NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE CODE: BHM 726

COURSE TITLE: GLOBAL ECONOMIC ENVIRONMENT

NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE GUIDE

GLOBAL ECONOMIC ENVIRONMENT

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Course Title	Global Economic Environment
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COURSE GUIDE

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BHM 726
COURSE GUIDE

INTRODUCTION

BHM 726: Global Economic Environment is a one semester course work having three credit units. It is available to students on PGD degree programme in the School of Management Sciences at the National Open University of Nigeria.

The course is 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:

Course Title: BHM 726: Global Economic Environment

Study Units

Unit 1 International Trade

Unit 2 Strategic Aspects of International Trade

Unit 3 International Trade and International Business

Unit 4 Terms of Trade and Theories of International Trade

Unit 5 Globalization/International Institutions

Unit 6 Global Power and Wealth Distribution

Unit 7 Multilateral Negotiations

Unit 8 Global Culture and Information Technology

Unit 9 Determinants of Economic Growth

Unit 10 Global Economic Environment

Unit 11 Import Substitution Industrialization Strategy

Unit 12 Export Industrialization Strategy

Unit 13 Lessons from Asian and Mexican Financial Crises

Unit 14 Inflation

Unit 15 Interest Rates

Unit 16 Exchange Rates

Unit 17 Free Market Economy

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 grading. The marks you obtain from these assignments, will count towards the final mark you will obtain to hit the required pass-mark for the course.

ASSESSMENT

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

Tutor-market Assignment	30%
Final Examination	70%

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

TUTOR-MARKED ASSIGNMENT

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

Each unit of this course has a TMA attached to it. You can only do this assignment after covering the materials and exercise in each unit. Normally, the TMAs are kept in a separate file.

Currently, they are being administered on-line. When you answer the questions on-line, the system will automatically grade you. Always pay careful attention to the feedback and comments made by your tutor and use them to improve your subsequent assignments.

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

FINAL EXAMINATION AND GRADING

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

HOW TO GET THE BEST OUT OF THIS COURSE

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

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

FACILTATORS/TUTORS AND TUTORIALS

Full information about learning support services or tutorial contact hours will be communicated to you in due course. You will also be notified of the dates, time and location of these tutorials, together with the names 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 to 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 helps firms to source raw materials any where they have cost advantage. The supply chain for raw materials and finished products 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.

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UNIT 1: INTERNATIONAL TRADE

CONTENTS

1.0 INTRODUCTION

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 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 different from domestic trade as the motivation and the behavior 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 of importing 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.

In this unit, we shall be discussing the various models of international trade and ranking countries by total international trade (goods and services). We shall also rank top traded commodities in international trade.

2.0 OBJECTIVES

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

1. Explain the meaning and scope of international trade;
2. Discuss the models of international trade; and
3. List the largest countries by total international trade of goods and services.

3.0 MAIN CONTENT

3.1Models of international trade

The following are noted models of international trade.

Adam Smith's model

Adam Smith displays trade taking place on the basis of countries exercising absolute advantage over one another.

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

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; being more abundant in capital, U.S would be expected to export capital-intensive goods and import labor-intensive ones. Nonetheless Leontief found out that the U.S's exports were less capital intensive than its imports. This is what is referred to as Leontief's paradox.

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.

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.

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.

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.

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.

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.

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.

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**.

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.

3.2 **Largest Countries by Total International Trade**

Rank	Country	International Trade of Goods (Billions of USD)	Date of information
-	World	36,534.0	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	International Trade of Services	Date of

		(Billions of USD)	information
-	World	8,452.6	2012 est.
-	**European Union**	1,465.8	2012 est.
1	**United States**	1,019.7	2012 est.
2	**Germany**	539.7	2012 est.
3	**China**	471.0	2012 est.
4	**United Kingdom**	453.9	2012 est.
5	**France**	379.2	2012 est.
6	**Japan**	313.4	2012 est.
7	**India**	272.8	2012 est.
8	**Singapore**	250.1	2012 est.
9	**Spain**	229.3	2012 est.
10	**South Korea**	214.2	2012 est.

Top traded commodities (exports)

Rank	Commodity	Value in US$('000)	Date of information
1	Mineral fuels, oils, distillation products, etc.	$2,183,079,941	2012
2	Electrical, electronic equipment	$1,833,534,414	2012
3	Machinery, nuclear reactors, boilers, etc.	$1,763,371,813	2012
4	Vehicles other than railway, tramway	$1,076,830,856	2012
5	Plastics and articles thereof	$470,226,676	2012
6	Optical, photo, technical, medical, etc. apparatus	$465,101,524	2012
7	Pharmaceutical products	$443,596,577	2012
8	Iron and steel	$379,113,147	2012
9	Organic chemicals	$377,462,088	2012
10	Pearls, precious stones, metals, coins, etc.	$348,155,369	2012

Source: International Trade Centre.

4.0 CONCLUSION

Models of international trade help in appreciating the basis of international trade. It 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. 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.

5.0 SUMMARY

This unit served as an introduction to international trade and has introduced you into models of international trade and ranking of countries on the basis of total international trade of goods and services. It also ranked the top traded commodities in international trade.

6.0 TUTOR-MARKED ASSIGNMENTS

- Name the first three countries on the basis of international trade of goods and of services.
- Explain the central argument in fragmentation theory in international trade.

7.0 REFERENCES/FURTHER READING

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UNIT 2: STRATEGIC ASPECTS OF INTERNATIONAL TRADE

Contents

1. INTRODUCTION

Economics deals with the proper allocation and efficient use of scarce resources. *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. Such benefits of production efficiency like better quality and lower price are available to all peoples of the world.

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 free 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. Because of 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.

In this unit, we shall be discussing free trade, advantages and disadvantages of globalization, advantages and disadvantages of international trade and trade barriers.

2. OBJECTIVES

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

- Discuss the importance of international trade;
- Describe free trade;
- Discuss the ad vantages and disadvantages of globalization
- from an economic view;
- Explain the advantages and disadvantages of international trade; and
- Discuss trade barriers.

3. MAIN CONTENT

3.1 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, 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.

3.1.1 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

3.2 The Advantages Of Globalization (An Economic View)

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.

3.2.1 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.

3.3 Advantages and Disadvantages of International Trade

3, 3.1. Advantages of International Trade

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

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.

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.

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.

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.

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

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.

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

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.

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.

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

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.

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.

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.

3.4. Trade barrier

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.

3.4.1. Examples of free trade areas

- North American Free Trade Agreement (NAFTA)
- South Asia Free Trade Agreement (SAFTA)
- European Free Trade Association

- European Union (EU)
- Union of South American Nations
- New West Partnership (An internal free-trade zone in Canada between Alberta, British Columbia, and Saskatchewan)
- Gulf Cooperation Council common market

3.4.2. 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

3.4.2.1. What Is a Tariff?

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.

3.4.2.2. Why Are Tariffs and Trade Barriers Used?

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:

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).

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.

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 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.

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.

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.

3.4.3. Types of Tariffs and Trade Barriers

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

Specific Tariffs

Ad Valorem Tariffs

Licenses

Import Quotas

Voluntary Export Restraints

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.

3.4.3.1. Who Benefits?

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 see a 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.

3.4.3.2. How Do Tariffs Affect Prices?

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.

3.4.3.3. Tariffs and Modern Trade.

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.

3.5. The Bottom Line

Free trade benefits consumers through increased choice and reduced prices, but because the global economy brings with it uncertainty, many governments impose tariffs and other trade barriers to protect industry. There is a delicate balance between the pursuit of efficiencies and the government's need to ensure low unemployment

4. CONCLUSION

International trade is important to both rich and poor countries, importing and exporting countries, domestic and foreign businesses. 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.

5. SUMMARY

This unit built on the meaning and scope of international trade and models of international trade discussed in unit 1. It specifically explained the importance of international trade, free trade concept, advantages and disadvantages of globalization, advantages and disadvantages of international trade and the concept of trade barriers.

