus on industrial development impoverishes local commodity producers, who are primarily rural.

3) Rather than maintain an inward-looking economy, the idea of catching up can be much faster with strong competition rather than with domestic competition with people with similar levels of human capital.

4) Furthermore, with small external scale economies, the country's costs maintain high and knowledge accumulation will not steadily or slowly increase. Goldar takes note that in India "that policies of import substitution and domestic industrial licensing have led to considerable inefficiency in the industrial sector, and that policies for checking concentration (restrictions against large industrial houses, discrimination in favour of small scale units, etc.) have resulted in significant loss of scale economies,".

5) Import substitution was in place as a remedy for mass poverty, unemployment and economic growth, however, import substitution policies had created major distortions and had thereby resulted in a misuse of resources.

So it was increasingly evident that something needed fixing. Two other sources of concern appeared in the early 1970s and suggested that there were other things that needed fixing as well. The first, already referred to, was that the demand for labor in the new activities was growing more slowly than the rates of growth of output and investment had led most observers to expect. As a consequence of the slow growth of employment (and other things), poverty was alleviated only modestly," (Bruton, 2002).

SELF ASSESSMENT EXERCISE 3

What are the disadvantages of Import substitution industrialization

1.8 Summary

The History of Import substitution industrialization and Theoretical basis. More analysis of Import substitution industrialization shall be discussed in subsequent units.

The concept of Import substitution industrialization civil service is fully discussed hereby discussing the history of Import substitution industrialization and its theoretical basis and with reference to the Latin American that adopted the strategy of Import substitution industrialization and finally its advantages and its disadvantages.

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1.10 Possible Answers to SAEs

Answer to SAE 1

The import substitution industrialization (ISI) is based on the premise that a country should attempt to reduce its foreign dependency through the local production of industrialized products. The term primarily refers to 20th-century development economics policies, although it has been advocated since the 18th century by economists such as Friedrich List. ISI policies were enacted by countries within the Global South with the intention of producing development and self-sufficiency through the creation of an internal market. ISI works by having the state lead economic development through nationalization, subsidization of vital industries (including agriculture, power generation, etc.), increased taxation, and highly protectionist trade policies

Answer to SAE 2

Import substitution was heavily practiced during the mid-20th century as a form of developmental theory that advocated increased productivity and economic gains within a country. This was an inward-looking economic theory practiced by developing nations after WW2. Many economists at the time considered the ISI approach as a remedy to mass poverty: bringing a third-world country to first-world status through national industrialization. Mass poverty is defined thusly: "the dominance of agricultural and mineral activities -- in the low-income countries, and in their inability, because of their structure, to profit from international trade," (Bruton, 2002).

Mercantilist economic theory and practices of the 16th, 17th, and 18th centuries frequently advocated building up domestic manufacturing and import substitution. In the early United States, the Hamiltonian economic program, specifically the third report and the magnum opus of Alexander Hamilton, the Report on Manufactures, advocated for the U.S. to become self-sufficient in manufactured goods. This formed the basis of the American School, which was an influential force in the United States during its 19th- century industrialization.

Answer to SAE 3

(1) The industries it creates are inefficient and obsolete, as they are not exposed to internationally competitive industries, which constitute their rivals.

(2) The focus on industrial development impoverishes local commodity producers, who are primarily rural.

3) An inward-looking economy, the idea of catching up can be much faster with strong competition rather than with domestic competition with people with similar levels of human capital.

4) Furthermore, with small external scale economies, the country's costs maintain high and knowledge accumulation will not steadily or slowly increase, leading to considerable inefficiency in the industrial sector.

5) Import substitution was in place as a remedy for mass poverty, unemployment and economic growth, however, import substitution policies had created major distortions and had thereby resulted in a misuse of resources.

UNIT 4 EXPORT LED INDUSTRIALIZATION STRATEGY

Unit Structure

4.1 Introduction

The previous study unit has been used to expose to the realm of import substitution industrialization. Relatedly, this unit is intended to discuss the other side of international trade as a policy evolved overtime by some nations particularly in third world to encourage exports of their commodities towards generating foreign exchange (forex) earnings. The term "export" derives from the conceptual meaning as to ship the goods and services out of the port of a country. You can understand that in this wise, the seller of such goods and services is referred to as an "exporter" who is based in the country of export whereas the overseas based buyer is referred to as an "importer".

You have learned from earlier study units that in International Trade, "exports" refer to selling goods and services produced in the home country to other markets. Hence in the process of exports of goods and services by one country to other countries, some revenue will be generated in foreign currencies, which in totoality is regarded as froeign echange earnings in favour of exporting country. Export of commercial quantities of goods normally requires involvement of the customs authorities in both the country of export and the country of import. The advent of small trades over the internet such as through Amazon and eBay have largely bypassed the involvement of Customs in many countries because of the low individual values of these trades. An export's counterpart is an import. You will learn more of this in this study unit subsequently.

4.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss what export is all about;
- Analyze the historical background and process of export;
- Discuss the export strategy and ways of exporting;
- Demonstarte how coutries do promote exports; and
- Analyze the challenges involved in exporting.

4.3 Meaning of Exports and Export strategy

4.3.1 Definition of Exports

In national accounts "exports" consist of transactions in goods and services (sales, barter, gifts or grants) from residents to non-residents. The exact definition of exports includes and excludes specific "borderline" cases. A general delimitation of exports in
national accounts is given below:

An export of a good occurs when there is a change of ownership from a resident to a non-resident; this does not necessarily imply that the good in question physically crosses the frontier. However, in specific cases national accounts impute changes of ownership even though in legal terms no change of ownership takes place (e.g. cross border financial leasing, cross border deliveries between affiliates of the same enterprise, goods crossing the border for significant processing to order or repair). Also smuggled goods must be included in the export measurement.

Export of services consists of all services rendered by residents to non-residents. In national accounts any direct purchases by non-residents in the economic territory of a country are recorded as exports of services; therefore all expenditure by foreign tourists in the economic territory of a country is considered as part of the exports of services of that country. Also international flows of illegal services must be included.

National accountants often need to make adjustments to the basic trade data in order to comply with national accounts concepts; the concepts for basic trade statistics often differ in terms of definition and coverage from the requirements in the national accounts:

Data on international trade in goods are mostly obtained through declarations to custom services. If a country applies the general trade system, all goods entering or leaving the country are recorded. If the special trade system (e.g. extra-EU trade statistics) is applied goods which are received into customs warehouses are not recorded in external trade statistics unless they subsequently go into free circulation in the country of receipt.

A special case is the intra-EU trade statistics. Since goods move freely between the member states of the EU without customs controls, statistics on trade in goods between the member states must be obtained through surveys. To reduce the statistical burden on the respondents small scale traders are excluded from the reporting obligation.

Statistical recording of trade in services is based on declarations by banks to their central banks or by surveys of the main operators. In a globalized economy where services can be rendered via electronic means (e.g. internet) the related international flows of services are difficult to identify.

Basic statistics on international trade normally do not record smuggled goods or international flows of illegal services. A small fraction of the smuggled goods and illegal services may nevertheless be included in official trade statistics through dummy shipments or dummy declarations that serve to conceal the illegal nature of the activities.

What does a firm or country do to get rid of surplus quantity of products?

SELF ASSESSMENT EXERCISE 1

What is an export? Give five (5) examples of Nigerian exports to other countries

4.3.2 Dumping and Subsidies

Dumping: Dumping involves a country producing highly excessive amounts of goods and pushing them into another foreign country, producing the effect of prices that are "too low". Too
low can refer to either pricing the good from the foreign market at a price lower than charged in the domestic market of the country of origin.

The other reference to dumping relates or refers to the producer selling the product at a price in which there is no profit or a loss. The purpose (and expected outcome) of the tariff is to encourage spending on domestic goods and services.

Protective tariffs sometimes protect what are known as infant industries that are in the phase of expansive growth. A tariff is used temporarily to allow the industry to succeed in spite of strong competition.

Protective tariffs are considered valid if the resources are more productive in their new use than they would be if the industry had not been started. The infant industry eventually must incorporate itself into a market without the protection of government subsidies.

Tariffs can create tension between countries. Examples include the United States steel tariff of 2002 and when China placed a 14% tariff on imported auto parts. Such tariffs usually lead to filing a complaint with the World Trade Organization (WTO) and, if that fails, could eventually head toward the country placing a tariff against the other nation in spite, to impress pressure to remove the tariff.

Subsidies: To subsidize an industry or company refers to, in this instance, a governmental policy of providing supplementary financial support to manipulate the price below market value. Subsidies are generally used for failing industries that need a boost in domestic spending. Subsidizing encourages greater demand for a good or service because of the slashed price.

The effect of subsidies deters other countries that are able to produce a specific product or service at a faster, cheaper, and more productive rate. With the lowered price, these efficient producers cannot compete. The life of a subsidy is generally short- lived, but sometimes can be implemented on a more permanent basis.

The agricultural industry is commonly subsidized; Nigeria, the United States, and in other countries including Japan and nations located in the European Union (EU) are known for granting subsidies on their respective agricultural sectors.

Critics argue such subsidies cost developing nations billion of dollars annually in lost income according to a study by the International Food Policy Research Institute, a D.C. group funded partly by the World Bank. However, other nations are not the only economic 'losers'. In Nigeria, subsidy on agricultural produce takes the form of low cost fertilizers being supplied to farmers that spending a lot of money by the government through annual budget allocations.. Subsidies in the U.S. heavily depend upon taxpayer dollars. The country spends a lot of money in subsidies to the agricultural industry. The EU is being reckoned to be spending billion of Euro annually on their agricultural sector to the extent of nearly half its annual budget on its common agricultural policy and rural development.

What actions do government take to encourage exports from their own countries?

SELF ASSESSMENT EXERCISE 2

How is dumping different from subsidies?

4.3.3 Export Strategy

Export strategy involves deliderat policies or actions towrds selling commodities to other economies or countries through agreements, which can be bilateral (two countries) or multilateral agreements (many countries such as a regional block like EU, ASEAN or ECOWAS. In economics, an export is any good or commodity, transported from one country to another country in a legitimate fashion, because there must be an agreement between the countiries involved.

i) Advantages of exporting

a) Ownership advantages are the firm's specific assets, international experience, and the ability to develop either low-cost or differentiated products within the contacts of its value
chain.

b) The locational advantages of a particular market are a combination of market potential and investment risk.

c) Internationalization advantages are the benefits of retaining a core competence within the company and threading it though the value chain rather than obtain to license, outsource, or sell it. In relation to the Eclectic paradigm, companies that have low levels of ownership advantages either do not enter foreign markets. If the company and its products are equipped with ownership advantage and internalization advantage, they enter through low-risk modes such as exporting.

d) Exporting requires significantly lower level of investment than other modes of international expansion, such as FDI. As you might expect, the lower risk of export typically results in a lower rate of return on sales than possible though other modes of international business.

e) In other words, the usual return on export sales may not be tremendous, but neither is the risk. Exporting allows managers to exercise operation control but does not provide them the option to exercise as much marketing control. An exporter usually resides far from the end consumer and often enlists various intermediaries to manage marketing activities.

ii) Disadvantages of exporting

a) For Small-and-Medium Enterprises (SME) with less than 250 employees, selling goods and services to foreign markets seems to be more difficult than serving the domestic market. Indeed there are some SME's which are exporting, but nearly two-third of them sell in only to one foreign market.

b) The lack of knowledge for trade regulations, cultural differences, different languages and foreign-exchange situations as well as the strain of resources and staff interact like a block for exporting.

The following assumptions show the main disadvantages:

c) Risk of exchange rate fluctuation: To minimize the risk of exchange-rate fluctuation and transactions processes of export activity the financial management needs more capacity to cope the major effort

d) Communication problems: Even though there is improvement of communication technologies in recent years enable the customer to interact with more suppliers while receiving more information and cheaper communications cost at the same time like 20 years ago. There is the issue of interpretation because of varied languages in different countries.

e) Poor selection of overseas agents: This can result in loss of revenue or foreign exchange especially if fraudulent agents are enlisted as franchisees by froing. The management might tap in some of the organizational pitfalls, like poor selection of overseas agents or distributors or chaotic global organization.

4.4 Ways of Exporting

1. Direct selling in export through appointed representatives

Direct selling involves sales representatives, distributors, or retailers who are located outside the exporter's home country.

Direct exports are goods and services that are sold to an independent party outside of the exporter‘s home country. Mainly the companies are pushed by core competencies and improving their performance of value chain.

2. Direct selling through distributors

It is considered to be the most popular option to companies, to develop their own international marketing capability. This is achieved by charging personnel from the company to give them greater control over their operations.

Direct selling also give the company greater control over the marketing function and the opportunity to earn more profits. In other cases where network of sales representative, the company can transfer them exclusive rights to sell in a particular geographic region.

A distributor in a foreign country is a merchant who purchases the product from the manufacturer and sells them at profit. Distributors usually carry stock inventory and service the product, and in most cases distributes deals with retailers rather than end users.

In evaluating Distributors, some factors are necessary and such include:

- The size and capabilities of its sales force.
- It‘s an analysis of its territory.
- Its current product mix.
- Its facilities and equipment.
- Its marketing polices.
- Its customer profit.
- Its promotional strategy.

3. Direct selling through foreign end users

Exporters can also sell directly to foreign retailers.

Usually, products are limited to consumer lines; it can also sell to direct end users. A good way to generate such sales is by printing catalogs or attending trade shows.

4.Direct selling over the Internet

Electronic commerce is an important mean to small and big companies all over the world, to trade internationally.

You already can see how important E-commerce is for marketing growth among exporters companies in emerging economies, in order to overcome capital and infrastructure barriers.

E-commerce eased engagements, provided faster and cheaper delivery of information, generates quick feedback on new products, improves customer service, accesses a global audience, levels the field of companies, and support electronic data interchange with suppliers and customers.

5. Indirect selling

Indirect exports, is simply selling goods to or through an independent domestic intermediary in their own home county. Then intermediaries export the products to customers foreign markets.

In making the export decision it is necessary to be diligent to avoid risky approach in exporting. Once a company determines it has exportable products, it must still consider other factors, such as the following:

- What does the company want to gain from exporting?
- Is exporting consistent with other company goals?
- What demands will export place on the company's key resources - management and personnel, production capacity, and finance - and how will these demands be met?
- Are the expected benefits worth the costs, or would company resources be better used for developing new domestic business?

How does the countries around promote exports from their domestic products or commodities?

SELF ASSESSMENT EXERCISE 3

Name the main methods of exporting goods or commodities in foreign trade.

4.5 Export Promotion

Several countries around the world do establish strategies towards promoting their home made goods to be exported to other countries.

The U.S. Department of Commerce provides U.S. companies the opportunity to promote their products and services free of charge. To do so, the Export Yellow Pages is published online and in print and is delivered to embassies, trade centers, consulates, and associations worldwide.

The California Centers for International Trade Development (CITD's) have 13 offices throughout California; each CITD is hosted by a local community college and provides a variety of free low-cost programs & services to assist local companies in doing business abroad.

These include one-on-one technical assistance and consulting, market research, training and educational programs, trade leads and special events.

4.6 Challenges of Exporting

Exporting to foreign countries poses challenges not found in domestic sales. With domestic sales, manufacturers typically sell to wholesalers or direct to retailer or even direct to consumers. When exporting, manufacturers may have to sell to importers who then in turn sell to wholesalers. Extra layer(s) in the chain of distribution squeezes margins and manufacturers may need to offer lower prices to importers than to domestic wholesalers.

Manufacturers are normally required to register their products with the regulatory agencies of the importing countries before they are granted the permission to produce at their home countries before selling abroad to such countries. Such move is to ensure quality and international standards to safe guide the health and safety of the citizens of the importing nations.

