NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE CODE: ENT 318

COURSE TITLE: FINANCE OF INTERNATIONAL TRADE

COURSE DEVELOPMENT

ENT 318

FINANCE OF INTERNATIONAL TRADE

COURSE GUIDE

Course Developer: Aliyu A. Hamza
Academic Office,
National Open University of Nigeria,
Victoria Island, Lagos.

Unit Writer: Aliyu A. Hamza
Academic Office,
National Open University of Nigeria,
Victoria Island, Lagos.

Course Editor:

Programme Leader: Dr. Onyemachi J. Onwe
School of Management Sciences,
National Open University of Nigeria,
Victoria Island, Lagos.

Course Coordinator: Mrs. Caroline A. Aghedo
School of Management Sciences,
National Open University of Nigeria,
Victoria Island, Lagos.

ENT 318: FINANCE OF INTERNATIONAL TRADE

1.0 INTRODUCTION

ENT 318: Finance of International Trade is a second semester year three, two credit and 300 level core course. It will be available for all students offering undergraduate programme in B.Sc. Entrepreneurial and Business Management at the School of Management Sciences.

This course will is an introduction to the theory of international trade and finance with applications to current policy issues. In this course, you will be exposed the basic tools to understand what determines the flow of goods across countries, i.e. international trade, and what determines the flow of savings and investments from one country to another, i.e. international finance. The course will also cover applications to a number of topics of current interest including the debate on globalization, free trade agreements, the U.S. current account deficit, the medium run prospects for exchange rates, European Integration, and the debate on global financial architecture following the financial crises in East Asia and Argentina.

2.0 COURSE GUIDE

The course guide tells you briefly what the course is about, what course materials you will be using and how you can work your way through the study materials. It suggests some general guidelines for the amount of time you are likely to spend on each unit of the course in order to complete it successfully.

It also gives you some guidance on your tutor-marked assignments, which will be made available to you at the Study Centre. There are regular tutorial classes that are linked to the course. You are advised to attend these sessions.

3.0 WHAT YOU WILL LEARN IN THIS COURSE

The course ENT 318 consists of 14 units. Specifically, the course discusses the following:

- International Trade: Introductory Overview
- Method of entry into overseas markets
- Incoterms
- Transport and Other Documents used in International Trade
- International liquidity and international monetary cooperation
- Method of Payment I
- Method of Payment II
- Settlement of International Transfers and Methods of Remittance of Funds
- Foreign Exchange System in Nigeria
- Management of Foreign Currency Exposure
- Forward Exchange Contracts: Spot and Forward Rates

- Financial Facilities for Inland and Foreign Travellers
- Non-Monetary Incentives for Exporters
- Globalisation and Its Impact on World Economy

4.0 COURSE AIMS

The aim of the course can be summarised as follows:

This course aims to give you an understanding of the meaning of finance of international trade, what this means and how the theories and concepts can be applied in business operations. It also aims to help you develop knowledge of financing foreign trade. The course will expose you to the required knowledge and skills that you are expected to exhibit as a banker, an entrepreneur, a teacher in private and public educational institutions.

5.0 COURSE OBJECTIVES

To achieve the aims set out, the course sets overall objectives. Each unit also has specific objectives. The unit objectives are always specified at the beginning of a unit; you should read them before you start working through the unit. You may want to refer to them during your study of the unit to check your progress.

You should always look at the unit objectives after completing a unit. When you do that, you will ensure that you have followed the instructions in the unit.

Below are the overall objectives of the course. By meeting these objectives, you should have achieved the aims of the course as a whole. On successful completion of the course, you should be able to:

- Explain the methods of entry into overseas market
- Discuss international liquidity and monetary cooperation
- Identify and explain the risks associated with foreign trade
- Discuss sources of finance and method of payment in foreign trade
- Explain balance of trade and balance of payment.

6.0 WORKING THROUGH THIS COURSE

To complete this course, you are required to read the study units, read set books and read other materials provided by the National Open University of Nigeria (NOUN). Each unit contains self-assessment exercises, and at a point in this course, you are required to submit assignments for assessment purposes. At the end of the course, there will be a final examination. The course should take you a total of 16 – 17 weeks to complete.

Below, you will find listed all the components of the course. What you have to do and how you should allocate your time to each unit in order to complete the course successfully on time.

The list of all the components of the course is as presented.

7.0 COURSE MATERIALS

Major components of the course are:

- Course Guide
- Study Units
- Textbooks
- Assignment
- Presentation Schedule.

8.0 STUDY UNITS

The study units in this course are as follows:

MODULE 1: INTERNATIONAL TRADE AND LIQUIDITY

Unit 1: International Trade: Introductory Overview
Unit 2: Method of entry into overseas markets
Unit 3: Incoterms
Unit 4: Transport and Other Documents used in International Trade
Unit 5: International liquidity and international monetary cooperation

MODEL 2: FOREIGN EXCHANGE AND FINANCE OF INTERNATIONAL TRADE

Unit 1: Method of Payment I
Unit 2: Method of Payment II
Unit 3: Settlement of International Transfers and Methods of Remittance of Funds
Unit 4: Foreign Exchange System in Nigeria
Unit 5: Management of Foreign Currency Exposure
Unit 6: Forward Exchange Contracts: Spot and Forward Rates
Unit 7: Financial Facilities for Inland and Foreign Travellers

MODULE 3: GLOBALIZATION

Unit 1: Non-Monetary Incentives for Exporters
Unit 2: Globalisation and Its Impact on World Economy

9.0 ASSIGNMENT FILES

A number of self assessment exercises and fifteen assignments have been prepared to help you succeed in this course. The exercises will guide you to have understanding and good grasp of the course.

10.0 PRESENTATION SCHEDULE

The presentation schedule included in your course materials also have important dates of the year for the completion of tutor-marked assignments (TMAs) and your attending to tutorials.

Remember, you are required to submit all your assignments by the due date. You should guard against falling behind in your work.

11.0 ASSESSMENTS

There are two aspects to the assessment of the course: first are self-assessment exercises, second are the tutor-marked assignments; and third, there is also a written examination.

In tackling the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the ***Presentation Schedule*** and the ***Assignment File***. The work you submitted to your tutor will count for 30% of your total course mark.