6. TUTOR-MARKED ASSIGNMENT

- List and discuss the several types of tariffs and barriers that a government can employ.
- Who benefits from tariffs?
- How do tariffs affect prices?

7. REFERENCES/ FURTHER READINGS

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UNIT 3: INTERNATIONAL TRADE AND INTERNATIONAL BUSINESS

CONTENTS

1.0 INTRODUCTION

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

Facilitating trade among countries by creating conditions for competition that are fair and equitable.
Encouraging entering into negotiations for the reduction of tariffs and the removal of other barriers to trade

Applying a common set of rules to trade in goods and services.

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

2.0 OBJECTIVES

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

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

3.0 MAIN CONTENT

3.1 Comparison between International Trade and International Business

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

3.2 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.

3.3 Forms of International Trade

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

3.3.1 Direct Exporting

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

3.3.2 Foreign Licensing

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

SELF ASSESSMENT EXERCISE

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

3.4 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-related subject areas. The World Trade Organization agreements have a common dispute settlement mechanism through which members enforce their right and settle the differences that arise between them in the course of implementation.

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

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

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

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

3.4.1 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).

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

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

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

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

3.4.2 Legal Instrument at Uruguay Round

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

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

3.4.3 The Benefits and Usefulness of World Trade Organization

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

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

3.4.4 The Dynamic Nature of GATT Members to World Trade Organization

It is of greater important to examine any change in attitude of GATT membership and how GATT rules applied to issues. Such issues do not posit whether a certain policy is environmentally correct or not. They suggest that the US policy could be made compatible with GATT rules if members agreed on amendments or 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 exportoriented policies, under which they seek to promote economic growth by exporting more and more of their products. Another issue is related to the pace at which the world economy is globalizing through international trade and the flow of foreign direct investment. Similarly, this process of globalizing which has increases the dependence of countries on international trade is further accelerated by the shift in economic and trade policies noticeable in most countries. The collapse of communism has led to the gradual adoption of market-oriented policies in most countries where production and international trade had been state controlled. These countries, which in the past traded primarily among 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.

3.4.5 Major Features of World Trade Organization Agreement

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

Another important feature is that WTO is an international 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 products and domestically produced like goods, both in the matter of the levy of internal taxes and in the application of internal taxes.

3.4.6 Settlement of World Trade Organization Dispute

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

3.4.7 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 customs arrangements. A good example is the quality standards imposed by the European on imports of dairy products.

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

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

Control against dumping and anti-dumping: anti dumping is designed to allow countries to take action against dumped imports that cause or threaten to cause material injury to the domestic industry. Goods are 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).

3.4.8 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 into international law on January 1, 1948, GATT remained one of the focal features of international trade agreements until it was replaced by the creation of the World Trade Organization on January 1, 1995. The foundation of GATT was laid by the proposal of the international trade Organization in 1945; however the ITO was never completed.

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

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

3.4.9 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

Distinguish between WTO and National Treatments

4.0 CONCLUSION

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

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

5.0 SUMMARY

The goal of the WTO is to deregulate international trade. To accomplish this (and with one important exception) WTO rules seek to limit the capacity of governments 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.

6.0 TUTOR-MARKED ASSIGNMENT

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

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

ANSWER TO SELF ASSESSMENT 1

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

The major forms of International trade include:

- Direct exporting and importing

- Foreign licensing and franchising.

ANSWERS TO SELF ASSESSMENT 2

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

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UNIT 4: TERMS OF TRADE AND THEORIES OF INTERNATIONAL TRADE

CONTENTS

1.0 INTRODUCTION

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

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

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

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

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

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

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

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

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

The competitive advantage of nations

2.0 OBJECTIVES

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

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

3.0 MAIN CONTENT

3.1 Terms of Trade

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

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

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

3.1.1 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.

3.1.2 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.

Commodity terms of trade (TTC)

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

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

Where,

TTC = Commodity terms of trade

Px = price index of exports

Pm = price index of imports

TTC is limited by the choice of base years, weight and average. Gross Barter terms of trade

This is a measure introduced by F.W. Taussig. It is uses relative change in a country's volume of exports and imports as against the comparative changes in their prices.

This is given as

TTg = (Qm/Qx) x 100

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

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

3.2 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.

3.3 The Negative Effects of International Trade

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

Doubts however, began to 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.

3.3.1 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 be characterized by a more than proportionate increase in the production of its export commodity.

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

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

3.3.2 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 appreciate so much that its competitiveness in traditional industries weakness and even results in its de- industrialization to some extent. Netherlands developed its natural gas fields from the North Sea and gave birth to this term. Other countries that have suffered from the Dutch Disease are the United Kingdom, Norway, Australia and Mexico.

SELF ASSESSMENT EXERCISE

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

3.4 Theories of International Trade

These are also known as the basis of international trade.

3.4.1 The Theory of Absolute Advantage

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

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

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

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

3.4.2 The Theory of Comparative Advantage

This theory was first stated by Adam Smith and later developed by

David Richardo and John Stuart Mill.

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

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

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

3.4.3 The Rent for Surplus Theory

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

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

The population density of a country largely determines its export potential since the total volume of production is based on available labour so also is internal consumption level as well as what will be the surplus to be exported.

The surplus productive capacity of resources enables farmers to produce export crops without necessarily compromising the production of food crops which enter into the domestic market.

3.4.4 The Theory of Factor Proportions

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

This theory is based on four basic assumptions which are:

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

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

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

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

3.4.5 Competitive Advantage of Nations

Michael Porter of Harvard Business School developed this theory which attempts to explain why particular nations achieve international success in particular industries.
Porter states that "National Prosperity is created, not inherited. It does not grow out of a country's natural endowments its labour pools, its interest rates, or its currency's values, as classical economics insists." A nation's competitiveness depends on the capacity of its industry to innovate and upgrade. Porter points out the importance of country factors which he categorized into four major component. They are:

Factor conditions

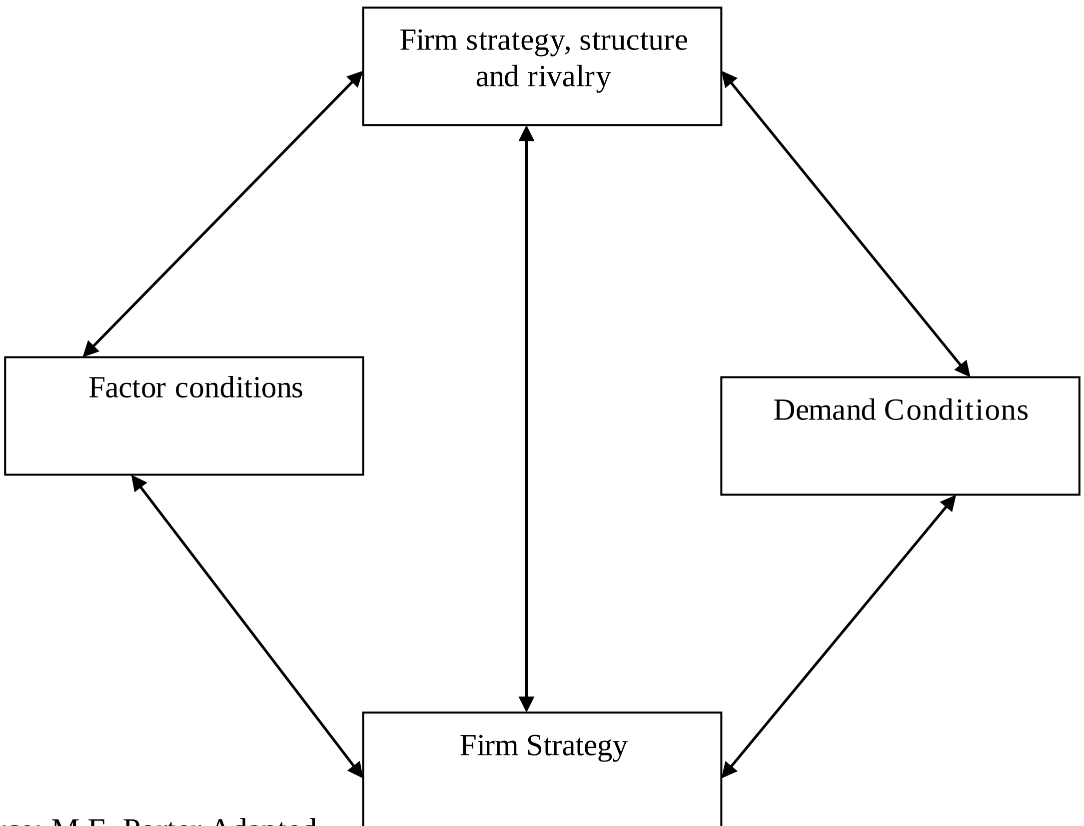
Demand conditions

Related and supporting industries

Firm strategy, structure and rivalry.