This is the work of NAFDAC in Nigeria. Hence, products from other countries must be registered with regulatory agent in the country before they can ship their them to Nigeria. The US has similar regulatory agency called Food and Drug Administration.

Export of commercial quantities of goods normally requires involvement of the customs authorities in both the country of export and the country of import. Furthermore, there are other forms of restrictions imposed on products moving from one country to another. You have already learned that such restrictions include tariffs, duties, quotas, total ban, trade war , and deliberate currency depreciation, as being practiced by the government of China.

4.7 Summary

You have been taken through the essence of exporting between countries and the strategies that can be instituted towards encouraging exports by various countries and their firms.

Furthermore, countries do establish policies towards promoting exportation of their respective products towards generating revenue such as foreign exchange earnings, which in turn boost the value of their currencies. You learned from this unit that the term export derives from the conceptual meaning as to ship the goods and services out of the port of a country. The seller of such goods and services is referred to as an "exporter" who is based in the country of export whereas the overseas based buyer is referred to as an "importer". In foreign trade, "exports" refers to selling goods and services produced in the home country to other markets. You can also recall that there are various methods that countries or firms can adopt in exporting their products such as direct and in directing selling abroad, and making use of agents and franchisees. Relatedly, modern technology has implied exports of goods and services to the benefits of all nations and the world economy.

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4.8 Possible Answers to SAEs

Answer to SAE 1

An export of a good occurs when there is a change of ownership from a resident to a non-resident; this does not necessarily imply that the good in question physically crosses the frontier. However, in specific cases national accounts impute changes of ownership even though in legal terms no change of ownership takes place (e.g. cross border financial leasing, cross border deliveries between affiliates of the same enterprise, goods crossing the border for significant processing to order or repair). Also smuggled goods must be included in the export measurement.

Examples of Nigerian exports to other countries include:

i. Crude oil
ii. Cocoa
iii. Hides and Skin
iv. Cassava
v. Beans

Answer to SAE 2

Dumping involves a country producing highly excessive amounts of goods and pushing them into another foreign country, producing the effect of prices that are "too low". Too low can refer to either pricing the good from the foreign market at a price lower than charged in the domestic market of the country of origin. The other reference to dumping relates or refers to the producer selling the product at a price in which there is no profit or a loss. The purpose (and expected outcome) of the tariff is to encourage spending on domestic goods and services.

Subsidy is a governmental policy of providing supplementary financial support to manipulate the price below market value. Subsidies are generally used for failing industries that need a boost in domestic spending. Subsidizing encourages greater demand for a good or service because of the slashed price. The effect of subsidies deters other countries that are able to produce a specific product or service at a faster, cheaper, and more productive rate. With the lowered price, these efficient producers cannot compete. The life of a subsidy is generally short-lived, but sometimes can be implemented on a more permanent basis.

The agricultural industry is commonly subsidized; Nigeria, the United States, and in other countries including Japan and nations located in the

European Union (EU) are known for granting subsidies on their respective agricultural sectors.

Answer to SAE 3

Main methods of exporting goods or commodities in foreign trade.

1. Direct selling in export through appointed representatives
2. Direct selling through distributors
3. Direct selling through foreign end users
4. Direct selling over the Internet
5. Indirect selling overseas

UNIT 5 FINANCIAL INFLUENCE ON INTERNATIONAL BUSINESS

Unit Structure

5.1 Introduction

You can appreciate the fact that all business entities require finance for their operations. Therefore, financial influence on international business is an uncontrollable

Factor. The elements of such influence on business operations include: foreign currency; exchange risks; national balance of payment; taxation; tariffs; national monetary; and fiscal policies; and inflation, among others. Though all these are uncontrollable variables looking like disadvantages to a business concern, but as you can appreciate, if well studied and applied accordingly, they could turn out to be advantageous to a business entity. This unit examines financial influence on international business.

5.2 Learning Outcomes

By the end of this unit, you will be able to:

- Analyze factors that affect international business finance
- Discuss the implications of foreign currency on international business
- Evaluate balance of payment
- Discuss tariff, taxation and government regulatory policy on international business activities
- Evaluate international accounting practice.

5.3 Financial Force

You can recall the uncontrollable nature of financial force on international business in respect for its elements. Such components are some financial factors that a business man, who goes international, struggles with in order to be successful in an international business environment.

These factors are uncontrollable, because as a businessman, you do not have control over them; however, you could critically study them and take advantage of the opportunity being created by them.

5.3.1 Fluctuating Currency Value

One of the major currencies Nigeria depends on in terms of exchange is the dollar. In the 1990s, to be precise, during Abacha's Regime, the naira was about 70 to 75 per dollar. From 1999 to 2006, Nigerian currency has been fluctuating between N160 and N180 per dollar.

Today, it is about N120 per dollar. What is the essence of such discussion?

You can appreciate the fact that the essence of this account is to examine the effect of this on an international businessman who operates in Nigeria at this period. The cost of goods that are brought in from outside Nigeria will continue to rise and fall thereby affecting business activities either positively or negatively depending on the situation at hand and the policies of the government. In a situation where the currency fluctuation is higher, the Central Bank may intervene in selling and buying the dollar.

You must be conversant with the exchange rate if you want to go into international business. It is very easy to get the currency value of the naira against major currencies in the world. You must bear it in mind that the rates are not always stable.

SELF ASSESSMENT EXERCISE 1

Identify five sources through which foreign currencies come into Nigeria.

1.3.2 Foreign Exchange Quotations

Foreign Exchange Quotations is the price of one currency expressed in terms of another. Ball et al (2002), in the world's currency exchange markets, the US dollar (US $) is the common unit being used for exchange for other currencies. This means, a Japanese businessman who wants to buy goods in the US will have to convert his Yen to dollars to buy his goods.

1.3.3 Currency Exchange Controls

Ball et al (2002), describe currency exchange control as currency exchange control limit or the legal limit allowed of a currency in international transaction. Typically, the value of the currency is arbitrarily fixed at a rate higher than its value in the free market and it is decided that all purchases or sales of other currencies be made through a government agency. As a result of this control, black markets inevitably spring up, as the official channel, most times, cannot cope with the volume of demand from business. However, the black market is rarely able to accommodate transactions of a large size and which may involve multinational organisations (Czinkota, 2007).

You can recall that until recently, in Nigeria, the currency exchange was highly controlled with two different exchange rates- Inter banks rate and FEM rate. FEM rate is determined at fortnightly auctions. Borrowing from abroad is subject to the Federal Ministry of Finance approval. For incoming direct investment, approval is needed from Finance Ministry and Ministry of Internal Affairs which control foreign equity. A hundred percent international ownership is not allowed. In coming portfolio market requires Finance Ministry's approval. Remittance of dividends and profits is also controlled by the Finance Ministry. In conclusion, the Federal Ministry of Finance also controls the remittance of principal capital, interest, sales fees and pre-tax profit, reparation of capital and documentation of transfer of business or sale. The Federal Ministry of Finance is the gate-keeper for international business.

SELF ASSESSMENT EXERCISE 2

How has the Nigerian government been able to control foreign exchange in the country?

1.3.4 Balance of Payments

Balance of payments is described as a situation where a country's export and import are equal. If the balance of payment is slipping into deficit, government may probably consider one or more market or non market measures to correct or suppress that deficit.

A government can do the following.

i) Currency devaluation
ii) Restrictive monetary or fiscal policies
iii) Currency or trade controls.

In terms of export, government will encourage export incentives, tax holidays, lower cost financing, or other advantages government may give to international businesses to encourage them to export, buy goods and services. All these affect international business either positively or negatively.

1.3.5 Tariffs or Duties

The terms tariff and duty are used interchangeably. They all refer to taxes usually imposed on imported goods. Tariffs and duties are imposed on some goods for the following reasons.

i. Natural defense
ii. Protecting infant industry
iii. Protecting domestic jobs from cheap foreign labour
iv. Scientific tariff or fair competition
v. Retaliation

Other reasons for tariff imposition are that it

vi. permits diversification of the domestic economy
vii. improves balance of trade.

SELF ASSESSMENT EXERCISE 3

Identify five ways through which the country can benefit from imposition of tariffs.

1.3.6 Taxation

Taxes are collected from corporations by government so as to provide social services to its citizens. So many people believe that customers pay taxes through high price of goods and the appropriate authorities remit them to the government. It means a company with a lower tax rate would charge its customers less for its products. This may sound good, but in practice, that is not the case especially in Nigeria.

International companies pay more taxes because they operate in many countries; this entails a lot of documentation and paying large fees.

There are different taxes in different countries. If you look at some countries, you will discover that the income tax is the biggest revenue earner for them, especially the US. There are other taxes like value-added tax, capital gain tax, property taxes and social security.

1.3.7 Inflation

From transfer knowledge, you can infer that increase in prices of goods and services over a period of time is known as inflation. Reasons for inflation may be because of:

- rise in demand
- increase in money supply

Since 2006, there has been increase in prices of goods and services worldwide; it is believed that it is because of invasion of Iraq by America. Iraq has ended up selling crude oil per barrel at $117 for the first time in the history of energy sector in the world.

Inflation has a lot of effects on interest rates because companies borrow; and the cost of borrowing is dependent on the rate of inflation. Once inflation sets in, the lender loses because the value of money is reduced and the borrower, gains, because the value of the money has gone down.

Inflation equally has an effect on a country’s monetary and fiscal policies. (Monetary policy is the amount of money in circulation, while fiscal policy is the collecting and spending of money by the government). Inflation has both positive and negative effects on a business especially the international business. To businessmen, high inflation encourages borrowing because, on repayment, it will be cheaper. High inflation rate brings about high interest rate and this may discourage lending to business organisations.

1.3.8 Household Savings

Ball et al (2002) stated that it is a percentage of disposable income which has a good measure of the saving rate in a country.

The USA has a low saving rate while Japan has a high saving rate. Japan’s economy is based on her saving rate which is better than that of the US in terms of investment and having good infrastructure. In Nigeria, during Babangida regime, we had no savings as a country but when Abacha took over and before he died we had a savings of $7 billion. Before Obasanjo handed over power in 2007, it was close to $50 billion. Today we are close to $70billion. It is expected that the money would be used in investing in infrastructural development and this would attract more international businesses.

1.4 Summary

You have been taken through discussion in this unit in relation to the various components of finance that affect business operations. Such components include Taxation, household savings, inflation, balance of payment, currency exchange control, tariffs and duties, foreign exchange quotation etc,. They are all financial forces that an international businessman must look into while contemplating doing international business. They could have both negative and positive effects on a business, depending on how they are handled. For instance, inflation could be advantageous to a borrower while on the other side, the cost of borrowing could be high.

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_International_Business_and_Trade

1.6 Possible Answers to SAEs

Answer to SAE 1

i) Foreign exchange earnings by government
ii) Transfers from Nigerians in diaspora
iii) Earnings from investment abroad
iv) Export earnings by individual exporters
v) Foreign exchange earnings by companies, e. g., oil multinational companies, etc.

Answer to SAE 2

In Nigeria, the currency exchange was controlled Foreign Exchange policies. For the control was at the purview of the apex bank (CBN) such as with two different exchange rates

i) Inter banks rate and
ii) Foreign Exchange Market (FEM) rate.

The FEM rate is determined at fortnightly auctions.

Answer to SAE 3

Five ways through which the country can benefit from imposition of tariffs include:

i) Increase in GDP;
ii) Enhancing production of domestic industries;
iii) Availability of job opportunities;
iv) Enhanced government revenue; and
v) Leads to enhanced economic growth and development of the country.

MODULE 4

UNIT 1 INFLATION

Unit Structure

1.1 Introduction

You have been taken through discussion on influence of finance on international business in the previous study unit. In this study unit, In this study unit, the discussion is on realm of inflation. Inflation as you have understood from transfer learning, connotes a rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. Consequently, inflation reflects a reduction in the purchasing power per unit of money – a loss of real value in the medium of exchange and unit of account within the economy. It is always necessary to keep tab on the trend of general price level which calls for monitoring prices on a continuous basis so that the government can institute to control the trend towards ensuring price stability and stable purchasing power that is key for economic buoyancy. You will learn more of this in this unit.

1.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the meaning of the term Inflation;
- Demonstrate how to measure inflation;
- Analyze the issues involved in measuring inflation;

1.3 Meaning and Measurement of Inflation

1.3.1 Meaning of Inflation

The term "inflation" originally referred to increases in the amount of money in circulation, and some economists still use the word in this way. However, most economists today use the term "inflation" to refer to a rise in the general price level. An increase in the money supply may be called monetary inflation, to distinguish it from rising prices, which may also for clarity be called 'price inflation'. Economists generally agree that in the long run, inflation is caused by increases in the money supply.

Other economic concepts related to inflation include: deflation – a fall in the general price level; disinflation – a decrease in the rate of inflation; hyperinflation – an out-of-control inflationary spiral; stagflation – a combination of inflation, slow economic growth and high unemployment; and reflation – an attempt to raise the general level of prices to counteract deflationary pressures.

Since there are many possible measures of the price level, there are many possible measures of price inflation. Most frequently, the term "inflation" refers to a rise in a broad price index representing the overall price level for goods and services in the economy. A chief measure of price inflation is the inflation rate, the annualized percentage change in a general price index (normally the consumer price index) over time.

The Consumer Price Index (CPI), the Personal Consumption Expenditures Price Index (PCEPI) and the GDP deflator are some examples of broad price indices. However, "inflation" may also be used to describe a rising price level within a narrower set of assets, goods or services within the economy, such as commodities (including food, fuel, metals), tangible assets (such as real estate), financial assets (such as stocks, bonds), services (such as entertainment and health care), or labor.

The Reuters-CRB Index (CCI), the Producer Price Index, and Employment Cost Index (ECI) are examples of narrow price indices used to measure price inflation in particular sectors of the economy. Core inflation is a measure of inflation for a subset of consumer prices that excludes food and energy prices, which rise and fall more than other prices in the short term.

The government of each of each country monitors the inflation rate in every economy for obvious reason because the rate affects the purchasing power of the consumers and by implication their standard of living. For instance, the National Bureau of Statistics and the CBN monitor inflation rate in Nigeria while the Federal Reserve Board in US pays particular attention to the core inflation rate to get a better estimate of long-term future inflation trends overall.

Inflation's effects on an economy manifest in many way and can be simultaneously positive and negative. Negative effects of inflation include an increase in the opportunity cost of holding money, uncertainty over future inflation which may discourage investment and savings, and if inflation is rapid enough, shortages of goods as consumers begin hoarding out of concern that prices will increase in the future. Positive effects include ensuring that central banks can adjust real interest rates (to mitigate recessions), and encouraging investment in non-monetary capital projects.

History

Increases in the quantity of money or in the overall money supply (or debasement of the means of exchange) have occurred in many different societies throughout history, changing with different forms of money used.

For instance, when gold was used as currency, the government could collect gold coins, melt them down, mix them with other metals such as silver, copper or lead, and reissue them at the same nominal value.

By diluting the gold with other metals, the government could issue more coins without also needing to increase the amount of gold used to make them. When the cost of each coin is lowered in this way, the government profits from an increase in seigniorage.

This practice would increase the money supply but at the same time the relative value of each coin would be lowered. As the relative value of the coins becomes lower, consumers would need to give more coins in exchange for the same goods and services as before. These goods and services would experience a price increase as the value of each coin is reduced.

But how do we estimate or measure rate of inflation?

SELF ASSESSMENT EXERCISE 1

what is inflation?