At the end of the course, you will need to sit for a final written examination of 'three hours' duration. This examination will also count for 70% of your total course mark.

12.0 TUTOR-MARKED ASSIGNMENT (TMAs)

Each of the units in the course material has a tutor-marked assignment (TMAs) in this course. You only need to submit five of the eight assignments. You are to answer all the TMAs and compare your answers with those of your course mates. However, you should ensure that you collect four (4) TMAs from the Study Centre. It is compulsory for you to answer 4 TMAs and submit them for marking at the Study Centre. Each TMA is allocated a total of 10 marks. However, the best three of the four marks shall be used as your continuous assessment score.

You will be able to complete your assignment from the information and materials contained in your reading, references and study units. However, it is desirable in all degree level education to demonstrate that you have read and researched more widely than the required minimum. Using other references will give you a broader viewpoint and may provide a deeper understanding of the subject.

13.0 FINAL EXAMINATION AND GRADING

The final examination for ENT 318 will not be more than three hours' duration and has a value of 70% of the total course grade. The examination will consist of questions, which reflect the types of self-testing, practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed.

Use the time between finishing the last unit and sitting for the examination to revise the entire course. You may find it useful to review your self-tests, tutor-marked assignments and comments on them before the examination. The final examination covers information from all parts of the course.

14.0 COURSE MARKING SCHEME

Total Course Marking Scheme:

Table 1: Course Marking Scheme

ASSESSMENT	MARKS
Assignment 4 (TMAs)	Best three marks of the 4 TMAs @ 10 marks = 30 marks of course = 30%
Final Examination	70% of overall course marks
Total	**100% of course marks**

15.0 COURSE OVERVIEW

This table brings together the units and the number of weeks you should spread to complete them and the assignment that follow them are taken into account.

Unit	Title of work	Weeks activity	Assessment (end of unit)
	Module I		
1	International Trade: Introductory Overview	1	Assignment 1
2	International Trade: Introductory Overview Method of entry into overseas markets	1	Assignment 2
3	Incoterms	1	
4	Transport and Other Documents used in International Trade	1	Assignment 3
5	International liquidity and international monetary cooperation	1	
	Module II		
1	Method of Payment I	1	Assignment 4
2	Method of Payment II	1	
3	Settlement of International Transfers and Methods of Remittance of Funds	1	
4	Foreign Exchange System in Nigeria	1	
5	Management of Foreign Currency Exposure	1	
6	Forward Exchange Contracts: Spot and Forward Rates	1	Assignment 5
7	Financial Facilities for Inland and Foreign Travellers	1	
	Module III		
1	Non-Monetary Incentives for Exporters	1	Assignment 8
2	Globalisation and Its Impact on World Economy	1	
	Revision		
	Total	***14***	

16.0 HOW TO GET THE MOST FROM THIS COURSE

In distance learning, the study units to replace the university lecturer. This is one of the great advantages of distance learning. You can read and work through the specially designed study materials at your own pace, and at a time and place that suits you best. Think of it as you read the lecture and that a lecturer might set you some readings to do.

The study unit will tell you when to read your other materials. Just as a lecturer might give you an in-class exercise, you study units also provide exercises for you to do at appropriate points.

Each of the study units follows a common format. The first item is an introduction to the subject matter of the unit, and how a particular unit is related with the other units and the course as a whole.

Next is a set of learning objectives. These objectives let you know what you should be able to do by the time you have completed the unit. You should use these objectives to guide your study. When you have finished the unit, you must go back and check whether you have achieved the objectives. If you make a habit of doing this, you will significantly improve your chances of passing the course.

The main body of the unit guides you through the required reading from other sources. This will usually be either from ***Reading Section*** or some other sources.

Self-tests are interspersed throughout the end of units. Working through these tests will help you to achieve the objectives of the unit and prepare you for the assignments and the examinations. You should do each self-test as you come to it in the study unit. There will also be numerous examples given in the study units, work through these when you come to them too.

The following is a practical strategy for working through the course. If you run into any trouble, telephone your tutor. When you need help, don't hesitate to call and ask your tutor to provide it. In summary,

(1) Read this course guide.

(2) Organise a study schedule. Refer to the course overview for more details. Note the time you are expected to spend on each unit and how the assignments relate to the unit. Important information e.g. details of your tutorials, and the date of the first day of the semester is available. You need to gather together all information in one place, such as your diary or a wall calendar. Whatever method you choose to use, you should decide on and write in your own dates for working on each unit.

(3) Once you have created your own study schedule, do everything you can to stick to it. The major reason that students fail is that they get behind with their coursework. If you get into difficulties with your schedule, please let your facilitator know before it is too late for help.

(4) Turn to unit 1 and read the introduction and the objectives for the unit.

(5) Assemble the study materials. Information about what you need for a unit is given in the 'Overview' at the beginning of each unit. You will always need both the study unit you are working on and one of your set books, on your desk at the same time.

(6) Work through the unit. The content of the unit itself has been arranged to provide a sequence for you to follow. As you work through this unit, you will be instructed to read sections from your set books or other articles. Use the unit to guide your reading.

(7) Well before the relevant due dates (about 4 weeks before the dates) access the Assignment file on the Web CT OLE and download your next required assignment. Keep in mind that you will learn a lot by doing the assignments carefully. They have been designed to help you meet the objectives of the course and, therefore, will help you pass the examination. Submit all assignments not later than the due dates.

(8) Review the objectives for each study unit confirm that you have achieved them. If you feel unsure about any of the objectives, review the study material or consult your tutor.

(9) When you are confident that you have achieved a unit's objectives, you can then start on the next unit. Proceed unit by unit through the course and try to pace your study so that you keep yourself on schedule.

(10) When you have submitted an assignment to your tutor for marking, do not wait for its return before starting on the next unit. Keep to your schedule. When the assignment is returned, pay particular attention to your facilitator's comments. Consult your tutor as soon as possible if you have any questions or problems.

(11) After completing the last unit, review the course and prepare yourself for the final examination. Check that you have achieved the unit objectives and the course objectives.

17.0 TUTORS AND TUTORIALS

There are eight (8) hours of tutorials provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the names and phone number of your tutor, as soon as you are allocated a tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter as they would provide assistance to you during the course. You must mail your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion board if you need help. The following might be circumstances in which you would find help necessary.