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

DETERMINANT OF NATIONAL COMPETITIVENESS



Source: M.E. Porter Adapted.

SELF ASSESSMENT EXERCISE

Highlight the major theories of international trade you know.

4.0 CONCLUSION

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

What a journey. Can you see how international trade covers a wide spectrum knowledge that is derived from economics and other field of study, beside you have learnt about why international trade is necessary.

5.0 SUMMARY

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

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

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

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

6.0 TUTOR MARKED ASSIGNMENT

1) Discuss succinctly the three key components of international trade

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

ANSWERS TO SELF ASSESSMENT 1

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

ANSWER TO SELF ASSESSMENT 2

The following theories are available in international trade.

The theory of absolute advantage

The theory of comparative cost advantage

The rent of surplus theory

The theory of factor proportions
The competitive advantage of nations.

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UNIT 5: GLOBALIZATION/INTERNATIONAL INSTITUTIONS

CONTENTS

1.0 INTRODUCTION

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

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

2.0 Objectives

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

* Demonstrate the understanding of global business
* Be knowledgeable about the New International Economic Order

* Understand Foreign Trade and Comparative Advantages

3.0 MAIN CONTENT

3.1 New International Economic Order

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

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

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

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

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

3.1.1 International Trade

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

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

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

3.1.2 Technology Transfer

The proposals of the New International Economic Order stress the establishment of mechanism for the transfer of technology to LDCs based on the needs and conditions prevalent in them. In this context, particular emphasis is on the (i) establishment of a legally binding international code regulating technology transfers, (ii) establishment of fair terms and prices for the licensing and sale of technology, (iii) expansion of assistance to LDCs in research and development of technologies and in the creation of indigenous technolo9gy, and (iv) adoption of commercial practices governing transfer of technology to the requirements of LDCs.

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

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

3.2.1 Reformation of the International Monetary System and Special Aid Programme

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

3.2.2 Interdependence and Cooperation

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

3.3 International Institutions using Indian economy as a case study

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

3.3.1 History

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

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

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

3.3.2 Objectives and Achievements of Plans

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

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

(8) To achieve self-reliance

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

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

(a) Growth

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

(b) Modernization

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

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

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

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

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

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

4.0 CONCLUSION

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

5.0 SUMMARY

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

6.0 TUTOR-MARKED ASSIGNMENT

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

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

*Discuss the advantages of international trade.

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UNIT 6: GLOBAL POWER AND WEALTH DISTRIBUTION

1.0 Introduction

2.0 Objectives

3.0 Main Content

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assessment

7.0 References/Further Readings

1.0 INTRODUCTION

Since the mid 1980s, Politics throughout the world has been rocked by dynamic and unpredictable developments. The most visible changes were set in motion from bipolar politics into uni-polar diplomacy, and revolutions of 1989 in central and Eastern Europe that led to the disintegration of much of the communist world. This also influenced economic diplomacy and wealth distribution across the globe. By the end of 1991, the soviet, once a formable superpower, had collapsed into fifteen troubles republics, including a much humbled Russia (William A. Joseph 2007).

Post-cold war political and economic changes and transformation of the global balance of power have produced new forms of international cooperation and competition – a new source of international tension and violence and new method of wealth distribution across the globe. The grime but predictable bipolar world of superpower rivalry between United States and Soviet Union, new Russia reinforced by NATO and Warsaw treaty organizational (Warsaw Pact) alliances has been replaced by the uncertainties of more fragmented map of global power.

These international changes have had far – reaching effects on economic redistribution of wealth on countries of Asia, Africa and the Batin America. The issues of debt rescheduling and conciliation, technological transfers, and other means of wealth redistribution have created problem and removed strategic leverage of economic empowerment on the less developed nations. The contemporary world politics, economic diplomacy has provided unique laboratory for the study of global powers and issues of wealth redistribution across nations. The instrument for wealth redistribution includes:

(a) Technological transfers
(b) Bilateral agreement
(c) Signing of economic pacts
(d) Regional economic means
(e) Gifts,
(f) The use of multination corporations.

The above represents instrument for redistribution among comity of nations today.

2.0 OBJECTIVES

The aim of this unit is to enable students evaluate the role of super powers or global powers in wealth distribution in modern state. Some of these objectives are as follows:-

(i) It depicts the interaction of states within the economic international order.

(ii) It also reveals the role of states and super powers in global economic management.

(iii) It enables students and readers to understand the role technological transfer and other instrument in wealth redistribution.

(iv) It shows that political economy and development is more conflicting that it reveals.

(v) It will enable students to know that, wealth distribution is based on the national interest of global powers, not merely on the interest of nation expecting development.

The above represents some of the objectives of this unit, but students are expected to study closely the contemporary political disturbances across the globe and issues of economic diplomacy and how it influenced diplomatic and economic relations.

3.0 MAIN CONTENT

3.1 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 globalization had become a mysterious, omnipotent and incontrollable force, somehow 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 oil but cannot exploit them because she depends on advanced nations to use its natural resources.

3.2 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 demal to deal with less developed nations where natural resources are endowed. For example, the super power has used threat assassination and coup to deal with less 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.

3.3 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.

Stieglitz(2010) 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 of less developed countries that 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 have came 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.

4.0 CONCLUSION

We attempted to look at global power and wealth distribution across the comity of nations. Global powers are super powers and their allies. The USA, 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 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.

5.0 In this unit, we examined the objective of unit, looked at global powers and the instrument they used the pursue wealth distribution. We also examined some of the problems inherent in wealth distribution based on the focus and Louis of global powers. This tendency has resulted into violence, financial crisis, indebtedness of third world nations, and lack of even development across the globe.

6.0 Tutor Marked Assignment

1. Which countries are regarded as global powers?
2. Identify instrument for wealth distribution?
3. What are the problems in wealth distribution?

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UNIT 7: **MULTILATERAL NEGOTIATIONS**

CONTENTS

1.0 INTRODUCTION

Negotiation whether it is multilateral (between nations) or local (between groups and individuals within a country) is guided by the same principles. Our negotiating skills are tested when we begin a new job, rent an apartment, live with a roommate, buy a house, buy or lease a car, ask for a raise or promotion, live with a spouse, divorce a spouse, or fight for custody of a child. 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, 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. In fact, participants in a study who had been trained in negotiating tactics negotiated more favourable outcomes than did those with no such training.

2.0 OBJECTIVES

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

- Understand the meaning of negotiation and its purpose
- Be familiar with the elements of negotiation
- Know the process of negotiation
- Understand what is meant by effective negotiation

3.0 MAIN CONTENT

3.1 Negotiation: Definition and Purpose

Definition 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.

Two common types of negotiation are "two-party" and "third-party negotiation." This distinction is evident 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:

(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.

3.1.1 **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. Trust 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.

3.1.2 **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 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.

3.2 **Approaches to Negotiation**

Approaches to negotiation can be classified as adversarial and partnership:

3.2.1 **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.