1.3.2 Measurement of Inflation

The inflation rate is widely calculated by calculating the movement or change in a price index, usually the consumer price index. The consumer price index measures movements in prices of a fixed basket of goods and services purchased by a "typical consumer. Hence the inflation rate is the percentage rate of change of a price index over time. The Retail Prices Index is also a measure of inflation that is commonly used in the United Kingdom. It is broader than the CPI and contains a larger basket of goods and services.

To illustrate the method of calculation, in January 2007, the U.S. Consumer Price Index was 202.416, and in January 2008 it was 211.080. The formula for calculating the annual percentage rate inflation in the CPI over the course of 2007 is The resulting inflation rate for the CPI in this one year period is 4.28%, meaning the general level of prices for typical U.S. consumers rose by approximately four percent in 2007.

Other widely used price indices for calculating price inflation include the following:

- Producer price indices (PPIs) which measure average changes in prices received by domestic producers for their output. This differs from the CPI in that price subsidization, profits, and taxes may cause the amount received by the producer to differ from what the consumer paid. There is also typically a delay between an increase in the PPI and any eventual increase in the CPI. Producer price index measures the pressure being put on producers by the costs of their raw materials. This could be "passed on" to consumers, or it could be absorbed by profits, or offset by increasing productivity. In India and the United States, an earlier version of the PPI was called the Wholesale Price Index.

- Commodity price indices, which measure the price of a selection of commodities. In the present commodity price indices are weighted by the relative importance of the components to the "all in" cost of an employee.

- Core price indices: because food and oil prices can change quickly due to changes in supply and demand conditions in the food and oil markets, it can be difficult to detect the long run trend in price levels when those prices are included. Therefore most statistical agencies also report a measure of 'core inflation', which removes the most volatile components (such as food and oil) from a broad price index like the CPI. Because core inflation is less affected by short run supply and demand conditions in specific markets, central banks rely on it to better measure the inflationary impact of current monetary policy.

Other common measures of inflation are:

- GDP deflator is a measure of the price of all the goods and services included in gross domestic product (GDP). The US Commerce Department publishes a deflator series for US GDP, defined as its nominal GDP measure divided by its real GDP measure.
- Regional inflation: The Bureau of Labor Statistics breaks down CPI-U calculations down to different regions of the US.
- Historical inflation: Before collecting consistent econometric data became standard for governments, and for the purpose of comparing absolute, rather than relative standards of living, various economists have calculated imputed inflation figures. Most inflation data before the early 20th century is imputed based on the known costs of goods, rather than compiled at the time. It is also used to adjust for the differences in real standard of living for the presence of technology.

Asset price inflation is an undue increase in the prices of real or financial assets, such as stock (equity) and real estate. While there is no widely accepted index of this type, some central bankers have suggested that it would be better to aim at stabilizing a wider general price level inflation measure that includes some asset prices, instead of stabilizing CPI or core inflation only. The reason is that by raising interest rates when stock prices or real estate prices rise, and lowering them when these asset prices fall, central banks might be more successful in avoiding bubbles and crashes in asset prices.

1.4 Issues in Measuring of Inflation

Measuring inflation in an economy requires objective means of differentiating changes in nominal prices on a common set of goods and services, and distinguishing them from those price shifts resulting from changes in value such as volume, quality, or performance.

For example, if the price of a 10 oz. can of corn changes from N0.90 to N1.00 over the course of a year, with no change in quality, then this price difference represents inflation.

This single price change would not, however, represent general inflation in an overall economy. To measure overall inflation, the price change of a large "basket" of representative goods and services is measured. This is the purpose of a price index, which is the combined price of a "basket" of many goods and services.

The combined price is the sum of the weighted prices of items in the "basket". A weighted price is calculated by multiplying the unit prices of an item by the number of that item the average consumer purchases. Weighted pricing is a necessary means to measuring the impact of individual unit price changes on the economy's overall inflation.

The Consumer Price Index, for example, uses data collected by surveying households to determine what proportion of the typical consumer's overall spending is spent on specific goods and services, and weights the average prices of those items accordingly.

Those weighted average prices are combined to calculate the overall price.

To better relate price changes over time, indexes typically choose a "base year" price and assign it a value of 100. Index prices in subsequent years are then expressed in relation to the base year price. While comparing inflation measures for various periods one has to take into consideration the base effect as well.

Inflation measures are often modified over time, either for the relative weight of goods in the basket, or in the way in which goods and services from the present are compared with goods and services from the past. Over time, adjustments are made to the type of goods and services selected in order to reflect changes in the sorts of goods and services purchased by 'typical consumers'.

New products may be introduced, older products disappear, the quality of existing products may change, and consumer preferences can shift. Both the sorts of goods and services which are included in the "basket" and the weighted price used in inflation measures will be changed over time in order to keep pace with the changing marketplace.

Inflation numbers are often seasonally adjusted in order to differentiate expected cyclical cost shifts. For example, home heating costs are expected to rise in colder months, and seasonal adjustments are often used when measuring for inflation to compensate for cyclical spikes in energy or fuel demand. Inflation numbers may be averaged or otherwise subjected to statistical techniques in order to remove statistical noise and volatility of individual prices.

When looking at inflation, economic institutions may focus only on certain kinds of prices, or special indices, such as the core inflation index which is used by central banks to formulate monetary policy.

Most inflation indices are calculated from weighted averages of selected price changes. This necessarily introduces distortion, and can lead to legitimate disputes about what the true inflation rate is. This problem can be overcome by including all available price changes in the calculation, and then choosing the median value. In some other cases, governments may intentionally report false inflation rates; for instance, the government of Argentina has been criticized for manipulating economic data, such as inflation and GDP figures, for political gain and to reduce payments on its inflation-indexed debt.

SELF ASSESSMENT EXERCISE 2

W
hat are the causes of inflation?

Mention various ways of measuring inflation.

1.5 Causes and Effects of Inflation

1.5.1 Causes of Inflation

Historically, a great deal of economic literature was concerned with the question of what causes inflation and what effect it has. There were different schools of thought as to the causes of inflation. Most can be divided into two broad areas: quality theories of inflation and quantity theories of inflation.

The quality theory of inflation rests on the expectation of a seller accepting currency to be able to exchange that currency at a later time for goods that are desirable as a buyer. The quantity theory of inflation rests on the quantity equation of money, that relates the money supply, its velocity, and the nominal value of exchanges. Adam Smith and David Hume proposed a quantity theory of inflation for money, and a quality theory of inflation for production.

Currently, the quantity theory of money is widely accepted as an accurate model of inflation in the long run. Consequently, there is now broad agreement among economists that in the long run, the inflation rate is essentially dependent on the growth rate of money supply relative to the growth of the economy.

However, in the short and medium term inflation may be affected by supply and demand pressures in the economy, and influenced by the relative elasticity of wages, prices and interest rates.

The question of whether the short-term effects last long enough to be important is the central topic of debate between monetarist and Keynesian economists. In monetarism prices and wages adjust quickly enough to make other factors merely marginal behavior on a general trend-line. In the Keynesian view, prices and wages adjust at different rates, and these differences have enough effects on real output to be "long term" in the view of people in an economy.

1. Keynesian view

Keynesian economics proposes that changes in money supply do not directly affect prices, and that visible inflation is the result of pressures in the economy expressing themselves in prices.

There are three major types of inflation, as part of what Robert J. Gordon calls the "triangle model":

- Demand-pull inflation is caused by increases in aggregate demand due to increased private and government spending, etc. Demand inflation encourages economic growth since the excess demand and favourable market conditions will stimulate investment and expansion.

- Cost-push inflation, also called "supply shock inflation," is caused by a drop in aggregate supply (potential output). This may be due to natural disasters, or increased prices of inputs. For example, a sudden decrease in the supply of oil, leading to increased oil prices, can cause cost-push inflation. Producers for whom oil is a part of their costs could then pass this on to consumers in the form of increased prices. Another example stems from unexpectedly high Insured Losses, either legitimate (catastrophes) or fraudulent (which might be particularly prevalent in times of recession)

- Built-in inflation is induced by adaptive expectations, and is often linked to the "price/wage spiral". It involves workers trying to keep their wages up with prices (above the rate of inflation), and firms passing these higher labor costs on to their customers as higher prices, leading to a 'vicious circle'. Built-in inflation reflects events in the past, and so might be seen as hangover inflation.

Demand-pull theory states that inflation accelerates when aggregate demand increases beyond the ability of the economy to produce (its potential output). Hence, any factor that increases aggregate demand can cause inflation. However, in the long run, aggregate demand can be held above productive capacity only by increasing the quantity of money in circulation faster than the real growth rate of the economy. Another (although much less common) cause can be a rapid decline in the demand for money, as happened in Europe during the Black Death, or in the Japanese occupied territories just before the defeat of Japan in 1945.

The effect of money on inflation is most obvious when governments finance spending in a crisis, such as a civil war, by printing money excessively. This sometimes leads to hyperinflation, a condition where prices can double in a month or less. Money supply is also thought to play a major role in determining moderate levels of inflation, although there are differences

of opinion on how important it is. For example, Monetarist economists believe that the link is very strong; Keynesian economists, by contrast, typically emphasize the role of aggregate demand in the economy rather than the money supply in determining inflation.

That is, for Keynesians, the money supply is only one determinant of aggregate demand.

Some Keynesian economists also disagree with the notion that central banks fully control the money supply, arguing that central banks have little control, since the money supply adapts to the demand for bank credit issued by commercial banks. This is known as the theory of endogenous money, and has been advocated strongly by post-Keynesians as far back as the 1960s. It has today become a central focus of Taylor rule advocates. This position is not universally accepted – banks create money by making loans, but the aggregate volume of these loans diminishes as real interest rates increase. Thus, central banks can influence the money supply by making money cheaper or more expensive, thus increasing or decreasing its production.

A fundamental concept in inflation analysis is the relationship between inflation and unemployment, called the Phillips curve. This stability and employment. Therefore, some level of inflation could be considered desirable in order to minimize unemployment. The Phillips curve model described the U.S. experience well in the 1960s but failed to describe the combination of rising inflation and economic stagnation (sometimes referred to as stagflation) experienced in the 1970s.

Thus, modern macroeconomics describes inflation using a Phillips curve that shifts (so the trade-off between inflation and unemployment changes) because of such matters as supply shocks and inflation becoming built into the normal workings of the economy. The former refers to such events as the oil shocks of the 1970s, while the latter refers to the price/wage spiral and inflationary expectations implying that the economy "normally" suffers from inflation. Thus, the Phillips curve represents only the demand-pull component of the triangle model.

Another concept of note is the potential output (sometimes called the "natural gross domestic product"), a level of GDP, where the economy is at its optimal level of production given institutional and natural constraints. (This level of output corresponds to the Non-Accelerating Inflation Rate of Unemployment, NAIRU, or the "natural" rate of unemployment or the full-employment unemployment rate.) If GDP exceeds its potential (and unemployment is below the NAIRU), the theory says that inflation will accelerate as suppliers increase their prices and built-in inflation worsens. If GDP falls below its potential level (and unemployment is above the NAIRU), inflation will decelerate as suppliers attempt to fill excess capacity, cutting prices and undermining built-in inflation.

However, one problem with this theory for policy-making purposes is that the exact level of potential output (and of the NAIRU) is generally unknown and tends to change over time.

Inflation also seems to act in an asymmetric way, rising more quickly than it falls. Worse, it can change because of policy: for example, high unemployment under British Prime Minister Margaret Thatcher might have led to a rise in the NAIRU (and a fall in potential) because many of the unemployed found themselves as structurally unemployed (also see unemployment), unable to find jobs that fit their skills. A rise in structural unemployment implies that a smaller percentage of the labor force can find jobs at the NAIRU, where the economy avoids crossing the threshold into the realm of accelerating inflation.

- Inflation and Unemployment

A connection between inflation and unemployment has been drawn since the emergence of large scale unemployment in the 19th century, and connections continue to be drawn today.

However, the unemployment rate generally only affects inflation in the short-term but not the long-term. In the long term, the velocity of money supply measures such as the MZM ("Money Zero Maturity," representing cash and equivalent demand deposits) velocity is far more predictive of inflation than low unemployment.

In Marxian economics, the unemployed serve as a reserve army of labor, which restrain wage inflation. In the 20th century, similar concepts in Keynesian economics include the NAIRU (Non-Accelerating Inflation Rate of Unemployment) and the Phillips curve.

2. Monetarist view

Monetarists believe the most significant factor influencing inflation or deflation is how fast the money supply grows or shrinks. They consider fiscal policy, or government spending and taxation, as ineffective in controlling inflation. According to the famous monetarist economist Milton Friedman, "Inflation is always and everywhere a monetary phenomenon." Some monetarists, however, will qualify this by making an exception for very short-term circumstances.

Monetarists assert that the empirical study of monetary history shows that inflation has always been a monetary phenomenon. The quantity theory of money, simply stated, says that any change in the amount of money in a system will change the price level. This theory begins with the equation of exchange: where is the nominal quantity of money. is the velocity of money in final expenditures; is the general price level; is an index of the real value of final expenditures;

In this formula, the general price level is related to the level of real economic activity (Q), the quantity of money (M) and the velocity of money (V). The formula is an identity because the velocity of money (V) is defined to be the ratio of final nominal
expenditure () to the quantity of money (M).

Monetarists assume that the velocity of money is unaffected by monetary policy (at least in the long run), and the real value of output is determined in the long run by the productive capacity of the economy. Under these assumptions, the primary driver of the change in the general price level is changes in the quantity of money. With exogenous velocity (that is, velocity being determined externally and not being influenced by monetary policy), the money supply determines the value of nominal output (which equals final expenditure) in the short run. In practice, velocity is not exogenous in the short run, and so the formula does not necessarily imply a stable short-run relationship between the money supply and nominal output. However, in the long run, changes in velocity are assumed to be determined by the evolution of the payments mechanism. If velocity is relatively unaffected by monetary policy, the long-run rate of increase in prices (the inflation rate) is equal to the long-run growth rate of the money supply plus the exogenous long-run rate of velocity growth minus the long run growth rate of real output.

3. Rational expectations theory

Rational expectations theory holds that economic actors look rationally into the future when trying to maximize their well-being, and do not respond solely to immediate opportunity costs and pressures. In this view, while generally grounded in monetarism, future expectations and strategies are important for inflation as well.

A core assertion of rational expectations theory is that actors will seek to "head off" central- bank decisions by acting in ways that fulfill predictions of higher inflation. This means that central banks must establish their credibility in fighting inflation, or economic actors will make bets that the central bank will expand the money supply rapidly enough to prevent recession, even at the expense of exacerbating inflation. Thus, if a central bank has a reputation as being "soft" on inflation, when it announces a new policy of fighting inflation with restrictive monetary growth economic agents will not believe that the policy will persist; their inflationary expectations will remain high, and so will inflation. On the other hand, if the central bank has a reputation of being "tough" on inflation, then such a policy announcement will be believed and inflationary expectations will come down rapidly, thus allowing inflation itself to come down rapidly with minimal economic disruption.

- Heterodox views

There are also various heterodox theories that downplay or reject the views of the Keynesians and monetarists.

4. Austrian view

The Austrian School asserts that inflation is an increase in the money supply, rising prices are merely consequences and this semantic difference is important in defining inflation.[54] Austrians stress that inflation affects prices to various degrees (i.e., that prices rise more sharply in some sectors than in other sectors of the economy). The reason for the disparity is that excess money will be concentrated to certain sectors, such as housing, stocks or health care. Because of this disparity, Austrians argue that the aggregate price level can be very misleading when observing the effects of inflation.

Austrian economists measure inflation by calculating the growth of new units of money that are available for immediate use in exchange, that have been created over time.