Contact your tutor if:

- you do not understand any part of the study units or the assigned readings.
- you have difficulty with the self-tests or exercises.
- you have a question or problem with an assignment with your tutor's comment on an assignment or with the grading of an assignment.

You should try your possible best to attend the tutorials. This is the only chance to have face-to-face contact with your tutor and to ask questions which are answered instantly. You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participating in discussions actively.

18.0 SUMMARY

As earlier stated, the course ENT 318: Finance of International Trade is designed to introduce you to various techniques, guides, principles, practices etc. relating to finance of international trade.

We hope you enjoy your acquaintances with the National Open University of Nigeria (NOUN). We wish you every success in the future.

COURSE DEVELOPMENT

ENT 318

FINANCE OF INTERNATIONAL TRADE

MAIN TEXT

Course Developer: Aliyu A. Hamza
Academic Office
National Open University of Nigeria
Victoria Island, Lagos.

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CONTENTS

MODULE ONE INTERNATIONAL TRADE AND LIQUIDITY

UNIT 1 INTERNATIONAL TRADE: INTRODUCTORY OVERVIEW

Table of Contents

1.0 INTRODUCTION

As you must have read in the course guide, ENT 318 (Finance of International Trade) is a second semester year three, two credit and 300 level core course. You are therefore welcome to the first unit of the first module in this course.

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.

In this unit, discussion will centre on overview of international trade, international business or foreign trade (all of them are synonymous and can be used interchangeably as the case may be). Other issues to be discussed include differences between Domestic Trade and International Trade, benefits of International Trade, theories of Absolute and Comparative Advantage, restrictions in International Trade, balance of trade and balance of payment, foreign exchange, financing of international trade, risks in international trade and international financial institutions.

2.0 OBJECTIVES

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

- define international trade or international business or foreign trade;
- enumerate the reasons for international trade;
- differentiate between domestic and international/foreign trades;
- enumerate the benefits of international trade;
- describe the absolute and comparative advantage;
- discuss the meaning of balance of trade and balance of payment;
- explain the concept of foreign exchange;
- describe how international trade is finance;
- list the functions of the risks involve din international trade;
- enumerate and discuss the financial institutions which aids international trade.

3.0 MAIN CONTENT

3.1 Concepts of International Trade/International Business/Foreign Trade

By way of introduction or preamble, trade means exchange of goods and services. When such transaction takes place within the shores of a country, we refer to it as domestic trade.

However, where the exchange of goods and services takes place between an individual and organisation of one country and an individual and organisation of another country, it is referred to as international or foreign trade.

The concepts would be defined separately as follows:

(1) International Trade
(2) Foreign Trade
(3) International Business

3.1.1 Definition International Trade

Hornby (2006) defines the activity of buying and selling or of exchanging goods or services between people or countries. Wikipedia (2011) also define international trade or business as the exchange of capital, goods and services across international borders or territories. It stated further that in most countries such trade represents a significant share of gross domestic product (GDP).

Economy Watch (2010) describes international trade as the exchange of services, goods and capital among various countries and regions, without much hindrance. While international trade has been present throughout much of history; it's economic, social and political importance has been on the rise in recent centuries.

Gimba (2003) defined international trade as the exchange of goods and services between one country and another. He described international trade as a branch of international economics (which itself is a branch of economic) concerned with the exchange of goods and services between or among nations that is usually carried out along international boundaries and the movement of factors of production (labor and capital) across these boundaries.

3.1.2 Definition Foreign Trade

Hornby (2006) defines foreign trade as the exchange of goods and services involving other countries.

Black (2011), on the other hand, defines foreign trade as the trading of goods and services that are destined for a country other than their country of origin. It can also mean investing in foreign securities, though this is a less common use of the term. He states that foreign trade is all about imports and exports. For instance, when consumers in the U.S. purchase Swiss-made watches, Guatemalan-grown fruits, Chinese-made toys and electronics, and Japanese-manufacture automobiles, they experience the end result of international trade.

3.1.3 Definition International Business

Hornby (2006) defines international business as the activity of making, buying and selling or supplying goods or services for money between two or more individuals, organisations and regions beyond their shores.

Daniels, Radebaugh and Sullivan (2007) define international business as a term used to collectively describe all commercial transactions (private and governmental, sales, investments, logistics, and transportation) that take place between two or more regions, countries and nations beyond their political boundary. Usually, private companies undertake such transactions for profit; while governments undertake them for profit and for political reasons.

Czinkota, Ronkainen and Moffett (1996) say that international business consists of transactions that are devised and carried out across national borders to satisfy the objectives of individuals and organisations. Joshi and Mohan, (2009) refer international business to all those business activities which involves cross border transactions of goods, services, resources between two or more nations. Transaction of economic resources include capital, skills, people etc. for international production of physical goods and services such as finance, banking, insurance, construction etc.

3.1.4 Convergence of Views

You will agree with me that there is a convergence in all the definitions of the three concepts listed above. One thing that is clear from the definitions of the concepts is that, whether it is foreign trade, international trade or international business, the underlisted must be present:

- there must be the activity of making, buying and selling or supplying of goods or services;
- the commercial transactions must take place between two or more individuals, organisations (private or public) of country and another country;
- the transactions are undertaken for profit motive;
- it involves import and export of goods and services;
- it is a trade beyond international borders or territories.

The backbone of any foreign trade between nations are those products and services which are being traded to some other location outside a particularly country's borders. Some nations adept at producing certain products at a cost-effective price which is because they have the labour supply or abundant natural resources consisting of the raw materials needed.

3.2 Reasons for International Trade

Gimba (2003) listed and discussed the reasons for trade among nations of the world to include:

- differences in natural resources/endowments;
- differences in climatic conditions;
- quality of human resources;
- production techniques;
- nature of capital required for production;
- need for foreign exchange earnings;
- taste and fashion.

(a) Differences in Natural Resources – resources are not evenly distributed among nations or countries. Resources such as crude oil, coal, uranium, gold, water and other metallic resources (solid minerals) are not evenly distributed on earth. What is found in a country may not be found in some other countries. For instance, crude oil is found in commercial quantity in Saudi Arabia, but same crude oil is not in Niger Republic. Even within the same country, the resources are not evenly distributed. For example, crude oil is found in commercial quantity in Niger Delta Region while same is yet to be discovered in the Middle Belt of Nigeria. The implication of these is that the countries which do not possess these at all or countries where they are scarce are compelled to buy them from countries that have surplus.