3.2.2 **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.

3.3 **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.
-

3.3.1 **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.

3.3.2 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 of one'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.

3.3.3 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

4.0 CONCLUSION

Negotiation whether it is national or international has the same objective. We negotiate to get the best value, price or advantage for our organization. Our negotiating skills are tested when we buy a house, buy or lease a car, ask for a raise or promotion. 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 kind of negotiation. Sadly, 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. This lends credence to the old saying that practice makes perfect.

5.0 SUMMARY

In actual negotiation practice, 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. These include: discuss the more difficult issues first, use questions to elicit information and keep pressure on the opponent. Concessions are a means of securing movement when negotiations are deadlocked but never concede to the disadvantage of your organization.

6.0 TUTOR-MARKED ASSIGNMENT

1. Define “negotiation” and state its main purpose to the bargaining organization

2. What do you understand by “substance goals’ and ‘relationship goals’ in a Negotiation deal?

3. Mention two main factors that are involved in a global negotiation.

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UNIT 8: **GLOBAL CULTURE AND INFORMATION TECHNOLOGY**

CONTENTS

1.0 INTRODUCTION

The basic problem we have with information technology today is the culture we have unconsciously developed around it. We do not like to speak or discuss about its workings in spite of the fact that almost our whole life today depends on information technology. We must use the cell phones or desk phones to make contact every day. We must use the internet and numerous other electronic communication media to transact our daily business.

2.0 OBJECTIVES

After studying this unit, you will be able to:

* Understand the origin and workings of various gadgets of information technology
* Briefly trace the trend of information technology in local firms and global businesses
* Assess the position of local and foreign firms in the current information technology age

3.0 MAIN CONTENT

3.1 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.

3.1.1 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.

3.1.2 Transaction processing with the aid of 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.

3.2 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.

3.2.1 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.

A Three-Step Process of Innovation

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 dificient step can ruin the innovation process.

3.2.2 **Promoting Technological Innovation through Entrepreneurship**

When someone is called an entrepreneur, we generally think of him as being a creative individual who has risked everything while starting his or her own business. Indeed, entrepreneurs are a vital innovative force in the economy.

A lesser-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

3.3 **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. Unlike European and Asian managers, who grow up expecting to see international service, 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:

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, especially 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.

3.3.1 **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.

Three managerial attitudes toward international operations are identifiable. These are; ethnocentric, polycentric, and geocentric:

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.

3.3.2 The Cultural Imperative

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

4.0 CONCLUSION

We are at the present living in the age of Information technology (IT). Information technology 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.

5.0 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 and equipment. 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.

6.0 TUTOR-MARKED ASSIGNMENT

* Discuss the pre-history of information technology.

* How can technological innovation be promoted through entrepreneurship

* What is the effect of culture in international operations?

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Unit 9: DETERMINANTS OF ECONOMIC GROWTH

1.0 INTRODUCTION

Growth on general term could be fined to increase in output. This indicates an increase in gratuity 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. Levels and rates of growth of income per capita to take into account the ability of a nation to expand its output at a rates 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 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.

2.0 OBJECTIVES

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

- Explain the factors that influence economic growth.
- Discuss the variables that influence the definition of economic growth and development; and
- Describe how social indices like poverty, inequality and land use can influence the definition of growth and development in third world nations like Nigeria.

3.0 MAIN CONTENT:

3.1 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:-

Source 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. Physical 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 sizes, quality of labour force are critical in determining the productive capacity of a country. The human resources include the size of labour force and the managerial and the technical skills acquired by the labour force.

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 which both physical and human resource 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.

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.

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.

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 of WHO 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 in 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.

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.

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, Professor Nurkse also says 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.

4.0 CONCLUSION

Economic development is necessary to put nations into populace if is better harness. The real per capita income is necessary to actualize economic growth. There are many factors we have discussed that may determine economic growth. These include capital accumulation, capital output ratio, technological progress, population policy, creative and dynamic entrepreneurship, appropriate attitudes.

5.0 SUMMARY

We attempted to look at the factors that determined economic growth. Defined economic development, examined the modern conceptualsation of economic development. Look at the objectives of the Unit and examine factors like capital accumulation as factor that can influence economic development. We wish respective students and readers to use

Nigeria as a means learning more about factors like colonialism and neo-colonial factors as factor that can determine economic growth.

6.0 TUTOR MARKED ASSIGNMENT

(1) How would you conceptualize economic development?
(2) What are the factors that determine economic growth?
(3) Using Nigeria as a case of study relate Nigeria economic indicator for growth?

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UNIT 10: GLOBAL ECONOMIC ENVIRONMENT

1.0 Introduction

1.0. INTRODUCTION

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

2.0. OBJECTIVES OF THE SESSION

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

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

3.0. MAIN CONTENT

3.1. Concept Of Global Economy

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

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

3.1.1 Characteristics of global economy

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

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

3.2. Economic environment

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

Five main components of the environment are:

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

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

At the national level, economic conditions relate to:

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

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

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

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

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

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

Self assessment exercise

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

3.3. Status of global economic environment

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

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

The following are some of the important features observed from studies of the current global economy (Economy Watch, 2010):

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

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

4.0. CONCLUSION

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

5.0. SUMMARY

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

6.0. TUTOR MARKED ASSIGNMENT

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

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UNIT 11: IMPORT SUBSTITUTION INDUSTRIALIZATION STRATEGY

CONTENTS

1.0 **INTRODUCTION**

Import substitution industrialization (ISI) is a trade and economic policy that advocates replacing foreign imports with domestic production.

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.

2.0 **OBJECTIVES**

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

- Define and state what Import substitution industrialization is all about

3.0 **MAIN CONTENT**

3.1 **History of Import Substitution Industrialization**

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 905).

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, pp. 95–96).

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.

Theoretical basis

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.

SELF ASSESSMENT EXERCISE

Explain the meaning of Import substitution industrialization in your own way

Latin America

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.”

Advantages and disadvantages

The major advantages claimed for ISI include

(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.

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.

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,".

Additionally, import substitution was in place as a remedy for mass poverty, unemployment and economic growth however,

"The collections of Balassa and Little et al. made abundantly clear that 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 917).

4.0 **CONCLUSION**

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

5.0 **SUMMARY**

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.

6.0 **TUTOR – MARKED ASSIGNMENT**

Explain the different between explanation of Henry J. Burton and Bishwanath Goldar in details.

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UNIT 12: EXPORT LED INDUSTRIALIZATION STRATEGY

CONTENTS

1.0 **INTRODUCTION**

This 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 International Trade, "exports" refers to selling goods and services produced in the home country to other markets.

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.

Nonetheless, these small exports are still subject to legal restrictions applied by the country of export. An export's counterpart is an import.

2.0 **OBJECTIVES**

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

- Define and state what export is all about;

- Explain the historical background and process of export; and
- Mention the export strategy and ways of exporting.

Definition

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.

History

The theory of international trade and commercial policy is one of the oldest branches of economic thought. Exporting is a major component of international trade, and the macroeconomic risks and benefits of exporting are regularly discussed and disputed by economists and others.

Two views concerning international trade present different perspectives. The first recognizes the benefits of international trade. The second concerns itself with the possibly that certain domestic industries (or laborers, or culture) could be harmed by foreign competition.

Process

Methods of export include a product or good or information being mailed, hand-delivered, shipped by air, shipped by vessel, uploaded to an internet site, or downloaded from an internet site. Exports also include the distribution of information that can be sent in the form of an email, an email attachment, a fax or can be shared during a telephone conversation.

National regulations

United States

The export of defense-related articles and services on the United States Munitions List (USML) is governed by the Department of State under the International Traffic in Arms Regulations (ITAR).

The Bureau of Industry and Security (BIS) is responsible for implementing and enforcing the Code of Federal Regulations Title 15 chapter VII, subchapter C, also known as *Export Administration Regulations* (EAR), in the United States.