Critics of the Austrian view point out that their preferred alternative to fiat currency intended to prevent inflation, commodity-backed money, is likely to grow in supply at a different rate than economic growth. Thus it has proven to be highly deflationary and destabilizing, including in instances where it has caused and prolonged depressions.

5. Real bills doctrine

Within the context of a fixed specie basis for money, one important controversy was between the quantity theory of money and the real bills doctrine (RBD). Within this context, quantity theory applies to the level of fractional reserve accounting allowed against specie, generally gold, held by a bank. Currency and banking schools of economics argue the RBD, that banks should also be able to issue currency against bills of trading, which is "real bills" that they buy from merchants. This theory was important in the 19th century in debates between "Banking" and "Currency" schools of monetary soundness, and in the formation of the Federal Reserve. In the wake of the collapse of the international gold standard post 1913, and the move towards deficit financing of government, RBD has remained a minor topic, primarily of interest in limited contexts, such as currency boards. It is generally held in ill repute today, with Frederic Mishkin, a governor of the Federal Reserve going so far as to say it had been "completely discredited."

The debate between currency, or quantity theory, and banking schools in Britain during the 19th century prefigures current questions about the credibility of money in the present. In the 19th century the banking school had greater influence in policy in the United States and Great Britain, while the currency school had more influence "on the continent", that is in non-British countries, particularly in the Latin Monetary Union and the earlier Scandinavia monetary union.

6. Anti-classical or backing theory

Another issue associated with classical political economy is the anti-classical hypothesis of money, or "backing theory". The backing theory argues that the value of money is determined by the assets and liabilities of the issuing agency. Unlike the Quantity Theory of classical political economy, the backing theory argues that issuing authorities can issue money without causing inflation so long as the money issuer has sufficient assets to cover redemptions. There are very few backing theorists, making quantity theory the dominant theory explaining inflation.

1.5.2 Effects of Inflation

- General Effects

i) An increase in the general level of prices implies a decrease in the purchasing power of the currency. That is, when the general level of prices rises, each monetary unit buys fewer goods and services.

ii) The effect of inflation is not distributed evenly in the economy, and as a consequence there are hidden costs to some and benefits to others from this decrease in the purchasing power of money.

For example, with inflation, those segments in society which own physical assets, such as property, stock etc., benefit from the price/value of their holdings going up, while those who seek to acquire them will need to pay more for them.

Their ability to do so will depend on the degree to which their income is fixed. For example, increases in payments to workers and pensioners often lag behind inflation, and for some people income is fixed. Also, individuals or institutions with cash assets will experience a decline in the purchasing power of the cash.

iii) Increases in the price level (inflation) erode the real value of money (the functional currency) and other items with an underlying monetary nature.

Debtors who have debts with a fixed nominal rate of interest will see a reduction in the "real" interest rate as the inflation rate rises. The real interest on a loan is the nominal rate minus the inflation rate.

The formula $R = N-I$ approximates the correct answer as long as both the nominal interest rate and the inflation rate are small. The correct equation is $r = n/i$ where r, n and i are expressed as ratios (e.g. 1.2 for +20%, 0.8 for −20%). As an example, when the inflation rate is 3%, a loan with a nominal interest rate of 5% would have a real interest rate of approximately 2%.

Any unexpected increase in the inflation rate would decrease the real interest rate.
Banks and other lenders adjust for this inflation risk either by including an inflation risk premium to fixed interest rate loans, or lending at an adjustable rate.

- Negative Effects of Inflation

High or unpredictable inflation rates are regarded as harmful to an overall economy. They add inefficiencies in the market, and make it difficult for companies to budget or plan long-term.

a. Inflation can act as a drag on productivity as companies are forced to shift resources away from products and services in order to focus on profit and losses from currency inflation. Uncertainty about the future purchasing power of money discourages investment and saving.

b. And inflation can impose hidden tax increases, as inflated earnings push taxpayers into higher income tax rates unless the tax brackets are indexed to inflation.

c. With high inflation, purchasing power is redistributed from those on fixed nominal incomes, such as some pensioners whose pensions are not indexed to the price level, towards those with variable incomes whose earnings may better keep pace with the inflation.

d. This redistribution of purchasing power will also occur between international trading partners. Where fixed exchange rates are imposed, higher inflation in one economy than another will cause the first economy's exports to become more expensive and affect the balance of trade.

There can also be negative impacts to trade from an increased instability in currency exchange prices caused by unpredictable inflation.

i) Cost-push inflation
High inflation can prompt employees to demand rapid wage increases, to keep up with consumer prices. In the cost-push theory of inflation, rising wages in turn can help fuel inflation. In the case of collective bargaining, wage growth will be set as a function of inflationary expectations, which will be higher when inflation is high. This can cause a wage spiral. In a sense, inflation begets further inflationary expectations, which beget further inflation.

ii) Hoarding

People buy durable and/or non-perishable commodities and other goods as stores of wealth, to avoid the losses expected from the declining purchasing power of money, creating shortages of the hoarded goods.

iii) Social unrest and revolts

Inflation can lead to massive demonstrations and revolutions. For example, inflation and in particular food inflation is considered as one of the main reasons that caused the 2010– 2011 Tunisian revolution and the 2011 Egyptian revolution, [40] according to many observators including Robert Zoellick, president of the World Bank. Tunisian president Zine El Abidine Ben Ali was ousted, Egyptian President Hosni Mubarak was also ousted after only 18 days of demonstrations, and protests soon spread in many countries of North Africa and Middle East.

iv) Hyperinflation

If inflation gets totally out of control (in the upward direction), it can grossly interfere with the normal workings of the economy, hurting its ability to supply goods. Hyperinflation can lead to the abandonment of the use of the country's currency, leading to the inefficiencies of barter.

V) Allocative efficiency

A change in the supply or demand for a good will normally cause its relative price to change, signaling to buyers and sellers that they should re-allocate resources in response to the new market conditions. But when prices are constantly changing due to inflation, price changes due to genuine relative price signals are difficult to distinguish from price changes due to general inflation, so agents are slow to respond to them. The result is a loss of allocative efficiency.

vi) Shoe leather cost

High inflation increases the opportunity cost of holding cash balances and can induce people to hold a greater portion of their assets in interest paying accounts. However, since cash is still needed in order to carry out transactions this means that more "trips to the bank" are necessary in order to make withdrawals, proverbially wearing out the "shoe leather" with each trip.

vii) Menu costs

With high inflation, firms must change their prices often in order to keep up with economy-wide changes. But often changing prices is itself a costly activity whether explicitly, as with the need to print new menus, or implicitly, as with the extra time and effort needed to change prices constantly.

viii) Business cycles

According to the Austrian Business Cycle Theory, inflation sets off the business cycle.

Austrian economists hold this to be the most damaging effect of inflation. According to Austrian theory, artificially low interest rates and the associated increase in the money supply lead to reckless, speculative borrowing, resulting in clusters of mal investments, which eventually have to be liquidated as they become unsustainable.

- Positive Effects of Inflation

1. Labour-market adjustments

   Nominal wages are slow to adjust downwards. This can lead to prolonged disequilibrium and high unemployment in the labor market. Since inflation allows real wages to fall even if nominal wages are kept constant, moderate inflation enables labor markets to reach equilibrium faster.

2. Room to maneuver

   The primary tools for controlling the money supply are the ability to set the discount rate, the rate at which banks can borrow from the central bank, and open market operations, which are the central bank's interventions into the bonds market with the aim of affecting the nominal interest rate. If an economy finds itself in a recession with already low, or even zero, nominal interest rates, then the bank cannot cut these rates further (since negative nominal interest rates are impossible) in order to stimulate the economy – this situation is known as a liquidity trap. A moderate level of inflation tends to ensure that nominal interest rates stay sufficiently above zero so that if the need arises the bank can cut the nominal interest rate.

3. Mundell–Tobin effect

   The Nobel laureate Robert Mundell noted that moderate inflation would induce savers to substitute lending for some money holding as a means to finance future spending.

That substitution would cause market clearing real interest rates to fall. The lower real rate of interest would induce more borrowing to finance investment. In a similar vein, Nobel laureate James Tobin noted that such inflation would cause businesses to substitute investment in physical capital (plant, equipment, and inventories) for money balances in their asset portfolios. That substitution would mean choosing the making of investments with lower rates of real return. (The rates of return are lower because the investments with higher rates of return were already being made before.) The two related effects are known as the Mundell–Tobin effect. Unless the economy is already overinvesting according to models of economic growth theory, that extra investment resulting from the effect would be seen as positive.

4. Instability with deflation

Economist S.C. Tsaing noted that once substantial deflation is expected, two important effects will appear; both a result of money holding substituting for lending as a vehicle for saving. The first was that continually falling prices and the resulting incentive to hoard money will cause instability resulting from the likely increasing fear, while money hoards grow in value, that the value of those hoards are at risk, as people realize that a movement to trade those money hoards for real goods and assets will quickly drive those prices up. Any movement to spend those hoards "once started would become a tremendous avalanche, which could rampage for a long time before it would spend itself. "Thus, a regime of long-term deflation is likely to be interrupted by periodic spikes of rapid inflation and consequent real economic disruptions. Moderate and stable inflation would avoid such a seesawing of price movements.

5. Financial market inefficiency with deflation

The second effect noted by Tsaing is that when savers have substituted money holding for lending on financial markets, the role of those markets in channeling savings into investment is undermined. With nominal interest rates driven to zero, or near zero, from the competition with a high return money asset, there would be no price mechanism in whatever is left of those markets. With financial markets effectively euthanized, the remaining goods and physical asset prices would move in perverse directions. For example, an increased desire to save could not push interest rates further down (and thereby stimulate investment) but would instead cause additional money hoarding, driving consumer prices further down and making investment in consumer goods production thereby less attractive. Moderate inflation, once its expectation is incorporated into nominal interest rates, would give those interest rates room to go both up and down in response to shifting investment opportunities, or savers' preferences, and thus allow financial markets to function in a more normal fashion.

1.6 Controlling Inflation

A variety of methods and policies have been used to control inflation.

1. Stimulating economic growth

If economic growth matches the growth of the money supply, inflation should not occur when all else is equal. A large variety of factors can affect the rate of both. For example, investment in market production, infrastructure, education, and preventative health care can all grow an economy in greater amounts than the investment spending.

2. Monetary policy

Today the primary tool for controlling inflation is monetary policy. Most central banks are tasked with keeping their inter-bank lending rates at low levels, normally to a target rate around 2% to 3% per annum, and within a targeted low inflation range, somewhere from about 2% to 6% per annum. A low positive inflation is usually targeted, as deflationary conditions are seen as dangerous for the health of the economy.

There are a number of methods that have been suggested to control inflation. Central banks such as the U.S. Federal Reserve can affect inflation to a significant extent through setting interest rates and through other operations. High interest rates and slow growth of the money supply are the traditional ways through which central banks fight or prevent inflation, though they have different approaches. For instance, some follow a symmetrical inflation target while others only control inflation when it rises above a target, whether express or implied.

Monetarists emphasize keeping the growth rate of money steady, and using monetary policy to control inflation (increasing interest rates, slowing the rise in the money supply). Keynesians emphasize reducing aggregate demand during economic expansions and increasing demand during recessions to keep inflation stable. Control of aggregate demand can be achieved using both monetary policy and fiscal policy (increased taxation or reduced government spending to reduce demand).

3. Fixed exchange rates

Under a fixed exchange rate currency regime, a country's currency is tied in value to another single currency or to a basket of other currencies (or sometimes to another measure of value, such as gold). A fixed exchange rate is usually used to stabilize the value of a currency, vis-a-vis the currency it is pegged to. It can also be used as a means to control inflation. However, as the value of the reference currency rises and falls, so does the currency pegged to it. This essentially means that the inflation rate in the fixed exchange rate country is determined by the inflation rate of the country the currency is pegged to. In addition, a fixed exchange rate prevents a government from using domestic monetary policy in order to achieve macroeconomic stability.

Under the Bretton Woods agreement, most countries around the world had currencies that were fixed to the US dollar. This limited inflation in those countries, but also exposed them to the danger of speculative attacks. After the Bretton Woods agreement broke down in the early 1970s, countries gradually turned to floating exchange rates. However, in the later part of the 20th century, some countries reverted to a fixed exchange rate as part of an attempt to control inflation. This policy of using a fixed exchange rate to control inflation was used in many countries in South America in the later part of the 20th century (e.g. Argentina (1991–2002), Bolivia, Brazil, and Chile).

4. Gold standard

The gold standard is a monetary system in which a region's common media of exchange are paper notes that are normally freely convertible into pre-set, fixed quantities of gold.

The standard specifies how the gold backing would be implemented, including the amount of specie per currency unit. The currency itself has no innate value, but is accepted by traders because it can be redeemed for the equivalent specie. A U.S. silver certificate, for example, could be redeemed for an actual piece of silver.

The gold standard was partially abandoned via the international adoption of the Bretton Woods System. Under this system all other major currencies were tied at fixed rates to the dollar, which itself was tied to gold at the rate of $35 per ounce. The Bretton Woods system broke down in 1971, causing most countries to switch to fiat money – money backed only by the laws of the country.

According to Lawrence H. White, an F. A. Hayek Professor of Economic History "who values the Austrian tradition", economies based on the gold standard rarely experience inflation above 2 percent annually.

However, historically, the U.S. saw inflation over 2% several times and a higher peak of inflation under the gold standard when compared to inflation after the gold standard. Under a gold standard, the long term rate of inflation (or deflation) would be determined by the growth rate of the supply of gold relative to total output. Critics argue that this will cause arbitrary fluctuations in the inflation rate, and that monetary policy would essentially be determined by gold mining.

5. Wage and price controls

Another method attempted in the past have been wage and price controls ("incomes policies"). Wage and price controls have been successful in wartime environments in combination with rationing. However, their use in other contexts is far more mixed.

Notable failures of their use include the 1972 imposition of wage and price controls by Richard Nixon. More successful examples include the Prices and Incomes Accord in Australia and the Wassenaar Agreement in the Netherlands.

In general, wage and price controls are regarded as a temporary and exceptional measure, only effective when coupled with policies designed to reduce the underlying causes of inflation during the wage and price control regime, for example, winning the war being fought. They often have perverse effects, due to the distorted signals they send to the market. Artificially low prices often cause rationing and shortages and discourage future investment, resulting in yet further shortages. The usual economic analysis is that any product or service that is under-priced is overconsumed. For example, if the official price of bread is too low, there will be too little bread at official prices, and too little investment in bread making by the market to satisfy future needs, thereby exacerbating the problem in the long term.

Temporary controls may complement a recession as a way to fight inflation: the controls make the recession more efficient as a way to fight inflation (reducing the need to increase unemployment), while the recession prevents the kinds of distortions that controls cause when demand is high.

However, in general the advice of economists is not to impose price controls but to liberalize prices by assuming that the economy will adjust and abandon unprofitable economic activity. The lower activity will place fewer demands on whatever commodities were driving inflation, whether labor or resources, and inflation will fall with total economic output. This often produces a severe recession, as productive capacity is reallocated and is thus often very unpopular with the people whose livelihoods are destroyed (see creative destruction).

6. Cost-of-living allowance

The real purchasing-power of fixed payments is eroded by inflation unless they are inflation- adjusted to keep their real values constant. In many countries, employment contracts, pension benefits, and government entitlements (such as social security) are tied to a cost-of-living index, typically to the consumer price index. A cost-of-living allowance (COLA) adjusts salaries based on changes in a cost-of-living index. Salaries are typically adjusted annually in low inflation economies. During hyperinflation they are adjusted more often. They may also be tied to a cost-of-living index that varies by geographic location if the employee moves.