(b) **Differences in Climatic Condition –** a climate refers to the atmospheric changes of a particular place over a long period of time. Climatic conditions within a country and between countries are not identical or the same. These climatic conditions, to a large extent, determine agricultural production and for the fact that countries fall into different climatic zones, their agricultural production also differs. For example, the central U.S. sates have a climate favourable for the production of wheat but not rice while Thailand has a good climate for rice production. Ivory Coast has a favourable climate for cocoa and coffee while Chad Republic does not have. The implication of this is that certain countries can grow certain crops and raise certain animals that are impossible to produce and or rear in other countries. This becomes inevitable for such country that cannot produce such agricultural products to look beyond its boundaries.

(c) **Quality of Human Resources –** the quality of human resources (labour) varies from one country to another. Some countries do not have good quality human resources and technical know-how required for the exploitation and production of some types of goods and services. Therefore, they might have no option than to rely on the other countries for such goods and services.

(d) **Production Techniques –** new products demand new ways or techniques of production by the country producing them which can bring about international trade. Other countries wanting to produce them may be compelled to buy in order to copy-manufacture their own. For example, Malaysia copied our production of palm produce by importing palm seedlings from Nigeria. Having studied it and produced it, Malaysia is now a net exporter of palm produce even more than Nigeria where she copied. The same attitude is imbibed by China.

(e) **Nature of Capital Required or Production –** the production of some commodities are highly capital-intensive while others are labour-intensive. Some countries do not have the required capital to bring such commodities into existence and for this they are compelled to buy them from other countries rather than producing themselves.

(f) **Need for Foreign Exchange Earnings –** the need for foreign exchange earnings to import or buy goods and services that are not produced domestically calls for international trade which, in itself, makes a country to sell its goods and services to other countries in order to gain foreign exchange.

(g) **Taste and Fashion –** these bother on production and consumption which also breed international trade. If for one reason or the other the tastes and fashion of the nationals of a country rise in favour of a particular commodity; such a country will import the commodity from the country that has it. For instance, although U.S. manufactures her own cars, there is still a high taste for

Japanese cars by Americans because Japanese cars consume less gasoline than Americans'.

Self Assessment Exercise 1.1

1. In your own words, define the following concepts and show the area of convergence:
   - International Trade
   - Foreign Trade
   - International Business

2. List and discuss some of the reasons why countries engage in international trade.

3.3 Differences between Domestic Trade and International Trade

International trade is, in principle, not different from domestic trade as the motivation and the behaviour of parties involved in a trade do not change fundamentally regardless of whether trade is across a border or not (Mundra, 2010). The main difference is that international trade is typically more costly than domestic trade. The reason for this 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.

Gimba (2003) state that differences in advantage may arise because of natural causes like geographic and climatic conditions. These lead to territorial division of labour and localization of industries. For instance, some countries may have particular mineral resources like coal, iron ore, copper etc. while other countries may have land or climate suitable for certain crops e.g. cocoa in Nigeria and Ghana and coffee in Kenya and Ethiopia.

Another difference between domestic and international trade is that factors of production such as capital and labour are typically more mobile within a country than across countries. Thus, international trade is mostly restricted to trade in goods and services, and only to a less extent to trade in capital, labour or other factors of production. Trade in goods and services can serve as a substitute for trade in factors of production.

To this end, 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 labour-intensive goods by the United States from China. Instead of importing Chinese labour, the United States imports goods that were produced with Chinese labour. Another example is where Nigeria establishes motor assembly plants and only imports the parts from abroad with a view to assembling these parts together to become a vehicle.

Self Assessment Exercise 1.2

List and discuss the major differences between domestic and international trade.

3.4 Benefits of International Trade

Explaining the benefits of international trade, Economy Watch (2010) comment that international trade has flourished over the years due to the many benefits it has offered to different countries across the globe. According to this magazine, international trade accounts for a good part of a country's gross domestic product (GDP). International trade serves as one of the important sources of revenue for a developing country like Nigeria.

By way of explanation, the restrictions to international trade would limit the nations to the services and goods produced within its territories, and they would lose out on the valuable revenue from the global trade. With the help of modern production techniques, highly advanced transportation systems, transnational corporations, outsourcing of manufacturing and services, and rapid industrialization, the international trade system is growing and spreading very fast.

The benefits of international trade have been major drivers of growth for the last half of the 20th century, as nations with strong international trade have become prosperous and have the power to control the world economy;

Some of the benefits of international trade include:

- the global trade can become one of the major contributors to the reduction of poverty;
- enhances the domestic competitiveness;
- takes advantage of international trade technology;
- increase sales and profits;
- extend sales potential of the existing products;
- maintain cost competitiveness in your domestic market;
- enhance potential for expansion of your business;
- gains a global market share;
- reduce dependence on existing markets;
- stabilize seasonal market fluctuations.

Self Assessment Exercise 1.3

Do you think international trade has any benefit? If yes list the benefits and if no, why?

3.5 Theories of International Trade

Six theories of international trade will be discussed (Esezobor, 2009), namely:

(1) Mercantilist theory;
(2) Berlin Ohlin theories;
(3) Leontief Paradox;
(4) Michael Porter's theory of competitive advantage of the nations;
(5) New trade theory; and

(6) Raymond Vernon's Product Life-cycle theory.

3.5.1 Mercantilist Theory

The Mercantilists were philosophers in the sixteenth to eighteenth centuries who advocated that countries should export more than they import with a view to accumulating surpluses which at the time, resulted in a net inflow of gold from the deficit countries to the surplus countries. Amongst these philosophers, emerged two great thinkers who booked their respective places in history with their contributions of the theories of Absolute Advantage and Comparative Advantage.

(a) Principle of Absolute Advantage

Adam Smith, a classical economist, in his book, "The Wealth of Nations" published in 1776, advocated that nations should produce those things for which they have absolute advantage and hands off those things they had no absolute advantage over. This was a departure from the accepted counsel at the time that nations should produce in order to export more than what they import so as to garner gold in settlement.