The BIS regulates the export and re-export of most commercial items. Some commodities require a license in order to export. There are different requirements to export lawfully depending on the product or service being exported.

Depending on the category the 'item' falls under, the company may need to obtain a license prior to exporting. EAR restrictions can vary from country to country. The most restricted destinations are countries under economic embargoes or designated as supporting terrorist activities, including Cuba, North Korea, Sudan, Syria and Iran . Some products have received worldwide restrictions prohibiting exports.

An item is considered an export whether or not it is leaving the United States temporarily, if it is leaving the United State but is not for sale (a gift), or if it is going to a wholly owned U.S. subsidiary in a foreign country. A foreign-origin item exported from the United States, transmitted or transhipped through the United States, or being returned from the United States to its foreign country of origin is.

Barriers

Trade barriers are generally defined as government laws, regulations, policy, or practices that either protect domestic products from foreign competition or artificially stimulate exports of particular domestic products.

While restrictive business practices sometimes have a similar effect, they are not usually regarded as trade barriers. The most common foreign trade barriers are government-imposed measures and policies that restrict, prevent, or impede the international exchange of goods and services.

Strategic

International agreements limit trade in, and the transfer of, certain types of goods and information e.g. goods associated with weapons of mass destruction, advanced telecommunications, arms and torture, and also some art and archaeological artefacts. Examples include Nuclear Suppliers Group - limiting trade in nuclear weapons and associated goods (currently only 45 countries participate).

The Australia Group - limiting trade in chemical & biological weapons and associated goods (currently only 39 countries), Missile Technology Control Regime - limiting trade in the means of delivering weapons of mass destruction (currently only 34 countries) and The Wassenaar Arrangement - limiting trade in conventional arms and technological developments (currently only 40 countries).

Tariffs

A tariff is a tax placed on a specific good or set of goods exported from or imported to a country, creating an economic barrier to trade.

Usually the tactic is used when a country's domestic output of the good is falling and imports from foreign competitors are rising, particularly if there exist strategic reasons for retaining a domestic production capability.

Some failing industries receive a protection with an effect similar to a subsidies in that by placing the tariff on the industry, the industry is less enticed to produce goods in a quicker, cheaper, and more productive fashion. The third reason for a tariff involves addressing the issue of dumping.

Dumping involves a country producing highly excessive amounts of goods and *dumping* the goods on 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 government providing supplemental 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, both in the United States, and in other countries including Japan and nations located in the European Union (EU).

Critics argue such subsidies cost developing nations $24 billion 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'. Subsidies in the U.S. heavily depend upon taxpayer dollars. In 2000, the U.S. spent an all-time record $32.3 billion for the agricultural industry. The EU spends about $50 billion annually, nearly half its annual budget on its common agricultural policy and rural development.

Exports and free trade

The theory of comparative advantage materialized during the first quarter of the 19th century in the writings of 'classical economists'.

While David Ricardo is most credited with the development of the theory, James Mill and Robert Torrens produced similar ideas. The theory states that all parties maximize benefit in an environment of unrestricted trade, even if absolute advantages in production exist between the parties.

In contrast to Mercantilism, the first systematic body of thought devoted to international trade, emerged during the 17th and 18th centuries in Europe. While most views surfacing from this school of thought differed, a commonly argued key objective of trade was to promote a *"favorable" balance of trade*, referring to a time when the value of domestic goods exported exceeds the value of foreign goods imported. The "favorable" balance in turn created a *balance of trade surplus*.

Mercantilists advocated that government policy directly arrange the flow of commerce to conform to their beliefs. They sought a highly interventionist agenda, using taxes on trade to manipulate the balance of trade or commodity composition of trade in favor of the *home country*.

3.0 **MAIN CONTENT**

3.1 **Export Strategy**

Export strategy is to ship commodities to other places or countries for sale or exchange. In economics, an export is any good or commodity, transported from one country to another country in a legitimate fashion, typically for use in trade.

Advantages of exporting

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.

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

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.

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.

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.

Disadvantages of exporting

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.

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.

Indeed there are some SME's which are exporting, but nearly two-third of them sell in only to one foreign market.

The following assumption shows the main disadvantages:

Financial management effort: 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

Communication technologies improvement: The 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. This leads to more transparency. The vendor is in duty to follow the real-time demand and to submit all transaction details.

Management mistakes: The management might tap in some of the organizational pitfalls, like poor selection of overseas agents or distributors or chaotic global organization.

3.2 **Ways of Exporting**

Direct selling in export strategy

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.

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.

Evaluating Distributors

- 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.

Direct selling through foreign retailers and 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.

Direct selling over the Internet

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

We 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.

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.

Making the export decision

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?

3.3 **Export Promotion**

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 or 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.

3.4 **Challenges**

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.

4.0 **CONCLUSION**

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.

Methods of export include a product or good or information being mailed, hand-delivered, shipped by air, shipped by vessel, uploaded to an internet site, or downloaded from an internet site. Exports also include the distribution of information that can be sent in the form of an email, an email attachment, a fax or can be shared during a telephone conversation.

5.0 **SUMMARY**

This 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 International Trade, "exports" refers to selling goods and services produced in the home country to other markets.

Export strategy is to ship commodities to other places or countries for sale or exchange. In economics, an export is any good or commodity, transported from one country to another country in a legitimate fashion, typically for use in trade.

6.0 **TUTOR-MARKED ASSIGNMENT**

What are the Advantages and disadvantages of exportation

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UNIT 13: LESSONS FROM ASIAN AND MEXICAN FINANCIAL CRISES

CONTENTS

1.0 INTRODUCTION

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. 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. In the past century or so, the focus on globalization has intensified a lot. More and more trade has 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, we shall discuss global financial crises with particular reference to the Asian and Mexican financial crises. The lessons from those financial crises will be our focal point.

2.0 OBJECTIVES

After a careful study of this unit, you should be able to:

- Explain global financial crises;
- Discuss the Asian and Mexican financial crises; and
- Discuss the lessons from the Asian and Mexican financial crises.

3.0 MAIN CONTENT

3.1 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 slid 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.

SELF-ASSESSMENT EXERCISE 1

Explain what you understand by 'global financial crises'.

3.2 ASIAN FINANCIAL CRISES

3.2.1 DIAGNOSING FINANCIAL CRISES

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 budget deficits. Foreign exchange reserves fall gradually until 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.

3.2.2 SUMMARY OF THE ASIAN FINANCIAL CRISES

Also called the "Asian Contagion", this 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. Often 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.

SELF-ASSESSMENT EXERCISE 2

Give a summary of the Asian financial crises.

3.3 MEXICAN FINANCIAL CRISES

The 1994 financial/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 PartidoRevolucionarioInstitucional (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.

3.4 LESSONS FROM ASIAN AND MEXICAN FINANCIAL CRISES

3.4.1 THE ASIAN LESSONS

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 markets 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.

3.4.2 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

What lessons can be learnt from the Asian and Mexican financial crises?

4.0 CONCLUSION

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.

5.0 SUMMARY

In this Unit, we have been able to:

- Explain global financial crises, and pointed that the financial crises which peaked 2007/2008 can be considered to be the worst since the Great Depression of the 1930s;
- Discuss the Asian and Mexican financial crises;
- Discuss the lessons from the Asian and Mexican financial crises.

6.0 TUTOR-MARKED ASSIGNMENT

1. Distinguish between currency crisis and financial crisis.

2. Compare the Asian and Mexican financial crises.

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UNIT 14: INFLATION

CONTENTS

1.0 INTRODUCTION

In economics, 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. 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. 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

Inflation's effects on an economy are various 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.

Economists generally agree that high rates of inflation and hyperinflation are caused by an excessive growth of the money supply.

Views on which factors determine low to moderate rates of inflation are more varied. Low or moderate inflation may be attributed to fluctuations in real demand for goods and services, or changes in available supplies such as during scarcities, as well as to changes in the velocity of money supply measures; in particular the MZM ("Money Zero Maturity") supply velocity.