Annual escalation clauses in employment contracts can specify retroactive or future percentage increases in worker pay which are not tied to any index. These negotiated increases in pay are colloquially referred to as cost-of-living adjustments ("COLAs") or cost-of-living increases because of their similarity to increases tied to externally determined indexes.

SELF ASSESSMENT EXERCISE 3

Mention various means being adopted to control inflation.

1.7 Summary

From this study unit, you have been acquainted that inflation is a rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. You have also understood that

Inflation reflects a reduction in the purchasing power per unit of money – a loss of real value in the medium of exchange and unit of account within the economy. A chief measure of price inflation is the inflation rate, the annualized percentage change in a general price index (normally the consumer price index) over time You also learned that ieffect of inflation on an economy are varied and can be simultaneously positive and negative. Negative effects of inflation include an increase in the opportunity cost of holding money, uncertainty over future inflation which may discourage investment and savings, and if inflation is rapid enough, shortages of goods as consumers begin hoarding out of concern that prices will increase in the future. Positive effects include ensuring that central banks can adjust real interest rates (to mitigate recessions), and encouraging investment in non-monetary capital projects.

Furthermore, the discussion in this study unit also provided that there are various through which inflation can be controlled all by the actions of the government and the monetary authority.

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1.8 Possible Answers to SAEs

Answer to SAE 1

The term "inflation" originally referred to increases in the amount of money in circulation, and some economists still use the word in this way. However, most economists today use the term "inflation" to refer to a rise in the general price level. An increase in the money supply may be called monetary inflation, to distinguish it from rising prices, which may also for clarity be called 'price inflation'. Economists generally agree that in the long run, inflation is caused by increases in the money supply.

Answer to SAE 2

Consumer Price Index
Producer price indices

Core price indices
Gross Domestic Deflator
Regional inflation

Asset price inflati5o5n

Historical inflation

Answer to SAE 3

Stimulating Economic Growth
Monetary Policy
Fixed Exchange Rate
Use of Gold Standard
Wage and price control
Cost of living allowance

UNIT 2 INTEREST RATES

Unit Structure

2.1 Introduction

You have learned from the previous study unit what inflation is all about. In this study, you will be taken through discussion on interest rate. Making use of money owned by other people or interest through borrowing involves some cost. This cost refers to the fee charged by a lender to a borrower for the use of borrowed money, usually expressed as an annual percentage of the amount of money borrowed called principal. The cost charged on borrowed money depends on factors such as: time value of money; the credit risk of the borrower; and the inflation rate, among others. In other words, such cost on borrowed funds can also mean a return earned on an investment by the lender. In this Unit, we shall explore the definition of interest (rate) as well as discuss its theories. We shall also highlight interest rate as a monetary policy instrument or intermediate policy target in Nigeria. Furthermore, we shall discuss Nigeria‘s interest rate structure and its relationship to both investment decision and the balance of payment. Lastly, a look will be made at the United State‘s response to the prevailing global low interest level.

2.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the meaning of interest and interest rate;
- Analyze the theories of interest rate, pointing out the various arguments of the economists;
- Demonstrate how interest rate being used as a monetary policy instrument in Nigeria;

- Analyze Nigeria‘s interest rate structure and its relationship to both investment decision and the balance of payment;
- Discuss the experience of US in response to low interest level.

2.3 Meaning of Interest Rates

Making use of money owned by other people or entity through borrowing involves some cost. This cost refers to the fee charged by a lender to a borrower for the use of borrowed money, usually expressed as an annual percentage of the amount of money borrowed called principal. The cost charged on borrowed money depends on factors such as: time value of money; the credit risk of the borrower; and the inflation rate, among others. In other words, such cost on borrowed funds can also mean a return earned on an investment by the lender.

The rate of interest is the price of loan or the price paid for the use of money. Interest is expressed as a rate. It can be defined as a reward for lending and a cost of borrowing what may best be described as loanable funds.‘ Classical economists treated interest as a reward for saving or the reward for waiting. The neo-classical economists treated it as the return from capital (which is equal to the marginal product of capital) or the price that has to be paid for the use of loan capital. Keynes considered this as the reward for parting with liquidity (cash).

Knut Wicksell has defined interest as the payment made by the borrower of capital, by virtue of its productivity, as a reward for his abstinence.‘ Meyer has defined it as the price paid for the use of loanable funds. To some economists, notably Craver, it is the income that goes to the owner of capital.‘ A. C. Cairncross defines this as the price for the hire of loan.‘ Keynes treats interest as a purely monetary phenomenon and defines it as the premium which has to be offered to induce people to hold their wealth in some forms other than hoarded money.‘ All these definitions make one thing clear at least:

interest is the payment that is made for the use of money or loanable funds.

Therefore, the interest rate is the percent charged, or paid, for the use of money. It is determined or charged when the money is being borrowed, and paid when it is being used or when the fund borrowed is being returned on instalmental basis. The interest rate that the lender charges is a percent of the total amount loaned. Similarly, the interest rate that an institution, such as a bank, pays to hold your money is a percent of the total amount deposited.

Anyone can lend money and charge interest, or hold deposits and pay interest. However, it is usually the function of bank to make loans or hold deposits. How do banks get the money to make loans? Banks use the deposits made by people who keep their savings or checking accounts with them. Banks convince people to make deposits by paying interest rates. Banks are paying depositors for the right of using their money.

Banks then use that money to make loans. Banks charge borrowers a little higher interest rate than they pay depositors for that same money so they can profit for providing these services. Banks want to charge as much interest as possible on loans, and pay as little as possible on deposits, so they can be more profitable.

Interest rates are charged not only for loans, but also for mortgages, credit cards and unpaid bills.

The interest rate is applied to the total unpaid portion of your loan or bill. It is important to know what your interest rate is (even as an individual), and how much it adds to your outstanding debt. If your interest rate adds more to your debt than the amount you are paying, your debt could actually increase even though you are making payments.

Interest rate is applicable on all types of lending all over the world. The factors/determinants include:

- Gross Domestic Product (GDP)
- Consumer Price Index
- Budget Deficit
- Money Supply
- Remittance
- Foreign Direct Investment

But what are bases underlining the interest and interest rate?.

SELF ASSESSMENT EXERCISE 1

Explain the meaning of interest rate in your own words.

2.4 Theories of Interest Rates

Theories of interest rates have a long history, and its determination has been a controversial issue among economists. The core of the controversy is on the factors that influence interest rate determination. Many theories have been propounded on interest rate determination. Some of these can be highlighted.

1. The Classical Theory

The classical economists attempted to explain the determination of the rate of interest by the interaction of the market forces, that is, by the demand for capital (or investment) and the supply of capital (or savings). The capital theory lays stress on such real factors as thrift, time preference and productivity of capital. This is why it is called the real theory of interest.

The classical economists considered that the long-run interest rates were determined by the real forces – savings and productivity of capital. Thus, a higher interest rate should induce more savings. The reason could be seen in the fact people would tend to save more to derive more income in the future as a result of interest payment. The decision to save more and consume less could be considered as a choice between immediate consumption and deferred satisfaction. This could be on the opportunity cost of each alternative which could be measured by the real rate of interest. The real interest rate could therefore be taken to mean a price of deferred consumption.

2. The Loanable Funds Theory

The classical time preference –cum – marginal productivity theory attempted to explain interest in real' terms and it focused on the consumer goods or additional capital bought with borrowed money. But during the 1930s, some economists shifted attention to the monetary aspects of interest and maintained that the interest rate is determined by the supply of and demand for loanable funds.

The supply schedule, according to this theory, depends not only upon the amount of savings but also on the new additions to the money supply. The demand schedule is based largely on business needs for investment funds and cash balances to conduct everyday transactions. These schedules behave like any other demand and supply schedules, and their interaction determines the exchange rate.

Economists like D. Robertson and others who developed the loanable funds theory treated this theory as a monetary theory. They did not discard the earlier notions of time preference and the marginal productivity of capital. Instead, they supplemented the ‗real' influences on the rate of interest by the monetary determinants. In other words, according to the loanable funds theory, the rate of interest is determined by both monetary forces such as money creation by commercial banks and non-banking financial institutions, hoarding and dishoarding of money, consumption loan given by banks, etc., as also by real forces such as thriftiness (which refers to an increased desire to save), waiting, time preference and productivity of capital.

3. The Liquidity Preference (or Monetary) Theory

A break with earlier theories occurred in 1936 with the publication of Keynes' —General Theory of Employment, Interest and Money. Keynes was skeptical about the importance of time and ‗real' determinants of interest such as productivity of capital and also saving and investment. He developed a new concept, liquidity preference, and looked interest from a different angle. According to Keynes, the rate of interest is purely monetary phenomenon and is the reward not for saving but for parting with liquidity for a specific time period. And it is determined by the demand for and supply of money.

Keynes argued that people do not save because they want to defer consumption or because of the thrift motive. The amount of money that a person saves depends primarily upon his level of income. Keynes did not deny that the thrift motive exists but he felt that thrift had very little, if any, influence on the interest rate.

4. Expectations Theory of Interest Rates

This is a theory that purports to explain the shape of the yield curve, or the term structure of interest rates. The forces that determine the shape of the yield curve have been widely debated among academic economists for a number of years. The American economist Irving Fisher advanced the expectations theory of interest rates to explain the shape of the curve.

According to this theory, longer-term rates are determined by investor expectations of future short-term rates.

In mathematical terms, the theory suggests that:

$(1 + R2)2 = (1 + R1) \times (1 + E (R1))$

Where

R2 = the rate on two-year securities,
R1 = the rate on one-year securities,

E (R1) = the rate expected on one-year securities one year from now.

The left side of this equation is the amount per dollar invested that the investor would have after two years if he invested in two-year securities. The right side shows the amount he can expect to have after two years if he invests in one-year obligations.

Competition is assumed to make the left side equal to the right side.

The theory is easily generalized to cover any number of maturity classes. And however many maturity classes there may be, the theory always explains the existence of longer-term rates in terms of expected future shorter-term rates.

The expectations theory of interest rates provides the theoretical basis for the use of the yield curve as an analytical tool by economic and financial analysts. For example, an upward-sloping yield curve is explained as an indication that the market expects rising short-term rates in the future. Since rising rates normally occur during economic expansions, an upward-sloping yield curve is a sign that the market expects continued expansion in the level of economic activity.

Financial analysts sometimes use this equation to obtain a market-related forecast of future interest rates. It can be rewritten as follows:

$$E (R1) = [(1 + R2)2 \quad / (1 + R1)] - 1$$

The equation suggests that the short-term rate expected by the market next period can be obtained from knowledge of rates today.

How can the interest rate be used as a monetary policy instrumrnt?

SELF-ASSESSMENT EXERCISE 2

Briefly explain the Expectation Theory of interest rate.

2.5 Interest Rate as a Monetary Policy Instrument or Intermediate Policy Target

Interest rate could be used as a monetary policy instrument in a regulated economic environment.

This was the case in Nigeria up to 1986. When it was an instrument, the main target was that of influencing the immediate policy targets – credit availability – which in turn would produce the desired effects within the economy. Since interest rate represents the cost of borrowing, its increase in general tends to decrease the volume of credit available and implicitly the demand for loanable funds, all things being equal.

In the industrialized western countries however, interest rates are considered as immediate monetary targets and are therefore supposed to vary accordingly with the forces of the market.

Interest rate fluctuation should not however be allowed to continue wildly as this could be detrimental to the economic progress of the society. Unstable interest rates create uncertainty in the assessment of future investment yields which may involve higher risk premiums in determining the levels of long-term interest rates. This implicitly means that unstable interest rates may further induce a higher average level of interest rates than would have otherwise been the case in a stable rate. It should therefore imply that a higher interest rate would hamper the rate of growth in economic development through the discouragement of the demand for loanable funds which is negatively related to the level of interest rates.

When the demand for loanable funds decreases, the growth rate in money stock also decreases and therefore, any excess supply of money over output potential may be contained. The excess of money stock over the output potential is what invariably leads to a rise in the general level of prices.

2.6 Interest Rate Structure in Nigeria and its Relationship with both Investment Decisions and the Balance of Payments

Interest rates in Nigeria were generally low up to 1986 and the structure was more or less being administered by the Central Bank. Nigeria is a developing country and as such, like others, is in need of financial resources to execute various development programmes. Before funds are used, it is a precondition that they must be mobilized. The funds, which must be mobilized, consist of the savings of different units which must be utilized at a cost as represented by the interest rate. If the market information system is efficient and the cost of funds is relatively at a desirable level, more savings would likely be attracted both internally and externally. Households can even reduce their consumption in order to set aside an adequate part of their income for the purpose of acquiring income earning assets (debt instruments) with their savings.

The main point of interest is that higher interest rates attract more savings. In a developing nation like Nigeria, though the level of income is low, people still save for ‗a rainy day.' Those who are aware of the existence of investment opportunities invest their savings properly. Borrowers, on the other hand, borrow money because of their operating deficits. Even though borrowers want money, they normally want it at a reduced cost. This depends more on the expected profitability of investment. Investors normally use the rate of return in deciding at what rate to borrow.

The economic limit to any expansion of investment opportunities is where the internal rate of return is equal to the average interest rate on borrowed funds. In as much as the internal rate of return is higher than the interest rate, it is economically advisable to increase investment until the marginal efficiency of capital is equal to the cost of capital.

For reasons of accelerated economic development, interest rates have to be maintained at low levels for the following reasons:

- To encourage the demand for loanable funds for increased economic activities by both private and public sector borrowers;
- To minimize the debt servicing cost on the part of the government.

However, a low interest rate structure may have an undesirable impact on the balance of payments. The inward and outward flow of capital funds depends on the interest rate differentials between two countries or a group of countries with trade and financial relationships.

Low levels of short-term interest rates discourage any form of inflow of short-term foreign capital. This could increase the level of funds in the money market and at the same time increase the volume of foreign exchange reserves. The positive effect of this is that of the stability of balance of payments, especially, the above-the-line section, which would be subjected to forces of instability due to the movements of short-term foreign capital.

Moreover, an average low level of interest rates could deny an economy much of this form of needed short-term capital. The implication is that since the low levels of short-term interest rates discourage any form of inflow of short-term foreign capital and also fail to attract private sector savers (especially on government securities), the Central Bank has to be forced to fill the gap. This in itself means inflationary monetary stance.

The inward movement of long-term foreign private capital is a reflection of direct foreign investment in industrial concerns more than that of portfolio investment in marketable fixed interest securities. This is because the purchase of fixed interest securities (portfolio investment) is different from direct foreign investment in promising companies. The former is limited to interest which is low. In addition, there are limited possibilities, if any, of having additional income from positive price differentials. The latter is subject to payment of dividends. The level of dividends, however, depends on the rate of return on invested capital and the dividend policy of the company.

SELF-ASSESSMENT EXERCISE 3

Give two reasons foe encouraging low interest rates in an economy.

2.7 Experience of US in Response to Low Interest Level

The financial crisis that began in 2007 was the most intense period of global financial strains since the Great Depression, and it led to a deep and prolonged global economic downturn. The Federal Reserve (apex bank of US) took extraordinary actions in response to the financial crisis to help stabilize the U.S. economy and financial system. These actions included reducing the level of short-term interest rates to near zero. In addition, to reduce longer-term interest rates and thus provide further support for the U.S. economy, the Federal Reserve has purchased large quantities of longer-term Treasury securities and longer-term securities issued or guaranteed by government-sponsored agencies such as Fannie Mae or Freddie Mac. Low interest rates help households and businesses finance new spending and help support the prices of many other assets, such as stocks and houses.