The use of principle of absolute advantage demonstrated that a country could benefit from trade, if it has the least absolute cost of production of goods, i.e. per unit input yields a higher volume of output. According to him, a country has an absolute advantage over its trading partners if it is able to produce more of a good or service with the same amount of resources or the same amount of a good or service with fewer resources.

Example:

Commodity	Country X	Country Y
Wheat	10 tons	1 ton
Coffee	3 tons	5 tons

Source: Esezobor, E.E. (2009). International Finance (2nd edition). Lagos: CIBN Press Limited, ISBN: 978-37278-4-2.

In the above hypothetical example, it is assumed that Country X produces 10 tons of wheat while Country Y produces only 1 ton within the same timeframe. Clearly, it could be seen that Country X has the absolute advantage in wheat production, and according to Adam Smith, it should concentrate its resources in the production of wheat.

In coffee production, Country X only achieves 3 tons as against 5 tons by Country Y given the same production timeframe. Country Y, in Adam Smith's view, should hands off wheat production and concentrate only on coffee production over which it has absolute advantage. In that way, both countries would fare better in both products. The theory no doubt, appeared narrow and simplistic. It considered only two products and assumed that only two countries are involved in international trade. It however failed to explain standards by which one ton of wheat could be exchanged for one ton of coffee. David Ricardo, a later revelation, provided a more convincing analysis in his work now referred to as "The Law of Comparative Advantage" in international trade.

(b) The Law of Comparative Advantage

As stated above, the proponent of this law was another mercantilist, David Ricardo (1772 – 1823). He is one of the classical economists of the nineteenth century (Gimba, 2003). He was a stockbroker and self-made millionaire, expert on the theory of land rent and of currency who came up in 1817 with his beautiful proof that international specialization pays for a nation. In his theory of comparative costs, (which was propounded to refine absolute advantages theory put forward by Adam Smith as a basis of international trade), he suggested that countries should concentrate on producing those things for which it has the least opportunity cost of production. The law, according to Esezobor (2009) states that a country should concentrate on producing those things for which it has the least opportunity cost of production. According to him, it is possible for a country to have the absolute advantage in the production of two things; yet it would pay it better to concentrate on only one of the two of which, it has a lower opportunity cost and leave the second where the opportunity cost is high, compared with another country. It in turn means that countries will specialize and trade in goods and services in which they have a comparative advantage. According to him, it is easy to see that if countries have an absolute advantage, there are advantages to trade. However, what happens if one country has an absolute advantage over its trading partners in the production of a number of goods.

Example:

Country	Man Hours to Produce 1 ton of Cocoa	Man Hours to Produce 1 Calculator
Country X	200	100
Country Y	120	80

Source: Esezobor, E.E. (2009). International Finance (2nd edition). Lagos: CIBN Press Limited, ISBN: 978-37278-4-2.

Country X in both instances enjoys absolute advantage because it needs fewer number of hours to produce 1 ton of cocoa and 1 calculator. In the reasoning of Adam Smith, proponent of the theory of absolute advantage, the above scenario is a "done deal"; Country X should specialize in both products while Country Y go and find another line of production for which it can secure an absolute advantage. David Ricardo used statistics to prove that even in the above setting; Country Y was not totally disadvantaged. According to him, for the production of cocoa, Country X's cost advantage in relative terms over Country "Y" is 12/200 = 0.6 hour while in the production of calculators, the cost advantage is 80/100 = 0.8 hour. The Ricardian counsel is that Country X should specialize in the production of cocoa and leave calculators where the cost advantage is lower or where the opportunity cost is higher. Country Y, on the other hand, with a disadvantage of 200/120 = 1.67 hours for cocoa and 100/80 = 1.25 hours for calculators would do well to close shop on cocoa production where the opportunity cost is far higher than in the calculator factories. Esezobor (2009) however reasoned that the pay rates for labour in both countries would determine, to a large extent, the cost of one ton of cocoa and one calculator.

Gimba (2003) however pointed that the need for David Ricardo's theory was because Adam Smith's theory could not rationalise substantial proportion of international trade. He pointed out that while profits in the same country in different employment tended to equalize, this was not the case between different countries. The reason is that there is mobility of labour within a country but not between different countries. By arithmetical example, he showed that even if Portugal could produce both cloth and wine cheaper than England, it could pay Portugal to concentrate on the production of wine only in which her comparative advantages was greater and import cloth from England. The following assumptions guided his theory:

(1) There are only two countries in the world;
(2) Only two commodities are produced;
(3) Labour is perfectly mobile within a country, but immobile across a country;
(4) Existence of constant cost of production;
(5) Labour is the only factor of production;
(6) Technology is constant;
(7) Full employment of all factors of production;
(8) Production function is the same within the country but not the same across the country;
(9) There is free trade (that is no transport cost and no barrier of any form).

Specialization and trade can still result in there being welfare gains made from trade. A country has a comparative advantage in the production of a good or service that it produces at a lower opportunity cost than its trading partners. Some countries have an absolute advantage in the production of many goods relative to their trading partners. Some have an absolute disadvantage. They are inefficient in producing anything, relative to their trading partners. The theory of comparative costs argues that, it is better for a country that is inefficient at producing a good or service to specialize in the production of that good it is least inefficient at, compared with producing other goods.

Countries will **specialize** in and export those products which use intensively the factors of production which they are most endowed. It is reasoned that if each country **specializes** in those goods and services where they have an advantage, then total output and **economic welfare** can be increased (under certain assumptions). This is true even if one nation has an **absolute advantage** over another country. All trade takes place because of the differences in cost of production. Such differences can be of three (3) different types, namely:

1. Absolute differences in cost (advantage);
2. Equal differences in cost (advantage); and
3. Comparative difference in cost (advantage).

Trade is possible in (i) and (iii) but not under (ii). Let us take the example one by one.

(i) Absolute differences in cost (advantage):

Country	Marginal cost of producing	
	Ground nuts	**Cocoa**
A	N5.00 per 1000 kg	N10.00 per 1000 kg
B	N10.00 per 1000 kg	N5.00 per 1000 kg

Source: Gimba, M.B.W. (2003). Monetary and International Economics, pp. 174 – 178.