However, the consensus view is that a long sustained period of inflation is caused by money supply growing faster than the rate of economic growth.

Today, most economists favor a low and steady rate of inflation. Low (as opposed to zero or negative) inflation reduces the severity of economic recessions by enabling the labor market to adjust more quickly in a downturn, and reduces the risk that a liquidity trap prevents monetary policy from stabilizing the economy.

The task of keeping the rate of inflation low and stable is usually given to monetary authorities. Generally, these monetary authorities are the central banks that control monetary policy through the setting of interest rates, through open market operations, and through the setting of banking reserve requirements.

2.0 OBJECTIVES

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

Define and state what inflation is all about; and

Explain the historical background and measures of inflation.

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.

Song Dynasty China introduced the practice of printing paper money in order to create fiat currency during the 11th century and, according to Daniel Headrick, "paper money allowed governments to spend far more than they received in taxes... in wartime, and the Song were often at war, such deficit spending caused runaway inflation."

- The problem of paper money inflation continued after the Song Dynasty. Peter Bernholz writes that "from then on, nearly every Chinese dynasty up to the Ming began by issuing some stable and convertible paper money and ended with pronounced inflation caused by circulating ever increasing amounts of paper notes to finance budget deficits."

During the Mongol Yuan Dynasty, the government spent a great deal of money fighting costly wars, and reacted by printing more, leading to inflation.

The problem of inflation became so severe that the people stopped using paper money, which they saw as "worthless paper."Fearing the inflation that plagued the Yuan dynasty, the Ming Dynasty initially rejected the use of paper money, using only copper coins. The dynasty did not issue paper currency until 1375.

Historically, infusions of gold or silver into an economy also led to inflation. From the second half of the 15th century to the first half of the 17th, Western Europe experienced a major inflationary cycle referred to as the "price revolution", with prices on average rising perhaps six fold over 150 years.

This was largely caused by the sudden influx of gold and silver from the New World into Spain. The silver spread throughout a previously cash-starved Europe and caused widespread inflation. Demographic factors also contributed to upward pressure on prices, with European population growth after depopulation caused by the Black Death pandemic.

By the nineteenth century, economists categorized three separate factors that cause a rise or fall in the price of goods: a change in the *value* or production costs of the good, a change in the *price of money* which then was usually a fluctuation in the commodity price of the metallic content in the currency, and *currency depreciation* resulting from an increased supply of currency relative to the quantity of redeemable metal backing the currency.

Following the proliferation of private banknote currency printed during the American Civil War, the term "inflation" started to appear as a direct reference to the *currency depreciation* that occurred as the quantity of redeemable banknotes outstripped the quantity of metal available for their redemption. At that time, the term inflation referred to the devaluation of the currency, and not to a rise in the price of goods.

This relationship between the over-supply of banknotes and a resulting depreciation in their value was noted by earlier classical economists such as David Hume and David Ricardo, who would go on to examine and debate what effect a currency devaluation (later termed *monetary inflation*) has on the price of goods (later termed *price inflation*, and eventually just *inflation*).

The adoption of fiat currency by many countries, from the 18th century onwards, made much larger variations in the supply of money possible. Since then, huge increases in the supply of paper money have taken place in a number of countries, producing hyperinflations – episodes of extreme inflation rates much higher than those observed in earlier periods of commodity money. The hyperinflation in the Weimar Republic of Germany is a notable example.

Definitions

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 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.

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 Federal Reserve Board pays particular attention to the core inflation rate to get a better estimate of long-term future inflation trends overall.

3.0 MAIN CONTENT

3.1 Measures

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". 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 measures 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.

3.2 Issues in Measuring

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 $0.90 to $1.00 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.

3.3 Effects

General

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.

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.

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 $R = N\text{-}I$ 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

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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

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 malinvestments, which eventually have to be liquidated as they become unsustainable.

Positive
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.

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.

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.

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.

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.

3.4 **Causes**

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.

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 model suggests that there is a trade-off between price 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.

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.

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.

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.

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.

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.

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.

3.5 Controlling Inflation

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

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.

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).

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).

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.

Wage and price controls

Another method attempted in the past has 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).

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.

4.0 **CONCLUSION**

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

Inflation's effects on an economy are various 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.

5.0 SUMMARY

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. 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. 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

Inflation's effects on an economy are various 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.

6.0 **TUTOR-MARKED ASSIGNMENT**

What are three major types of inflation, according to what Robert J. Gordon calls the "triangle model":

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UNIT 15: INTEREST RATES

CONTENTS

1.0 INTRODUCTION

Interest 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 principal; the rate is dependent upon the time value of money, the credit risk of the borrower, and the inflation rate. It can also mean a return earned on an investment. In this Unit, we shall explore the definition of interest (rate) as well as discuss the 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.

2.0 OBJECTIVES

After a careful study of this Unit, you should be able to:

- Define interest and interest rate;

- Discuss the theories of interest rate, pointing out the various arguments of the economists;
- Highlight interest rate as a monetary policy instrument in Nigeria;
- Discuss Nigeria's interest rate structure and its relationship to both investment decision and the balance of payment;
- Explain the United States' response to the prevailing global low interest level.

3.0 MAIN CONTENT

3.1 DEFINITION OF INTEREST

The rate of interest is the price of loan capital 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 (loan) capital.

Therefore, the interest rate is the percent charged, or paid, for the use of money. It is charged when the money is being borrowed, and paid when it is being loaned. 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

3.2 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:

$(1 + R_2)^2 = (1 + R_1) \times (1 + E(R_1))$

Where

R_2 = the rate on two-year securities,

R_1 = the rate on one-year securities,

$E(R_1)$ = 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:

$$E(R_1) = [(1 + R_2)^2 / (1 + R_1)] - 1$$

The equation suggests that the short-term rate expected by the market next period can be obtained from knowledge of rates today.

SELF-ASSESSMENT EXERCISE 1

Discuss the liquidity preference theory of Keynes.

3.3 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.

3.4 INTEREST RATE STRUCTURE IN NIGERIA AND ITS RELATIONSHIP TO 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 o 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 2

Discuss interest rate as a monetary policy instrument in Nigeria.

3**.5 The United States' Response to the 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 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 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.

4.0 CONCLUSION

The real long-term interest rate, which matters for the macroeconomic effect of monetary policy, is about zero in some countries, but not very low in others, especially in the euro area crisis countries. Thus monetary policy is not universally accommodative. Low nominal short-term rates can disrupt financial markets. There are good reasons to be concerned about excessively high stock prices in some countries. Pension funds are under pressure from low returns; even though the situation may remain difficult for a while, this is the time for them to draw on their reserves.

5.0 SUMMARY

In this Unit, we have been able to:

- Define interest and interest rate;
- Discuss the theories of interest rate, pointing out the various arguments of the economists;

- Highlight interest rate as a monetary policy instrument in Nigeria or intermediate policy target;
- Discuss Nigeria's interest rate structure and its relationship to both investment decision and the balance of payment;
- Explain the United States' response to the prevailing global low interest level.

6.0 TUTOR-MARKED ASSIGNMENT

1. Why is the prevailing global interest rate low?

2. How can Nigeria respond to the low interest rate?

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UNIT 16: EXCHANGE RATES

CONTENTS

1.0 INTRODUCTION

If you asked a layman what the exchange rate is, he would probably tell you "it's the amount of dollars (or euros, for example) you get to the naira". Whilst not the perfect definition, he is technically correct. 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. Take a typical supermarket price; say lemons are selling at the price of 3 for a naira or 33 kobo each. Then we can think of the naira-to-lemon exchange rate as being 3 lemons because if we give up one naira, we can get three lemons in return. Similarly, the lemon-to-dollar exchange rate is 1/3 of a naira or 33 kobo, because if you sell a lemon, you will get 33 kobo in return. Of course, most people would only need to understand exchanges rates when they go on holiday. But as an economist, one needs to understand how they affect the balance of payments, the inflation rate and many other important macroeconomic objectives. Unfortunately, the layman's definition of the exchange rate is not the only one.