By law, the Federal Reserve conducts monetary policy to achieve maximum employment, stable prices, and moderate long-term interest rates. The economy is recovering, but progress toward maximum employment has been slow and the unemployment rate remains elevated. At the same time, inflation has remained subdued, apart from temporary variations associated with fluctuations in prices of energy and other commodities. To support continued progress toward maximum employment and price stability, the US Federal Open Market Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens. In its December 2012 statement, the Committee indicated that it currently anticipates that a target range for the federal funds rate of 0 to 1/4 percent will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than half a percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.

2.8 Summary

In this study unit, you have been taken through the realm of interest and interest rate.

You have learned that interest is the cost of borrowing money and gain for the lender. The rate of interest is normally determined at the time of borrowing the fund that must be honoured with regular payment along with the principal amount. Some notable economists overtime propounded some theories to explain the bases of charging interest rates on loanable funds. Such economists include Maynard Keynes who propounded the General Theory of Employment, Interest and Money in 1936 and Irving Fisher for propounding Expectation Theory of Interest rates, among others. You also leaned that interest rate can be used as a monetary instrument policy as is the case in Nigeria in the past, and the experience of the US regarding the phenomenon of over low interest rate.

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2.10 Possible Answers to SAEs

Answer to SAE 1

Interest refers to the cost of making use of money owned by other people or entity through borrowing of the fund. This cost refers to the fee charged by a lender to a borrower for the use of borrowed money, usually expressed as an annual percentage of the amount of money borrowed called principal.

The cost charged o7n1borrowed money depends on factors such as: time value of money; the credit risk of the borrower; and the inflation rate, among others. In other words, such cost on borrowed funds can
also mean a return earned on an investment by the lender

The rate of interest is the price of loan or the price paid for the use of money determined at the time of lending the money by the lender of the fund. Interest is expressed as a rate. It can ben defined as a reward for lending and a cost of borrowing what may best be described as loanable funds.

Answer to SAE 2

According to Irving Fisher, who propounded the theory, the Expectations Theory of Interest Rates explains the shape of the yield curve, or the term structure of interest rates. This theory, longer-term rates are determined by investor expectations of future short-term rates. In addition, the theory is easily generalized to cover any number of maturity classes, and the theory always explains the existence of longer-term rates in terms of expected future shorter-term rates.

The expectations theory of interest rates provides the theoretical basis for the use of the yield curve as an analytical tool by economic and financial analysts. For example, an upward-sloping yield curve is explained as an indication that the market expects rising short-term rates in the future. Since rising rates normally occur during economic expansions, an upward-sloping yield curve is a sign that the market expects continued expansion in the level of economic activity.

Financial analysts sometimes use this equation to obtain a market-related forecast of future interest rates. It can be rewritten as follows:

$$E (R1) = [(1 + R2)2 \quad / (1 + R1)] - 1$$

The equation suggests that the short-term rate expected by the market next period can be obtained from knowledge of rates today.

Answer to SAE 3

For reasons of accelerated economic development, interest rates have to be maintained at low levels for the following reasons:

1. To encourage the demand for loanable funds by investors for increased economic activities; and

2. Minimize debts servicing cost particularly on the part of the government.

UNIT 3 EXCHANGE RATES

Unit Structure

3.1 Introduction

The previous study unit has been used to discuss interest rates, which involve cost of borrowing funds to the borrower but gains or returns to the lender. In this study unit, you will be taken through the realm of exchange rate. You can recall that the world is a global village, and therefore, we interact social and economically which involves the use of different currencies. Since different countries have their distinct currency, it implies that exchange of currencies between them must be involved in our mutual financial transactions such as in international business and foreign trade.

You can understand that like most other rates in economics, the exchange rate is essentially a price and can be analyzed in the same way we would a price. Of course, most people would only need to understand exchanges rates when they need to engage in international transactions involving traveling abroad, for instance, for studies, medical treatment, religious tourism (pilgrimage to Mecca and Jerusalem), going on vacation or holidays, and foreign trips for conferences and training, among others. However, economists, generally also considers how exchange rates affect the foreign trade and international business, which involve imports and exports, balance of payments, and the inflation rate, etc. You will learn more on this in this study unit macroeconomic objectives. Unfortunately, the layman's definition of the exchange rate is not the only one.

3.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the connotation and application of exchange rates;
- Demonstrate how foreign currencies are paired in forex market;
- Evaluate the various types of exchange rate systems & exchange rate models; and
- Analyze the difference between real and nominal exchange rates.

3.3 Meaning of Exchange Rate & Currency Pairs

33.1 Meaning of Exchange Rate

Exchange rate between two different national currencies is the rate at which one currency will be exchanged for another, that is, the value of one country‘s currency in terms of another. It is also known as foreign-exchange rate, forex rate or FX rate. Exchange rates are determined in the foreign exchange market, which is open to a wide range of different types of buyers and sellers where currency trading is continuous: 24 hours a day except weekends, i.e. trading from 20:15 GMT on Sunday until 22:00 GMT Friday. For example, an interbank exchange rate of 158 Nigerian Naira (NGN, ₦) to the United States dollar (US$) means that ₦158 will be exchanged for each US$1 or that US$1 will be exchanged for each ₦158. Spot exchange rate refers to the current exchange rate. Forward exchange rate refers to an exchange rate that is quoted and traded today but for delivery and payment on a specific future date.

3.3.2 Currency Pairs

A currency pair is the quotation of the relative value of a currency unit against the unit of another currency in the foreign exchange market. The quotation EUR/USD 1.2500 means that 1 Euro is exchanged for 1.2500 US dollars. Here, EUR is called the "base currency" or "unit currency", while USD is called the "term currency" or "price currency". There is a market convention that determines which is the base currency and which is the term currency. In most parts of the world, the order is: EUR – GBP – AUD – NZD – USD – others. Quotes using a country's home currency as the price currency (e.g., EUR 0.735342 = USD 1.00) are known as direct quotation or price quotation (from that country's perspective) and are used by most countries. Quotes using a country's home currency as the unit currency (e.g., EUR 1.00 = USD 1.35991) are known as indirect quotation or quantity quotation and are used in British newspapers and are also common in Australia, New Zealand and the Eurozone.

But what about the management of foreign exchange system in various countries?

SELF ASSESSMENT EXERCISE 1

a) What is Exchange Rate?
b) How is the spot rate different from future rate in foreign exchange?

3.4 Types of Exchange Rate Systems

Each country, through varying mechanisms, manages the value of its currency. As part of this function, it determines the exchange rate regime that will apply to its currency. The currency may be based on a free-floating or flexible, pegged or fixed, or a hybrid exchange rate system.

1. Fixed Exchange rate system:

Fixed exchange rate system is a system where the rate of exchange between two or more countries does not vary or varies only within narrow limits. Under the fixed or stable exchange rate system, the government of a country adjusts its economic policies in such a manner that a stable exchange rate is maintained; it is a system of changing "lock to the key".

In the strict sense, fixed exchange rate system refers to the international gold standard (as existed before 1914) under which the countries define their currencies in gold at a ratio assumed to be fixed indefinitely. But, in modern times, the fixed exchange rate system is identified with adjustable peg system of the International Monetary Fund (IMF) under which the exchange rate is determined by the government and enforced through pegging operations or through some exchange controls.

2. Flexible Exchange Rate System:

Flexible or free exchange rate system, on the other hand, is a system where the value of one currency in terms of another is freely determined by the market situations, and therefore allowed to fluctuate and establish its equilibrium level in the exchange market through the forces of demand and supply.

Under the flexible exchange rate system, the rate of exchange is allowed to vary to suit the economic policies of the government; it is a system of changing "key to the lock". The flexible exchange rates are determined by the forces of demand and supply in the exchange market.

4. Hybrid Exchange Rate Systems:

This system of forex system in foreign exchange markets does not allow for the rigid system of fixed exchange rates. At the same time, freely floating exchange rates expose a country to volatility in exchange rates. Hybrid exchange rate systems have evolved in order to combine the characteristics features of fixed and flexible exchange rate systems. They allow fluctuation of the exchange rates without completely exposing the currency to the flexibility of a free float. Common examples are the basket of currencies, crawling pegs, pegged with a band, currency boards and dollarization.

But how does the money dealer in forex market do his business?

SELF ASSESSMENT EXERCISE 2

List the various types of foreign exchange systems.

1.5 Buying and Selling Rate

In retail currency exchange market, a different buying rate and selling rate will be quoted by money dealers. Most trades are to or from the local currency. The buying rate is the rate at which money dealers will buy foreign currency, and the selling rate is the rate at which they will sell the currency. The quoted rates will incorporate an allowance for a dealer's margin (or profit) in trading, or else the margin may be recovered in the form of a "commission" or in some other way. Different rates may also be quoted for cash (usually notes only), a documentary form (such as traveler's cheques) or electronically (such as a credit card purchase). The higher rate on documentary transactions is due to the additional time and cost of clearing the document, while the cash is available for resale immediately. Some dealers on the other hand prefer documentary transactions because of the security concerns with cash.

What is the value of forex in relation to the effects of inflation?

1.6 Real Exchange Rate

The real exchange rate (RER) is the purchasing power of a currency relative to another. It is the exchange rate after being adjusted for the effects of inflation. Exchange rate before inflation adjustment is usually called nominal exchange rate. The equation follows:

real exchange rate = (nominal exchange rate X domestic price) / (foreign price).

The RER is based on the Gross Domestic Product (GDP) deflator measurement of the price level in the domestic and foreign countries, which is arbitrarily set equal to 1 in a given base year.

Therefore, the level of the RER is arbitrarily set depending on which year is chosen as the base year for the GDP deflator of two countries. The changes of the RER are instead informative on the evolution over time of the relative price of a unit of GDP in the foreign country in terms of GDP units of the domestic country. If all goods were freely tradable, and foreign and domestic residents purchased identical baskets of goods, purchasing power parity (PPP) would hold for the GDP deflators of the two countries, and the RER would be constant and equal to one.

An important relationship therefore exists between net exports and the real exchange rate within a country. When the real exchange rate is high, the relative price of goods at home is higher than the relative price of goods abroad.

In this case, import is likely because foreign goods are cheaper, in real terms, than domestic goods. Thus, when the real exchange rate is high, net exports decrease as imports rise. Alternatively, when the real exchange rate is low, net exports increase as exports rise. This relationship helps to show the effects of changes in the real exchange rate.

3.7 Models of Foreign Exchange

Models predicting foreign exchange rate behaviour have been developed overtime. Some of these models include the balance of payments and the asset market approach, which are expatiated thus below.

I) The balance of payments model holds that foreign exchange rates are at an equilibrium level if they produce a stable current account balance. A nation with a trade deficit will experience a reduction in its foreign exchange reserves, which ultimately lowers (depreciates) the value of its currency. A cheaper (undervalued) currency renders the nation's goods (exports) more affordable in the global market while making imports more expensive. After an intermediate period, imports will be forced down and exports to rise,

thus stabilizing the8t0rade balance and bring the currency towards equilibrium8.0Like purchasing power parity, the balance of payments model focuses largely on trade-able goods and services, ignoring the increasing role of global capital flows. In other words, money is not only chasing goods and services, but to a larger extent, financial assets such as stocks and bonds. Their flows go into the capital account item of the balance of payments, thus balancing the deficit in the current account. The increase in capital flows has given rise to the asset market model.

II) The asset market approach views currencies as asset prices traded in an efficient financial market.

Consequently, currencies are increasingly demonstrating a strong correlation with other markets, particularly equities. Like the stock exchange, money can be made (or lost) on trading by investors and speculators in the foreign exchange market. Currencies can be traded at spot and foreign exchange options markets. The spot market represents current exchange rates, whereas options are derivatives of exchange rates.

SELF ASSESSMENT EXERCISE 3

How does the Balance of Payments Model different from the Asset Mark Approach?

3.8 Manipulation of Foreign Exchange Rate

A country may gain an advantage in international trade if it manipulates the market for its currency to artificially keep its value low, typically by the national central bank engaging in open market operations. For instance, it has been argued by US legislators that the People's Republic of China has been acting in that way over a long period of time. In 2010, other nations, including Japan and Brazil, attempted to devalue their currency in the hopes of reducing the cost of exports and thus bolstering their ailing economies. A low (undervalued) exchange rate lowers the price of a country's goods for consumers in other countries but raises the price of goods, especially imported goods, for consumers in the manipulating country.

3.9 Summary

You have learned from this study unit that An exchange rate is the value of one currency expressed in terms of another currency. You have also understood that exchange rate (nominal exchange rate) between two different national currencies is the rate at which one currency will be exchanged for another. We also discussed that currencies may be based on a free-floating or flexible, pegged or fixed, or a hybrid exchange 8r1ate system. You learned from the discussions that t8h1e real exchange rate is the exchange rate after being adjusted for the effects of inflation. A currency that is becoming weaker or depreciating is a currency that is going down in value against another, which likened to the situation in Nigeria wherein the naira has become weakened since the floating forex regime was introduced by the Tinubu administration in 2023. In related terms, you learned that the value of a currency can be manipulated by the government towards making their exports cheaper for the other countries.

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3.11 Possible Answers to SAEs

Answer to SAE 1

a) What is Exchange Rate?
b) How is the spo8t2rate different from future rate in foreign exchange?

Answer to SAE 2

i. Fixed or pegged exchange rate system
ii. Floating or flexible exchange system

iii. Hybrid exchange rate system

Answer to SAE 3

I) The balance of payments model holds that foreign exchange rates are at an equilibrium level if they produce a stable current account balance. A nation with a trade deficit will experience a reduction in its foreign exchange reserves, which ultimately lowers (depreciates) the value of its currency. A cheaper (undervalued)currency renders the nation's goods (exports) more affordable in the global market while making imports more expensive. After an intermediate period, imports will be forced down and exports to rise, thus stabilizing the trade balance and bring the currency towards equilibrium.

The Asset Market Approach views currencies as asset prices traded in an efficient financial market.
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UNIT 4 GLOBALIZATION & INTERNATIONAL INSTITUTIONS

Unit Structure

4.1 Introduction

In the previous study unit, you have been taken through the discussion on exchange rates. In this study unit, you will be guided to become acquainted with the realm of globalization. You will understand that globalization evolves from the fact that the whole world has become a global village due to the advent of technology and internet. The implication is that the whole world has been brought on the finger tips of everybody through advancement in technology and the evolution of internet and its applications. You can deduce from your experience that with our technological gadgets such as GSM phones and its relevant applications coupled with internet search engines, individuals and corporate entities as well as publications can communicate and reach out to all parts of the globe at any time, any where and in any situation. However, as if the world was looking forward to such scenario coupled with the complex trade relationships among nations, some international institutions such as GATT and WTO have been created to address the fallouts from the international trade relationships. developments.

4.2 Learning Outcomes

By the end of this unit, you will be able to:

Discuss th8e4 term Globalization and its implications for international trade;

- Analyze the effects of Globalization on international trade;
- Evaluate the advantages and disadvantages of Globalization;
- Demonstrate that Globalization is beneficial to the world economy; and
- Discuss the differences between WTO and GATT.

4.3 Meaning of Globalisation

It is important for you to appreciate that it is difficult to come to agreement as to what actually is globalisation. In fact, it is interesting in the sense that every day on television shows, internet chat rooms, practical demonstrations, parliaments, management boardrooms and labour union meetings, people discuss globalisation, yet the definition that is acceptable is elusive. You can appreciate that interest groups such as the social scientists discuss globalisation according to their areas of interest, i.e., political globalisation, technological globalisation, etc. All the same, politics, society, environment, history, geography, and culture have some implications in globalisation.