Since price tends to be equal to the marginal cost of production, in country A, 1000 kg of groundnuts will exchange for 500 kg of cocoa. In country B, 1000 kg of grounds will exchange for 2000 kg of cocoa. Thus, in country A, 1 unit of groundnut is equal to ½ unit of cocoa or 1:2, and in country B, 1 unit of groundnuts is equal to 2 units of cocoa or 2 : ½. Thus country A has absolute advantage in groundnuts and B in cocoa. A will specialize in the production of groundnuts and B in cocoa. A will gain so long as she can get more than 500 kg of cocoa for 1000 kg of groundnuts. B will gain so long as she can get 1000 kg of groundnuts for less than 2000 kg of cocoa. The ratio of exchange will lie somewhere between 500 kg and 2000 kg of cocoa for 1000 kg of groundnuts. The actual rate will depend on the relative elasticities of the demands of each party for the product of the other. Trade due to absolute advantages usually exists between temperate and tropical countries on account of climatic and other differences.

(ii) Equal differences in cost (advantage):

When the comparative advantage is equal, no trade can permanently take place between the parties.

Country	Marginal cost of producing	
	Ground nuts	**Cocoa**
A	N5.00 per 1000 kg	N4.00 per 1000 kg
B	N10.00 per 1000 kg	N8.00 per 1000 kg

Source: Gimba, M.B.W. (2003). Monetary and International Economics, pp. 174 – 178.

Thus in country A, 1 unit of groundnuts is equal to ½ unit of cocoa which is 1:2, and in country B, 1 unit of groundnuts is equal to ½ unit of cocoa which is also 1:2. Under the above conditions, no benefit will accrue to the parties through specialization. If A specializes in groundnuts and B in cocoa, A only gain if 1000 kg of groundnuts gives her more than 500 kg of cocoa. But B will not give more than 500 kg of cocoa for 1000 kg of groundnuts, since she can produce that much at home by transferring productive resources from cocoa to groundnuts. Even if trade starts, it will come to an end after some time.

(iii) Comparative difference in cost (advantage):

When the comparative advantage is different, trade will arise and it will continue.

Country	Marginal cost of producing	
	Ground nuts	**Cocoa**
A	N7.00 per 1000 kg	N5.00 per 1000 kg
B	N14.00 per 1000 kg	N7.00 per 1000 kg

Source: Gimba, M.B.W. (2003). Monetary and International Economics, pp. 174 – 178.

In this case, country B can produce both groundnuts and cocoa cheaper than country A, but the comparative advantage is higher in the production of cocoa than in that of groundnuts. On the other hand, country A has a comparative disadvantage in the production of both the commodities, but the disadvantage is less in the case of groundnuts than in the case of cocoa. Thus in country A, 1000 kg of groundnuts is equal to 500 kg of cocoa which is 1:2, and in country B, 1000 kg of groundnuts is equal to 5/7 or 0.710 kg of cocoa which is also 1:1 2/7. It will therefore, pay country B to specialize in the production of cocoa and country A in groundnuts.

Determination of Comparative Advantage:

Comparative advantage is a dynamic concept. It can and does change over time. Some businesses find they have enjoyed comparative advantage in one product for several years only to face increasing competition as rival producers from other countries enter their markets. For a country, the following factors are important in determining the relative costs of production:

- The quantity and quality of factors of production available (e.g. the size and efficiency of the available labour force and the productivity of the existing stock of capital inputs). If an economy can improve the quality of its labour force and increase the stock of capital available it can expand the productive potential in industries in which it has an advantage.

- Investment in research and development (important in industries where patents give some firms significant market advantage).

- Movements in the exchange rate. An appreciation of the exchange rate can cause exports from a country to increase in price. This makes them less competitive in international markets.

- Long-term rates of inflation compared to other countries. For example, if average inflation in Country A is 4 percent whilst in Country B it is 8 percent over a number of years, the goods and services produced by Country A will become relatively more expensive over time. This worsens their competitiveness and causes a switch in comparative advantage.

- Import controls such as tariffs and quotas that can be used to create an artificial comparative advantage for a country's domestic producers – although most countries agree to abide by international trade agreements.

- Non-price competitiveness of producers (e.g. product design, reliability, quality of after-sales support).

3.5.2 Berlin Ohlin Theory

Berlin Ohlin, Swedish, criticised all the assumptions of the law of comparative costs and felt strongly, that the law was misleading (Esezobor, 2009). His work titled "The Modern Theory of International Trade" is also referred to as the General Equilibrium Theory of International Trade or the Heckscher – Ohlin Theory because he received the impetus for his study from the earlier works of Eli Heckscher.

The theory advocates exploitation in factor endowments inclusive of technology, tastes and preferences. Ohlin advised that:

(i) A country should concentrate in producing for exports, those products for which it has relative abundance and cheap resources to produce and import the products for which a great deal of relative scarce resources would be used to produce.

(ii) Trade can also prosper on decreasing cost of production.

(iii) Trade will lead to minimization in the differences f factor costs between trading nations whose productions are often limited because of differences in endowment and factor costs in terms of labour, land, capital and entrepreneurship.

The likely check to the successful operation of this theory, according to the proponent, is factor reversibility. Although not common, it happens where two countries have the same factor endowments and produce one common product equally and cheaply to the extent that the only option left between both countries is to attempt to sell to each other, the same product. An example is cocoa production in both Ghana and Nigeria. Both countries are the leading cocoa producers in the world because the climate, soil content and other natural endowments like large arable land and cheap unskilled labour amongst other things make possible the production for exports. If a situation arises where the only thing Ghana and Nigeria can trade on is cocoa, then the Ohlin's theory has failed because there would be no basis for trade in the first place (Ezesobor, 2009).

3.5.3 Leontief Paradox

The Heckscher – Ohlin theory generated interest amongst philosophers because it had fewer simple assumptions. One of such phillsophers/economists was Wassily Leontief, the 1973 Nobel Prize Winner in Economics (Esezobor, 2009). Writing in 1953, he questioned the validity of the Heckscher-Ohlin theory. In his views, the United States of America is well endowed in the production of capital-intensive products. In reality, he found that the US exports less capital-intensive goods but with innovative and skilled inputs like computer software while importing heavy capital goods like automobiles. For example, why would the US import automobiles when it is the world's greatest producer of high-performance auto vehicles? It is because it is more efficient for the US to do so while exporting aircrafts and military hardware amongst other things. This development of not exporting principally the fruits of a nation's endowment appeared a paradox and is today called the Leontief Paradox.