2.0 OBJECTIVES

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

- Explain the meaning and application of exchange rates;
- Identify the various types of exchange rate systems;
- Discuss the difference between real and nominal exchange rates; and
- Describe the different exchange rate models.

3.0 MAIN CONTENT

3.1 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.

3.2 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.

3.3 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 free 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.

3.Hybrid Exchange Rate Systems:

The current state of 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.

3.4 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.

Instrument	Rate	Sell	Buy	High	Low	Change	Chg %
USDJPY	82.152	82.152	82.182	82.202	82.023	-0.213	-0.26%
USDCHF	0.92840	0.92840	0.92880	0.93019	0.92872	0.00112	0.12%
USDHUF	215.63	215.63	216.38	216.87	216.38	-1.10	-0.51%
USDMXN	12.9548	12.9548	12.9648	12.9728	12.9637	0.0048	0.04%
USDPLN	3.1599	3.1599	3.1644	3.1702	3.1630	-0.0058	-0.18%
USDSEK	6.6462	6.6462	6.6512	6.6541	6.6448	0.0275	0.42%
USDSGD	1.22076	1.22076	1.22157	1.22246	1.22154	-0.00059	-0.05%
USDZAR	8.7875	8.7875	8.7995	8.8305	8.7920	-0.0737	-0.83%
USDDKK	5.7534	5.7534	5.7554	5.7644	5.7546	0.0075	0.13%
USDCAD	0.99164	0.99164	0.99204	0.99261	0.99181	-0.00080	-0.08%
USDNOK	5.6638	5.6638	5.6688	5.6695	5.6651	0.0088	0.16%
USDILS	3.8283	3.8283	3.8343	3.8396	3.8290	-0.0458	-1.18%
USDTRY	1.7878	1.7878	1.7898	1.7907	1.7897	-0.0050	-0.28%

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Table 1: US Foreign Exchange Rates

3.5 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.

3.6 Models of Foreign Exchange

Models predicting foreign exchange rate behavior have been developed. Some of these models include the balance of payments and the asset market approach and are expatiated thus.

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. Like 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.

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.

3.7 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. 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.

4.0 CONCLUSION

Exchange rate (nominal 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. Currencies may be based on a free-floating or flexible, pegged or fixed, or a hybrid exchange rate system. The real exchange rate is the exchange rate after being adjusted for the effects of inflation.

Other technical exchange rate terms are mentioned as follows. A bilateral exchange rate involves a currency pair, while an effective exchange rate is a weighted average of a basket of foreign currencies, and it can be viewed as an overall measure of the country's external competitiveness. A nominal effective exchange rate (NEER) is weighted with the inverse of the asymptotic trade weights. A real effective exchange rate (REER) adjusts NEER by appropriate foreign price level and deflates by the home country price level. Compared to NEER, a GDP weighted effective exchange rate might be more appropriate considering the global investment phenomenon.

5.0 SUMMARY

An exchange rate is the value of one currency expressed in terms of another. So £1 may be worth $1.55 and €1.33. A currency that is getting stronger or appreciating is a currency that is going up in value against another. So £1:$1.5 moving to £1:$1.8 means the pound is getting stronger. A currency that is becoming weaker or depreciating is a currency that is going down in value against another. So £1:$1.8 moving to £1:$1.5 means the pound is getting weaker. Currencies change in value against each other all the time. This is because most currencies are based on flexible exchange rates (as against fixed exchange rates). Currencies change in value because there is a change in demand for holding that currency. Households, governments and businesses need other countries currencies to buy their goods and services (e.g. holiday makers for purchasing wine or a business buying spare parts for machinery from France will need Euros).

A change in exchange rates might affect a business in the following ways: Exchange rates changes can increase or lower the price of a product sold abroad, the price of imported raw materials may change and the price of competitors' products may change in the home market. For example an increase in the exchange rate will mean that price abroad goes up, lowering sales; price of imported raw materials falls, either leading to a fall in price and more sales, or an increase in profits; competitors' prices fall, meaning lower sales.

6.0 TUTOR MARKED ASSIGNMENT (TMA)

1. What is the definition of exchange rate?
2. Explain the various types of exchange rate systems.
3. What is the difference between nominal and real exchange rate?

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UNIT 17 FREE MARKET ECONOMY

CONTENTS

1.0 INTRODUCTION

A free market economy promotes the production and sale of goods and services, with little to no control or involvement from any central government agency. Instead of government-enforced price controls, as seen in many socialist and communist countries, a free market economy allows the relationships between product supply and consumer demand to dictate prices.

In this unit, we shall commence our study with the definition of a free market economy. We shall also look at the characteristics of a free market economy. We shall briefly consider the advantages and disadvantages of a free market economy, explaining the role of government in the free market economy.

2.0 OBJECTIVES

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

- define a free market economy
- explain the roles of government in a free market economy
- outline the advantages and disadvantages of a free market economy

3.0 MAIN CONTENT

3.1 WHAT IS FREE MARKET ECONOMY

A Market economy (free market economy) is a social institution where the basic economic problem of "what, how, for whom to produce" is solved by the firms and consumers who decide what they will produce and purchase, as opposed to a Centrally Planned Economy in which the government controls the basic economic problem. In a Market economy the "means of labour" are owned mainly privately, which enables the owners to act in accordance with their own self-interests. Everybody acts on their own behalf, yet everybody's actions are aimed at the satisfaction of the consumer's needs as well as at their own satisfaction.

This system is manoeuvred by "price mechanism" where the prices of goods and services are not set by the government but by the interchange of supply and demand in which the price acts as a signal for suppliers to increase or decrease supply and reach equilibrium between the supply and demand and optimal allocation of resource. Through the price mechanism supply is shared, income is distributed and resources are allocated efficiently.

A free market economy is driven by individual innovation and the notion that hard work and ingenuity will be rewarded by success. All businesses exist to make a profit. Therefore, in the free market system, a successful business makes a consistent profit in a field of competitors. The concept of competition is an important component of a free market system.

Competition in the marketplace provides the best possible product to the customer at the best price. When a new product is invented, it usually starts out at a high price, once it is in the market for a period of time, and other companies begin to copy it, the price goes down as new, similar products emerge. In a competitive market, the poor versions of the product or the overpriced will be pushed out of the market because consumers will reject them.

The free market system determines the winners and losers in each industry based on the demands of the customer, whether industrial, business customers, or consumers, people who buy for personal use.

In a free market system, the entrepreneur takes a great risk to launch a business, putting up capital, with the hope that the product or service will succeed. If the risk is considered a disadvantage, when the business succeeds, the profit and control of the businesses future is determined by the owner, not the government.

History has shown that free market economies perform substantially better than government-run economies. They have proven to be more responsive to customer needs, and create a wider variety of products than alternative economic approaches. Intense competition pressures firms to produce ever-better goods and services at lower cost and more efficiently.

3.2 CHARACTERISTICS OF A FREE MARKET ECONOMY

A true free market economy is an economy in which all resources are owned by individuals. The decisions about the allocation of those resources are made by individuals without government intervention. There are no completely "free-enterprise" or market economies. The United States has more characteristics of a market economy than a command economy, where a government controls the market. In a market economy, the producer gets to decide what to produce, how much to produce, what to charge customers for those goods, and what to pay employees. These decisions in a free-market economy are influenced by the pressures of competition, supply, and demand. Characteristics of free market economy are as follows:

Limited government

Most economic decisions are made by buyers and sellers, not the government. A competitive market economy promotes the efficient use of its resources. It is a self-regulating and self-adjusting economy. No significant economic role for government is necessary. However, a number of limitations and undesirable outcomes associated with the market system result in an active, but limited economic role for government. In a market economy, almost everything is owned by individuals and private businesses- not by the government. Natural and capital resources like equipment and buildings are not government-owned. The goods and services produced in the economy are privately owned.