As you can appreciate from earlier discussion regarding the ideas of Ball et al (2002) for globalisation. They observed that there are aspects of economic globalisation, the international integration of goods, technology, labour, and capital; these implies that firms must come up with global strategies to address them. All these the management of firms link and coordinate their international activities on a worldwide basis (Yalcin, 2018).

In a nutshell, globalization involves the international integration of goods, technology, labour, and capital; these implies that firms must come up with global strategies to address them.

You can appreciate that globalisation is characterized by some forces. Such forces can be categorized into five major kinds of elements and they include:

i. Politics
   It is a trend toward the unification and socialisation of the global community.

ii. Technology

Advances in computers and communications technology have permitted increased flow of ideas and information across borders, enabling customers to learn about foreign goods.

iii. Markets

As companies globalise, they also become global customers. Example could be seen in Nigerian banking industry, Zenith Bank, First Bank, Intercontinental Bank, have gone global with global customers.

iv. Cost

Economics of scale which seek to reduce costs are always a management goal; you could achieve this through global product lines so as to reduce development, production and investing costs.

v. Competitiveness

Competition in the international market is keener than home markets, because of diverse products/services and as well as different marketing strategies in entering international market.

What are actually the benefits and drawbacks of Globalization?

SELF ASSESSMENT EXERCISE 1

Explain Globalisation in your own worlds.

4.4 Advantages and Diisadvantages of Globalization (An Economic View)

4.4.1 Advantages of Globalization

The economic benefits that greater openness to international trade bring are:

i) Faster growth: economies that have in the past been open to foreign direct investments have developed at a much quicker pace than those economies closed to such investment e.g. communist Russia

ii) Cheaper imports: this is down to the simple fact that if we reduce the barriers imposed on imports (e.g. tariffs, quota, etc.) then the imports will fall in price

iii) New technologies: by having an open economy we can bring in new technology as it happens rather than trying to develop it internally

iv) Spur of foreign competition: foreign competition will encourage domestic producers to increase efficiency. Carbaugh (1998) states that global competitiveness is a bit like golf, you get better by playing against people who are better than you.

v) Increase consumer income: multination will bring up average wage levels because if the multinationals were not there the domestic companies would pay less.

vi) Increased investment opportunities: with globalization companies can move capital to whatever country offers the most attractive investment opportunity. This prevents capital being trapped in domestic economies earning poor returns.

4.4.2 Disadvantages of Globalization

The negative drivers of globalization included culture which is a major hold back of globalization.

An example of how culture can negatively affect globalization can be seen in the French film industry. The French are very protective of this part of their culture and provide huge grants to help its development. As well as government barriers market barriers and cultural barriers still exist.

Also a negative aspect to a countries development is war e.g. tourism in Israel fell by 40% due to the latest violence. Corporate strategy can also be a negative driver of globalization as c8o6rporation may try to locate in one particular area.

Another negative driver of globalization is ―local focus" or ―localisation" as it is termed in Richard Douthwaite‘s book ―Short Circuit". Douthwaite (1996) believes that globalization can and should be reversed. He also believes that localisation is the way to do this. He defines localisation as ―not meaning everything being produced locally but it means a better a balance between local, regional, national and international markets and thus brings less control to multinational corporations‖. Another step to reverse globalization would be for governments to club together to curb the power of multinational by negotiating new trade and treaties that would remove the subsidies powering globalization and give local production a chance.

Douthwaite also states that the global economy is itself nothing less than a system of structural exploitation that creates hidden slaves on the other side of the world and also that the North should allow the South to produce for itself and not just for us (North). So it can be seen that

Douthwaite is very opposed to globalization especially that part of it exploited by multinational corporations.

Further arguments put forward against globalization by Mr. Lawton include that it actually destroys jobs in wealthy advanced countries. This is due to the lower costs of wages in developing countries.

Multinationals will move to areas of lower wage levels at the drop of a hat, e.g., Fruit of the Loom. Also this ability to relocate has meant that wage levels of unskilled workers in developed countries have actually fallen relatively speaking. This is down to the fact that one now needs skill and knowledge in developed economies to survive.

Also there is the loss of sovereignty that globalization brings. Many anti-globalization believers state that nations are losing their identity and selling their soul.

Then there are environmental factors of globalization as described earlier. These are becoming more and more controversial.

4.5 The World Trade Organization (WTO)

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 tax 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 as 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 made by govern international trade relations which was 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 basically applicable to international trade in goods was for years was modified to include new provisions particularly to deal with the trade problems of developing countries.

4.5.1 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 increase 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 Union (EU).

(WTO),north American Free Trade agreement (NAFTA), and the Europe an 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).

4.5.2 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.

4.5.3 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 theseagreements.
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 make life more efficient
j) Government are shielded

SELF ASSESSMENT 2

Mention five (5) benefits of the World Trade Organization.

4.5.4 Major Features of WTO 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 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 disp91ute resolutions.

Another important feature is that WTO is an international 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.

The other features of WTO include:

The objectives and principles of multilateral agreements on trade goods. Biding of tariffs Most favored nation treatment (MFN)

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

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

1.5.5 World Trade Organization Membership from Year 2000

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.

4.6. Settlement of Trade Disputes by WTO & Control of WTO

4.6.1 Settlement of Trade Disputes by WTO

Suppose a trade dispute arises because a country has taken action on trade (for example imposed a tax or restricted imports) WTO and another country objects. Should the GATT under dispute an environment be handled under agreement outside the WTO or the under 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.

No under the environmental agreements do to mean environmental issues would be ignored in WTO disputes. The WTO agreements allow panels examining a dispute to seek expert advice on environmental issues.

4.6.2 The Control on WTO 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-fiber 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 quality Custom arrangements. A good example is the 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 favour 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 said to be dumped when they are sold for export at less than their normal value.

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).

4.7 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 remains 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.

SELF ASSESSMENT EXERCISE 3

WTO is different from GATT. Explain.

4.8 Summary

You have learned from this study unit that globalization involves globalization involves the international integration of goods, technology, labour, and capital; these implies that firms must come up with global strategies to address them. You have learned that their are some advantages that globalizations brings to the world economy but other hand there are also some disadvantages associated with globalization. You also learned that WTO is international instion established to formulate rules on trade relations at international level while GATT is a treaty created following the conclusion of World War II. From the discussion in the unit, you have learned that the general agreement on tariffs and trade (GATT) was an international institution which was created from mutual agreement amongst nations charged with the objective to further regulate world trade to aide in the economic recovery following the war. You also understand that there are benefits accruing from Gobalization as well as the WTO in international economy and trade by fostering mutual understanding and economic development in many nations around the world.

4.9 References/Further Readings/Web Resources

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4.8 Possible Answers to SAEs

Answer to SAE 1

Globalization implies that as the world has been a global village, economic and trade relationships amongst nations have subjected to the aspects of global politics, environment, geography and culture.

Therefore, globalization involves the international integration of goods, technology, labour, and capital; these implies that firms must come up with global strategies to address them.

Answer to SAE 2

Five (5) benefits of the World Trade Organization.

i. The system helps promote peace.
ii. Dispute are handled constructively
iii. Rules make life easier for all
iv. Freer trade cuts the costs of living
v. It provides more choice of products and qualities

Answer to SAE 3

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

WTO is a forum created 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 rights and settle the differences that arise between them in the course of implementation.

GATT IS a treaty created following the conclusion of World War II. The general agreement on tariffs and trade was implemented to further regulate world trade to aide in the economic recovery following the war.

UNIT 5 LESSONS FROM ASIAN AND MEXICAN FINANCIAL CRISES

Unit Structure

5.1 Introduction

This is the last study unit in this study materials, You will recall that the global economy refers to the economy of the world, comprising of different economies of individual countries, with each economy related with the other in one way or another. You can a also that a key concept in the global economy is globalization, which is the process that leads to individual economies around the world being closely interwoven such that an event in one country is bound to affect the state of other world economies given the fact the world is now a global village. In the past century or so, the focus on globalization has intensified a lot. You can infer from transfer learning that more and more trading activities have been done between different countries, and restrictions on movement and business across borders have been reduced a great deal. The resulting phenomenon is what a global economy is all about.

In this Unit, you will be taken through discussion on global financial crisis with particular reference to the Asian and Mexican financial crises, with the lessons arising such financial crises as our focal point.

5.2 Learning Outcomes

By the end of this unit, you will be able to:

- Discuss the global financial crises;
- Analyze the Asian financial crisis;
- Discuss the Mexican financial crisis; and
- Evaluate the lessons arising from both Asian and Mexican financial crises.

5.3 Global Financial Crises

The financial crises which peaked 2007/2008 (also known as the Global Financial Crisis) can be considered to be the worst since the Great Depression of the 1930s. It resulted in the threat of total collapse of large financial institutions, the bailout of banks by national governments, and downturns in stock markets around the world. In many cases, the housing market suffered also, resulting in evictions, foreclosures and prolonged unemployment. The crisis played a significant role in the failure of key businesses, declines in consumer wealth and a downturn in economic activity leading to the 2008 – 2012 global recession and contributing to European – debt crisis. The active phase of the crisis, which manifested as a liquidity crisis, can be dated from August 7, 2007, when BNP Paribas terminated withdrawals from three hedge funds citing ‗a complete evaporation of liquidity'.

The bursting of the United State housing bubble, which peaked in 2006, caused the values of securities tied to U.S real estate pricing to plummet, damaging financial institutions globally. The financial crisis was triggered by a complex interplay of policies that encouraged home ownership, providing easier access to loans for subprime borrowers, overvaluation of bundled sub-prime mortgages based on the theory that housing prices would continue to escalate, questionable trading practices on behalf of both buyers and sellers, compensation structures that prioritize short-term deal flow over long-term value creation, and a lack of adequate capital holdings from banks and insurance companies to back the financial commitments they were making.

Questions regarding bank solvency, declines in credit availability and damaged investor confidence had an impact on global stock markets, where securities suffered large losses during 2008 and early 2009. Economies worldwide slowed during this period, as credit tightened and international trade declined. Governments and central banks responded with unprecedented fiscal stimulus, monetary policy expansion and institutional bailouts. For example, in the European Union, the United Kingdom responded with austerity measures of spending cuts and tax increases without export growth and it has since slipped into a double-dip recession.

Several authors have defined the financial crisis in various ways. The Central Bank of Nigeria defined it as a situation where financial institutions or assets suddenly lose a large part of their value. Eichengreen and Portes (1987) defined it ―as a sharp change in asset prices that leads to distress among financial markets participants‖. It has been highlighted that the lack of clarity between sharp and moderate price changes or the distinction between severe financial distresses from financial pressure. The crisis can be in form of a banking crisis, speculative bubble, international financial crisis and economic crisis. The financial crisis destabilized the global financial system and led to a major economic crisis in 2008.

Antecedents show the first financial crisis to be the Great Depression of 1929-1933.
The recent financial crisis which originated in the US was preceded by over a hundred episodes of financial crises (CBN, 2009). It is pertinent to note that 75 per cent of these crises had either been caused by the capital market or had affected the capital market, for example, Black Monday (1987) and the Asian Financial Crisis.

Many causes for the financial crisis have been suggested. For example, the U.S Senate‘s Levin-Coburn Report asserts that the crisis was the result of ‗high risk, complex financial products; undisclosed conflicts of interest; the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street.

In the immediate aftermath of the financial crisis, palliative fiscal and monetary policies were adopted to lessen the shock to the economy.

What is the nature of the Asian financial crisis?

SELF-ASSESSMENT EXERCISE 1

Explain what you understand by global financial crises.

5.4 Asian Financial Crisis

Not all financial crises are alike, even though superficial appearances may deceive. Only a close historical analysis, guided by theory, can disentangle the key features of any particular financial crisis, including the Asian crisis. Let us identify five main types of financial crises, which may in fact be intertwined in any particular historical episode:

1) Macroeconomic policy-induced crisis

Following the canonical Krugman (1979) model, a balance of payments crisis (currency depreciation; loss of foreign exchange reserves; collapse of a pegged exchange rate) arises when domestic credit expansion by the central bank is inconsistent with the pegged exchange rate. Often, as in the Krugman model, the credit expansion results from the monetization of bu1d0 get deficits. Foreign exchange reserves fall gradually10until the Central Bank is vulnerable to a sudden run, which exhausts the remaining reserves, and pushes the economy to a floating rate.

2) Financial panic

Following the Dybvig-Diamond (1983) model of a bank run, a financial panic is a case of multiple equilibria in the financial markets. A panic is an adverse equilibrium outcome in which short-term creditors suddenly withdraw their loans from a solvent borrower. In general terms, a panic can occur when three conditions hold: short-term debts exceed short-term assets; no single private-market creditor is large enough to supply all of the credits necessary to pay off existing short-term debts; and there is no lender of last resort. In this case, it becomes rational for each creditor to withdraw its credits if the other creditors are also fleeing from the borrower, even though each creditor would also be prepared to lend if the other creditors were to do the same. The panic may result in large economic losses (e.g. premature suspension of investment projects, liquidation of the borrower, creditor- grab- race, etc.).

3) Bubble collapse

Following Blanchard and Watson (1982) and others, a stochastic financial bubble occurs when speculators purchase a financial asset at a price above its fundamental value in the expectation of a subsequent capital gain. In each period, the bubble (measured as the deviation of the asset price from its fundamental price) may continue to grow, or may collapse with a positive probability. The collapse, when it occurs, is unexpected but not completely unforeseen, since market participants are aware of the bubble and the probability distribution regarding its collapse. A considerable amount of modeling has examined the conditions in which a speculative bubble can be a rational equilibrium.

4) Moral-hazard crisis

Following Akerlof and Romer (1996), a moral-hazard crisis arises because banks are able to borrow funds on the basis of implicit or explicit public guarantees of bank liabilities. If banks are undercapitalized or under-regulated, they may use these funds in overly risky or even criminal ventures. Akerlof and Romer argue that the ―economics of looting," in which banks use their state backing to purloin deposits is more common than generally perceived, and played a large role in the U.S. Savings and Loan crisis. Krugman (1998) similarly argues that the Asian crisis is a reflection of excessive gambling and indeed stealing by banks that gained access to domestic and foreign deposits by virtue of state guarantees on these deposits.

5) Disorderly workout

Following Sachs (1995), a disorderly workout occurs when an illiquid or insolvent borrower provokes a creditor grab race and a forced liquidation even though the borrower is worth more as an ongoing enterprise. A disorderly workout occurs especially when markets operate without the benefit of creditor coordination via bankruptcy law. The problem is sometimes known as a —debt overhang." In essence, coordination problems among creditors prevent the efficient provision of worker capital to the financially distressed borrower, and delay or prevent the eventual discharge of bad debts (e.g. via debt-equity conversions or debt reduction).

The theoretical differences among these five types of crises are significant at several levels: diagnosis, underlying mechanisms, prediction, prevention, and remediation. For example, to the extent that panic is important, policy makers face a condition in which viable economic activities are destroyed by a sudden and essentially unnecessary withdrawal of credits. The appropriate policy response, then, is to protect the economy through lender-of-last-resort activities. Alternatively, if the crisis results from the end of a bubble or the end of moral-hazard-based lending, it may be most efficient to avoid lender-of-last-resort operations, which simply keep the inefficient investments alive.

Unfortunately, in real-life conditions, these various types of financial crisis can become intertwined, and therefore are difficult to diagnose. The end of a bubble, for example, may trigger a panic, or a panic may trigger insolvency and a disorderly workout.

What is the nature of the Asian financial crisis?

Summary of Asian Crisis: Also called the "Asian Contagion", the Asian financial crisis was a series of currency devaluations and other events that spread through many Asian markets beginning in the summer of 1997. The currency markets first failed in Thailand as the result of the government's decision to no longer peg the local currency to the U.S. dollar. Currency declines spread rapidly throughout South Asia, in turn causing stock market declines, reduced import revenues and even government upheaval. As a result of the crisis, many nations adopted protectionist measures to ensure the stability of their own currency. All this led to heavy buying of U.S. Treasuries, which are used as a global investment by most of the world's sovereignties.