3.5.4 Michael Porter's theory of competitive advantage of the nations

According to Michael Porter, "nations don't compete, companies compete". That is, it is the companies that trade and create wealth (Esezobor, 2009). With increasing sophistication in technology, companies and industries are getting more globalised and international in scope and operations. The home nation of such companies takes on growing significance because it is the source of the skills and technology that drive the comparative advantage.

Porter advanced four attributes (which he called "the national diamond") of a nation, which can influence the pattern of trade:

(i) Factor Conditions defined as natural resources, plentiful labour, systems proficiency, research database, availability of scientists, engineers or experts in particular fields.

(ii) Demand Conditions – if there is a strong domestic demand for a particular product, this can give the industry a head start in global competition. For example, the US and Cuba are ahead in health services because there is internal heavy demand for such services in both countries. Other countries now seek these countries' expertise on health matters.

(iii) Related and Supporting Industries – successful industries are usually backed by strong supporting industries, which provide inputs for production. For example, in Japan, many companies specialize in making the different car parts the big motor companies assemble and brand.

(iv) Company Strategy, Structure and Rivalry – each company's strategic management, domestic rivalry and competition fuel growth and competitive strength in world trade.

Porter emphasised that these four attributes determine whether a nation has competitive advantage or not in international trade.

3.5.5 New trade theory

The theory (Esezobor, 2009) states that international trade allows a nation to specialize in the production of goods for which it enjoys economies of scale while buying those goods it does not produce from other countries that produce them on economic scale. While this theory appears a chip off the block of the Law of Comparative Advantage, it recognizes that only large firms and they are few, produce on economies of scale. If such firms dominate world trade, it implies that the world market is in the hands of a few well-heeled large firms.

International trade is therefore beneficial to the world at large because it encourages lower unit cost from mass production and economies of scale. It also allows for specialization, production of variety of goods and efficient utilization of resources. Increasing learning effects from research and development also follow from enterprise.

The early entrants to any product market called first-movers derive manifold advantages because they are able to carve a niche for themselves and enjoy global goodwill as with Boeing of the US in the hi-tech aircraft manufacture.

3.5.6 Raymond Vernon's Product Life-cycle theory

The theory (Esezobor, 2009) is known for recognising that trade patterns are influenced by where a new product is made and introduced to the international market. The theory was developed in the 1960s nu Raymond Vernon.

During his time, the US was the dominant inventor and mass producer of industrial and household appliances. With time, high production costs especially labour encouraged the manufacturers to seek cheaper production centres in the Far East countries of Singapore, Malaysia etc. Rather than export such goods, the US now imported the goods it manufactured in cost effective production centres.

It is not clear whether the new trend of manufacturing the parts of a product in different countries and assembling them in one country in a globalised and integrated world economy e.g. Toshiba laptop is assembled in Singapore while the component parts are manufactured in no less than five countries, can be regarded also as the Product Life-cycle Theory.

Self Assessment Exercise 1.4

1. Define the concepts: absolute advantage and comparative advantage.

2. Compare and contrast absolute and comparative advantage.

3. Write short notes on the following theories:

   (a) Berlin Ohlin
   (b) Leontief Paradox
   (c) Michael Porter
   (d) New Trade
   (e) Raymond Vernon

3.6 Restriction in International Trade

Governments restrict international trade in order to protect domestic industries from foreign competition. The restriction of international trade is called **protectionism**. There are two main protectionist methods employed by governments. They are:

1. Tariffs
2. Non-tariff barriers
3. Other control instruments

A tariff is a tax that is imposed by the importing country when an imported good crosses it international boundary. A non-tariff barrier is any action other than a tariff that restricts international trade. Examples of non-tariff barriers are quota or quantitative restrictions and licensing regulations that limit imports.

Tariff takes the form of import duties, excise duties, countervailing duties, specific tariff, advalorem tariff, compound tariff, prohibitive tariff and discriminatory tariff.

Non-tariff barriers are of two types, namely: quotas and voluntary export restraints. A **quota** is a quantitative restriction on the import of a particular good. It specifies the maximum amount of the good that may be imported in a given period of time. Quotas are set for the import of many items, some of which is sugar, cement, milk, rice, etc.

A **voluntary export restraint** is an agreement between two governments in which the government of the exporting country agrees to restrain the volume of its own exports.

Non-tariff barriers include quotas, administrative controls, foreign exchange controls, import monopolies.

Other control instruments adaptable by a country include subsidies and economic integration policies.

3.6.1 Effects of a Tariff

The temptation, on governments, to impose tariffs is a strong one. First, tariffs provide revenue to the government.

Second, they enable the government to satisfy special interest groups in import-competing industries.

3.6.2 Case For Protection

A country might restrict international trade and impose tariffs or quotas in an attempt to achieve three goals, namely:

- Achieving national security;

- Stimulating the growth of new industries; and
- Encouraging competition and restraining monopoly.

The national security argument for protection is that a country is better off if it protects its strategic industries – industries that produce defence equipment and armament (like Defence Industries Corporation of Nigeria) and the industries on which the defence industries rely for their raw materials and other intermediate inputs.

The second argument that is used to justify protection is the infant-industry argument – the proposition that protection is necessary to enable an infant industry (such as Obajana Cement Factory at Lokoja, Nigeria) to grow into a mature industry that can compete in world markets. The argument is based on the idea of dynamic comparative advantage, which can arise from learning-by-doing. There is no doubt that learning-by-doing is a powerful engine of productivity growth and that comparative advantage evolves and changes because of on-the-job experience.

The third argument used to justify protection is the dumping argument. Dumping occurs when a foreign firm sells its exports at a price below its cost of production. Dumping might be used by a firm that wants to gain a global monopoly. In this case, the foreign firm sells its output at a price below its cost in order to drive domestic firms out of business. This action will save jobs, allows the infant industry to compete with cheap foreign labour, brings diversity and stability, penalizes lax environmental standards and prevents rich countries from exploiting developing countries.

3.6.3 Case Against Restriction

The main arguments against trade restrictions are that subsidies and competition policies can achieve domestic goals more efficiently than protection and that protection can trigger a trade war in which all countries lose.