Private Ownership

Combined with the freedom to negotiate legally binding contracts, permits people to obtain and use resources as they choose.

Freedom of choice and free enterprise.

Private entrepreneurs are free to get and use resources and use them to produce goods and services. They are free to sell these goods and services in markets of their choice. Consumers are free to buy the goods and services that best fill their wants and needs. Workers are free to seek any jobs for which they are qualified.

Motive of self-interest

Consumers have the motive of trying to get the greatest benefits from their budgets. Entrepreneurs try to get the highest profits for their businesses. Workers try to get the highest possible wages and salaries. Owners of capital resources try to get the highest possible prices from the rent or sale of their resources. This "invisible hand" of self-interest is the driving force of a market economy.

Competition

Is another important characteristic of a market economy. Instead of government regulation, competition limits abuse of economic power by one business or individual against another. Each competitor tries to further his own self-interest. This economic rivalry means that buyers and sellers are free to enter or leave any market. It also means that buyers and sellers are acting independently in the marketplace. When businesses compete for customers, they want to sell their goods or services at the lowest possible price while still earning a profit for themselves. Consumers compete for goods and services. If the supply of a needed good or service is low, the consumer must pay a higher price. Consumers must compete to get goods or services by paying more or going out of their way to buy the products they need or want.

System of markets and prices

Working together are the structure of a market economy, not the central planning by government. A market brings buyers and sellers together. The wants of buyers and sellers are registered on the supply and demand sides of various markets. The outcome of these choices is a system of product and resource prices. Prices are the guideposts on which buyers and sellers make and revise their free choices in furthering their self-interests.

SELF-ASSESSMENT EXERCISE 1

What are the characteristics of Free Market Economy.

3.3 ADVANTAGES AND DISADVANTAGES OF A FREE MARKET ECONOMY

The Advantages and Disadvantages of Free Market Economy.

Advantages of Free Market Economy

1. Market economies can adjust to change easily (If there is a demand for one thing, companies have the ability to change what they produce instead of having to go through too much government protocol first)
2. Rational self interest in market economies are also encouraged (allow freedom for people to do what they want, make what they want, and, sell what they want -to a certain extent-, this can also be described as being able to decide what is going to be produced, how it is going to be produced and for whom it is going to be produced). the government tries to stay out of the way of businesses- Although the government sets certain standards businesses must follow- for the most part businesses can do as they please.
3. There is a great variety of goods and services for consumers (If there is a demand for a good or service, the demand will almost always be met in a market economy).
4. Market economy encourage competitive environment, (competition does encourage innovation, and the free market economy has produced well over a century of dizzying technical progress. At the same time productivity has also increased at a phenomenal rate. Competition is one of the basic reasons why there are generally so many different varieties of goods for consumers to choose from.
5. Free market economies allow business owners to innovate new ideas, develop new products and offer new services. Entrepreneurs need not depend on government agencies to tell them when the public needs a new product. They can study consumer demands, research popular trends and meet the customer's needs through innovation. Innovation also breeds competition among firms, as each firm attempts to improve on the previous product generations by adding more and better features to existing products.

6. In a free market economy, the customers make the ultimate decision on which products succeed or fail. When presented with two products that offer similar benefits, customers vote with their purchases and decide which product will survive. Customers also determine the

ultimate price point for a product, which requires producers to set product prices high enough to make a profit, but not so high that customers will hesitate to make a purchase.

Disadvantages of Free Market Economy

1. When a free market economy spins out of control, the consequences can be severe. From the Great Depression of the 1930s to the real estate market crash of 2008, market failures have devastated the lives of millions in lost income, unemployment and homelessness. Many of these failures have stemmed from those seeking short-term profits over slow and steady gains, usually aided by loose credit, highly-leveraged assets and minimal government intervention.

2. The primary objective for any company in a free market economy is to make a profit. In many cases, companies may sacrifice worker safety, environmental standards and ethical behavior to achieve those profits. The early 2000s saw such unethical behavior run rampant at companies such as Enron and WorldCom. The Deepwater Horizon oil spill in 2010, one of the largest environmental disasters in U.S. history, was largely attributable to the use of substandard cement and other cost-cutting measures.

3. Factors of production will be employed if only it's profitable to do so

4. The free market can fail to provide certain goods and services

5. The free market may encourage the consumption of harmful goods

6. The social effects of production may be ignored

7. The market system allocates more goods and services to those consumers who have more money than others

3.4 THE ROLE OF GOVERNMENT IN A FREE MARKET ECONOMY

In this light, it is apparent that the debate on the role of governments in a free-market economy revolves around three broad categories of topics:

(1) The evaluation of the features which legitimize the transfer of authority from the realm of individual decision-making to government;

(2) The analysis of the incentive systems to which government behaviour responds, that is the extent to which the civil servants personal goals depend on his ability to deliver in the public interest; and

(3) The birth and evolution of the institutional frameworks.

Of course, such topics are closely related. If the transfer is not legitimate, the substance of the transfer is not only authority, but includes power as well. Under such circumstances the principles of a free-market society would thus be undermined, since property rights would not be the object of a voluntary exchange, but rather of arbitrary extortion carried out by a more or less qualified majority. In addition, the rules which affect the creation and development of a society are influenced by how much power is attributed to the institutional actors.

If such actors have only authority, but no power, then institutions adapt to the needs of a free society and the state limits the production of goods and services to those areas where it is more efficient. Should agents prove unable to adjust, then the public body would lose authority – either agents are replaced, or the unsatisfactory set of norm is cancelled. But if agents have at least some power, and therefore are not entirely dependent on the public, then officials will be able to take advantage of their power in order to pursue their own personal interests, and even to change the rules of the game so as to expand their rent-seeking opportunities.

This insight can easily lead to extreme views. On the one hand, it is argued that unless some kind of a Wicksellian rule holds - i.e. unanimity or quasi-unanimity for constitutional law-making - governments are bound to develop their own interests, make it difficult for the principal(s) to control them, and eventually become some kind of rent-seeking leviathans living at the expense of the community. Put differently, it would be impossible to imagine a rule-of-law function for government, for it would be just the first step towards "unauthorized" policy making. Contrary to this view, it has been maintained that governments in fact compete among themselves, and are subject to an effective system of check and balances, so that their role is by and large consistent with the desires of the population.

Hence, they are efficient, that is they are welfare maximizing; and they may well be required to redistribute income and/or produce services and commodities, if in the public interest. From this standpoint, there would be no need to analyze what the role of government should be; just as it would make little sense to discuss about what and how much a firm should produce in a competitive environment.

If the former view is accepted, and given that consent on rule-of-law is usually based on a qualified majority at most, then governments should be denied any role, for they would interfere with private economic activities, expand rent-seeking and thwart opportunities for growth. This we call the traditional (normative) laissez-faire illusion. At the other extreme, the check-and-balances belief supports virtually any role for government, both in the rule-of-law and in the policy-making domains. Short-time imbalances remain possible, of course; but the check-and-balances system makes sure that the median voter forces the public body to pursue the most efficient outcomes, in order to preserve its authority.

SELF-ASSESSMENT EXERCISE 2

Carefully describe the role of government in a free market economy.

4.0 CONCLUSION

In this unit, you are aware that a free market economy is a type of economic system where supply and demand regulate the economy, rather than government intervention. A true free market economy is an economy in which all resources are owned by individuals. The decisions about the allocation of those resources are made by individuals without government intervention. There are no completely "free-enterprise" or market economies.

5.0 SUMMARY

In a free market economy, the producer gets to decide what to produce, how much to produce, what to charge customers for those goods, and what to pay employees. These decisions in a free-market economy are influenced by the pressures of competition, supply, and demand.

6.0 TUTOR-MARKED ASSIGNMENT

1. Outline and discuss the characteristics of a free market economy.
2. Briefly explain the role of the government in a free market economy.

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