The Asian Financial Crisis was stemmed somewhat by financial intervention from the International Monetary Fund and the World Bank.

However, market declines were also felt in the United States, Europe and Russia as the Asian economies slumped. The crisis in the Asian economies (Korea, Indonesia, Malaysia, Thailand and the Philippines) resulted from vulnerability to financial panic that arose from certain emerging weaknesses in these economies (especially growing short-term debt), combined with a series of policy mis-steps and accidents that triggered the panic. Viewing the crisis as a case of multiple equilibrium, the hypothesis is that the worst of the crisis could have been largely avoided with relatively moderate adjustments and appropriate policy changes.

There were macroeconomic imbalances, weak financial institutions, widespread corruption, and inadequate legal foundations in each of the affected countries. These problems needed attention and correction, and they clearly contributed to the vulnerability of the Asian economies.

However, most of these problems had been well-known for years, and the Asian-5 countries were able to attract $211 billion of capital inflows between 1994 and 1996, under widely known conditions of Asian capitalism. To attribute the crisis fully to fundamental flaws in the pre-crisis system is to judge that the global financial system is prone to sheer folly, or somehow expected to avoid losses despite the fundamental flaws. Paul Krugman‘s explanation of the crisis — that investors knew that their investments were to weak borrowers, but felt protected by explicit and implicit guarantees — also seems to be only a partial explanation. One obvious reason is that much of the lending was directed to private firms that did not enjoy these guarantees.

Approximately half of the loans by international banks and almost all of the portfolio and direct equity investments went to non-bank enterprises for which state guarantees were far from assured. This comes to around three-fifths of the total capital flows to the region.

Moreover, the actual market participants, by their statements and actions (e.g., decisions on credit ratings), while recognizing the flaws in these economies, simply did not foresee a crisis, with or without bailouts. It is difficult, therefore, to make the case that a crisis of this depth and magnitude was simply an accident waiting to happen. One may not believe that such a vicious crisis was necessary, nor that its depth should be interpreted as an indication of the extent of the underlying economic problems in the region. It has been opined that a much more moderate adjustment would have been possible had appropriate steps been taken in the early stages of the crisis.

What is also the nature of the Mexican financial crisis?

SELF-ASSESSMENT EXERCISE 2

Give a summary of the Asian financial crises.

5.5 Mexican Financial Crises

The 1994 financial cum economic crisis in Mexico, widely known as the peso crises or the Tequila crises, was caused by the sudden devaluation of the Mexico peso in December, 1994. This refers to the crisis that started after Mexico‘s devaluation of the peso in December 1994. It precipitated the worst banking crisis in Mexican history (1995-1997), the largest depreciation of the currency in one year, from about 5.3 pesos per dollar to over 10 pesos per dollar between December 1994 and November 1995, and the most severe recession in over a decade (with GDP falling over 6% in 1995).

According to Obstfeld and Taylor (2004), there were two major waves of financial globalization in the twentieth century, one before 1914, and a second that began in the last three to four decades of the century, and peaked in the 1990s. The Mexican financial crisis was particularly important as the first global crisis of this second wave. It raised significant issues about international financial architecture and the role that international bailouts should play in the latest era of financial globalization.

Also known as “The December mistake”, the root causes of the crises is usually attributed to Salinas de Gortari's policy decisions while in office, which ultimately strained the nation's finances. As in prior election cycles, a pre-election disposition to stimulate the economy, temporarily and unsustainably, led to post-election economic instability. There were concerns about the level and quality of credit extended by banks during the preceding low interest rate period, as well as the standards for extending credit.

The country‘s risk premium was affected by an armed rebellion in Chiapas, causing investors to be wary of investing their money in an unstable region. The Mexican government's finances and cash availability were further hampered by two decades of increasing spending, a period of hyperinflation from 1985 to 1993, debt loads, and low oil prices. Its ability to absorb shocks was hampered by its commitments to finance past spending.

Economists Hufbauer and Schott (2005) have commented on the macroeconomic policy mistakes that precipitated the crisis:

- 1994 was the last year of the sexenio, or six-year administration of Carlos Salinas de Gortari who, following the Partido Revolucionario Institucional (PRI) tradition on an election year, launched a high spending splurge and a high deficit.

- To finance the deficit (7% of GDP current account deficit), Salinas issued the Tesobonos; a type of debt instrument denominated in pesos but indexed to dollars.

- Mexico experienced lax banking or corrupt practices; moreover, some members of the Salinas family collected enormous illicit payoffs.

- The EZLN, an insurgent rebellion, officially declared war on the government on January 1; even though the armed conflict ended two weeks later, the grievances and petitions remained a cause of concern, especially amongst some investors.

The following can explain the country-risk issues precipitating the crisis:

- The EZLN's violent uprising in Chiapas in 1994 along with the assassination of presidential candidate Luis Donaldo Colosio made the nation's political future look less certain to investors, who then started placing a larger risk premium on Mexican assets.

- Mexico had a fixed exchange rate system that accepted pesos during the reaction of investors to a higher perceived country risk premium and paid out dollars.

However, Mexico lacked sufficient foreign reserves to maintain the fixed exchange rate and was running out of dollars at the end of 1994. The peso then had to be allowed to devalue despite the government's previous assurances to the contrary, thereby scaring investors away and further raising its risk profile.

- When the government tried to roll over some of its debt that was coming due, investors were unwilling to buy the debt and default became one of few options.

- A crisis of confidence damaged the banking system, which in turn fed a vicious cycle further affecting investor confidence.

All of the above concerns, along with increasing current account deficit fostered by consumer binding and government spending, caused alarm among those who bought the tesobonos. The investors sold the tesobonos rapidly, depleting the already low central bank reserves. Given the fact that it was an election year, whose outcome might have changed as a result of a pre-election day economic downturn, Banco de México decided to buy Mexican Treasury Securities to maintain the monetary base, thus keeping the interest rates from rising.

This caused an even bigger decline in the dollar reserves. However, nothing was done during the last five months of Salinas' administration. A few days after a private meeting with major Mexican entrepreneurs, in which his administration asked them for their opinion of a planned devaluation; Zedillo announced his government would let the fixed rate band increase to 15 percent (up to four pesos per US dollar), by stopping the previous administration's measures to keep it at the previous fixed level. The government, being unable even to hold this line, decided to let it float.

The peso crashed under a floating regime from four pesos to the dollar to 7.2 to the dollar in the space of a week. The United States intervened rapidly, first by buying pesos in the open market, and then by granting assistance in the form of $50 billion in loan guarantees. The dollar stabilized at the rate of six pesos per dollar. By 1996, the economy was growing (peaked at 7% growth in 1999). In 1997, Mexico repaid, ahead of schedule, all US Treasury loans. What are the lessons to learn from the financial crises?

SELF-ASSESSMENT EXERCISE 2

Give the factors that led to the Mexican financial Crisis.

5.6 Lessons from Asian and Mexican Financial Crises

5.6.1 Lessons from Asian Financial Crises

The Asian crisis led to some needed financial and government reforms in countries like Thailand, South Korea, Japan and Indonesia. It also serves as a valuable case study for economists who try to understand the interwoven markets of today, especially as it relates to currency trading and national accounts management.

There are ten lessons which can be learned from the Asian financial crisis:

1. Lawson‘s Rule that it is okay to run a current account deficit without a budget deficit has proven to be a fallacy;
2. Foreign exchange reserves are important;

3. Information and transparency are key;
4. The composition of capital inflows does matter;
5. Exchange rate regimes are extremely difficult to maintain;
6. Financial mark1e0ts are not perfectly efficient;
7. Moral hazard is the central market failure;
8. IMF programmes should consist of both macroeconomic and structural reforms;
9. Inevitably, countries will have to raise interest rates and lower exchange rates; and
10. Keynesianism is alive and well in Asia.

The fallacy of Lawson‘s Rule is not a new discovery. We have seen this phenomenon before in Chile and the United Kingdom. On the issue of foreign exchange reserves, we have to relearn the lesson that countries with high reserves, like Taiwan, are better able to weather crises. The issue of transparency is not new either. More information must be made available, and it should be utilized properly. Perhaps the two biggest new lessons from the crisis are that the composition of capital flows matter and those exchange rate regimes are difficult to maintain.

The lesson that financial markets are not always perfectly efficient seemed to have been forgotten. Hedge funds should not be blamed for this; rather, bandwagoning presents a major challenge to emerging financial markets. Financial contagion is not new, but the Asian crisis was the first time that unrelated countries in different regions were hit by such a crisis. This implies the need for a greater role for governments in the domestic financial system, but governments are not perfect either. Capital controls must be used sparingly, as in the case of Chile.

The lesson learned about the central role of moral hazard in the crisis is both important and useful.

To say that the IMF programmes cause moral hazard is wrong; domestic practices are crucial. The next lesson is equally important: There must be conditionality when the IMF makes loans.

Macroeconomic policies had been fairly good in the crisis countries; the financial and corporate sectors were the problems. Latin America‘s experience demonstrates that reform may be easier during a crisis, and the downside risk of social unrest may not be as great as feared.

International financial institutions must also evolve, but there are three important reasons why conditions should be attached to loans. First, loan conditions must address the root causes of the crisis. Second, conditions imposed by international financial institutions (IFIs) provide great political cover for the required bitter reform medicine. Finally, IFI conditions reassure investors that positive changes are made.

Governments may have to devalue the local currency, raise interest rates, and experience a recession in order to stabilize the economy. High interest rates alone do not sufficiently reassure investors. The effect of devaluation was much greater in the first year than originally predicted. It is also important to realize that Keynesianism is alive and well. The initial budget cuts in Korea and Thailand proved to be too severe. The governments can now play a key role in reflating the economy.

5.6.2 Lessons from Mexican Financial Crises

The overriding lesson is that the dynamics of financial crises in emerging market countries differ from those in industrialized countries because institutional features of their debt markets differ.

Several policy lessons for emerging market countries also emerge: (1) pegged exchange-rate regimes are extremely dangerous, (2) strong prudential supervision of the banking system is critical for prevention of financial crises, (3) financial liberalization must be managed extremely carefully and (4) different policies are needed to promote recovery in emerging market countries than those that are applicable to industrialized countries.

There are two key differences from industrialized countries in the institutional structure in emerging market countries - Mexico is a clear cut example - that make a huge difference in the dynamics of banking and financial crises.

1. Private debt contracts have very short duration.
2. Many debt contracts are denominated in foreign currencies.

For example, in emerging market countries like Mexico, private debt contracts are repriced at least once a month, so that the durations of this debt are very short. In contrast, private debt contracts in industrialized countries such as the US are much longer, with durations commonly extending to many years. An important reason why this occurs is that emerging market countries have typically experienced very high and variable inflation rates, so that the inflation risk in long-duration debt contracts is extremely high relative to that found in industrialized countries.

Short-duration debt contracts then dominate because they bear much less inflation risk.

High and variable inflation is also a driving force behind the second institutional feature of financial markets in emerging market countries. High and variable inflation leads to tremendous uncertainty about the future value of the domestic currency in emerging market countries.

How does a foreign exchange crisis lead to a financial crisis? With debt contracts denominated in foreign currency, when there is a large unanticipated depreciation or devaluation of the domestic currency, the debt burden of domestic firms shoots up sharply. Since assets of these firms are typically denominated in domestic currency, there is no matching rise in the value of assets when the value of the liabilities rise, so there is a sharp deterioration of firms' balance sheets and a large decline in net worth.

When firms have less net worth, asymmetric information problems in financial markets increase and can lead to a financial crisis and a sharp contraction in economic activity.

Four basic lessons can be drawn:

1. The dangers of pegged exchange-rate regimes,
2. The importance of strong prudential supervision of the banking system for prevention of financial crises,
3. The importance of managing financial liberalization, and
4. The need for different policies to promote recovery in emerging market countries from those applicable to industrialized countries.

A speculative attack on the exchange rate that results in devaluation can have devastating effects on the economy by interfering with information flows in financial markets. With a pegged exchange rate regime, depreciation of the domestic currency when it occurs is a highly nonlinear event because it involves devaluation. The resulting dramatic increase in interest rates and rise in indebtedness which results in a sharp deterioration in firms' and banks' balance sheets then tips the developing country into a full scale financial crisis, with devastating effects on the economy.

Strong prudential supervision of the banking system is crucial to the health of emerging market economies and the prevention of financial crises. Clearly good prudential supervision is important to industrialized countries. However, because the consequences of poor prudential supervision are so disastrous in emerging market countries, good prudential supervision is even more critical in these countries.

The importance of preventing banking crises in emerging market countries, however, suggests that financial liberalization may need to be phased gradually. If the proper bank supervisory structure is not in place when liberalization comes, the appropriate constraints on risk-taking behavior may be nonexistent, with the result that bank balance sheets are likely to suffer difficulties in the future. In addition, before liberalization occurs, banks may not have the expertise to make loans wisely and so opening them up to new lending opportunities too quickly may also lead to poor quality of the loan portfolio. Indeed, financial deregulation and liberalization often lead to lending booms, both because of increased opportunities for bank lending and also because of financial deepening in which more funds flow into the banking system. Although liberalization and financial deepening are positive developments for the economy in the long run, in the short run, the lending boom may outstrip the available information resources in the financial system, helping to promote a financial collapse in the future. Lending booms have been a feature of financial liberalization in many countries and have often been followed by banking crises.

Traditional measures used in industrialized countries to extirpate themselves from financial crises may be counterproductive in emerging market countries. In industrialized countries, the standard prescription for emerging from a financial crisis is for the central bank to become a lender of last resort and to pursue expansionary monetary policy.

SELF-ASSESSMENT EXERCISE 3

Mention four (4) lessons from the Mexican financial crisis.

5.6 Summary

In this Unit, you have been taken through the discussion on financial crises around the world some decades ago. You have learned the causes of such crises in many countries. You have learned from the discussions that:
the Asian currency and financial crises in 1997 and 1998 reflected structure and policy distortions in the countries of the region, even if market overreaction and herding caused the plunge of exchange rates, asset prices and economic activity to be more severe than warranted by the weak economic condition. Relative to Mexico, in designing appropriate policies for emerging market countries, it is essential that we take account of differences in the institutional structure of financial systems in these countries from those in industrialized countries.

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5.8 Possible Answers to SAEs

Answer to SAE 1

Global Financial crisis refers to a situation where financial institutions or assets suddenly lose a large part of their value. I other words, it can be regarded as a sharp change in asset prices that leads to distress among financial markets participants. The crisis leads to problems in banking crisis, speculative bubble, international financial crisis and economic crisis around the world.

Answer to SAE 2

The Asian financial crisis was a series of currency devaluations and other events that spread through many Asian markets beginning in the summer of 1997. The currency markets first failed in Thailand as the result of the government's decision to no longer peg the local currency to the U.S. dollar. Currency declines spread rapidly throughout South Asia, in turn causing stock market declines, reduced import revenues and even government upheaval. As a result of the crisis, many nations adopted protectionist measures to ensure the stability of their own currency. All this led to heavy buying of U.S. Treasuries, which are used as a global investment by most of the world's sovereignties.

Answer to SAE 3

Lessons from the Mexican financial crisis include:

1. The dangers of pegged exchange-rate regimes,
2. The importance of strong prudential supervision of the banking system for prevention of financial crises,
3. The importance of managing financial liberalization, and
4. The need for different policies to promote recovery in emerging market countries from those applicable to industrialized countries.