3.7 Terms of Trade

Gimba (2003) defined terms of trade as the basis on which two countries trade with each other. It refers to the value of a country's exports which have to be given in exchange for its imports. It indicates the rate at which a country exchanges its own good for that of another. If trade between two countries is such that one is specializing in agricultural production and the other in manufactures, the trade is not advantageous to the former. This is because, terms of trade are said to be favourable to a country when the prices of its exports are high relatively to the prices of its imports. Generally speaking, prices of agricultural products are lower than the prices of manufactured goods. Similarly, if a country is exporting minerals in a raw state and other raw-materials, the terms of trade are unfavourable to it. The terms of trade can be put in the form of an equation:

$$\text{Terms of Trade} \quad - \quad \frac{\text{Prices of Imports}}{\text{Prices of Exports}}$$

3.7.1 Factors affecting Terms of Trade of a Country

The factors affecting terms of trade of a country are (Gimba, 2003):

(1) Trade;
(2) Trade quotas;
(3) Degree of substitutiveness of commodities;
(4) Tariff;
(5) Market structure of the commodity;
(6) Inflationary trend;
(7) Scarce commodities in the world market;
(8) Devaluation of national currency.

- **Trade:** the terms of trade between countries is not determined within the framework of free interplay of the international forces of demand and supply. Most often, one finds government's intervention in action. Government's economic policy affects the commodities and factors of production used. These economic policies such as tariff and devaluation of currency influence the terms of trade of a country.

- **Trade quotas:** this is the specified quantity of goods that should be imported. This factor is well pronounced especially when it restricts the amounts of imports in return for exports of the country, such can affect the terms of trade.

- **Degree of substitutiveness of commodities:** commodities that have no substitutes which are highly demanded by the world market attract very high export prices and therefore can affect the terms of trade.

- **Tariff:** this is a tax imposed on both imports and exports. Tariff imposed on exports has the ability to affect the terms of trade because it can increase the prices of such exports with the difference in tax.

- **Market structure of the commodity:** production of commodities by a country or group of countries may be based on monopoly. For example, if a group of countries producing a particular commodity or group of commodities come together to form a cartel (as that of Oil Producing Exporting Countries – OPEC) to monopolise the trade, there is every likelihood tat members' terms of trade will be enhanced.

- **Inflationary trend:** the rate of inflation prevailing in a country can affect the terms of trade. When the domestic price index of commodities of Nigeria's factors of production results in production of export goods which are more expensive than other countries, the demand for Nigeria's exports will reduce and terms of trade will be affected accordingly.

- **Scarce commodities in the world market:** commodities that are demanded but scarce in the world market have a tendency of attracting high prices. If countries export such commodities, they might have their terms of trade affected positively because more of their exports will be demanded.

- **Devaluation of national currency:** devaluation means the reduction in the value of the home currency in terms of foreign currencies. So devaluation of a country's currency can affect her terms of trade. This is because it reduces the prices of imports from such and encourages the demand of same and for this, the terms of trade will be affected negatively.

Self Assessment Exercise 1.5

1. What is the difference between terms of trade and restriction in international trade?

2. List and discuss some of the factors which can affect a country's terms of trade.

3.8 Balance of Trade and Balance of Payment

In the modern world, there is hardly any country which is self-sufficient in the sense that it produces all the goods and services it needs (Gimba, 2003). Every country imports from other countries the goods that cannot be produced at all in the country, or can be produced only at an unduly high cost as compared to the foreign supplies. Similarly, a country exports to other countries the commodities which those countries prefer to buy from abroad rather than produce at home.

3.8.1 Balance of Trade

Gimba (2003) defines balance of trade as the relation over a period between the value of a country's exports and the value of its imports. Put very simply, it is the relation of the total value of the imports into and exports from a country over a period of time usually in a year. The balance of trade is the value of exports minus the value of imports. If the value of exports exceeds the value of imports, then the balance of trade is positive or that there is surplus or favourable balance of trade. However, when the value imports exceed the value of exports, the result is that you have negative, unfavourable or deficit balance of trade. There are two kinds of trade, viz: visible trade and invisible trade.

(a) Visible Trade

The visible trade is physical goods or products such as vehicles, equipment, cocoa, cassava, crude oil, rubber, palm kernel, cotton, etc.

(b) Invisible Trade

The invisible trade is concerned with the services rendered in the course of trade between two or more countries. This is also referred to as services. The services could be in the form of banking, transportation, clearing and forwarding, insurance, etc.

3.8.2 Balance of Payment

Gimba (2003) defined balance of payments as a comprehensive record of economic transactions of the residents of a country with the rest of the world. The record is so prepared as to provide meaning and measure to the various components of a country's external economic transactions. Thus, the aim is to present an account of all receipts and payments on account of goods exported, services rendered and capital received and capital transferred by residents of a country. In other words, a country's balance of payments accounts records its international trading, borrowing and lending.

The purpose of balance of payments is to summarise and analyse a country's financial and economic transactions with the rest of the world, and like all such records, it must balance, provided we take into account all items including capital and gold movements. Thus, the total of the credit column must be equal to that of the debit column. In theory, then, the balance of payment balances. This is the simple explanation for its balances, and the result of such an analysis will show how far the country is living with a current or investing abroad.

Like the balance of trade, a country's balance of international payments is said to be favourable or is surplus when the total receipts from its exports to the rest of the world, exceed the total payments for its imports from the rest of the world. Conversely, its balance of international payments is said to be unfavourable or in deficit if its receipts fall far short of its payments. Likewise, it is in equilibrium when its receipts are equal to its payments on account of its transactions with other countries. Payments and receipts on international account fall into three groups, namely:

1. The visible balance of trade
2. Invisible items, and
3. Capital movements.

(a) Visible items of Balance of Payments

The chief payments are for goods i.e. imports and exports. A country requires payments for its exports just as it must pay for its imports. The most important imports of Nigeria are manufactured goods and, its exports are mainly oil, groundnuts, cocoa, rubber, timber, palm oil and tin. Nigeria pays those countries which supply her with the commodities she imports and receives payments for those commodities she exports. Items in the balance of payments which relate to goods are known as visible items and the relation between imports and exports is known as the balance of trade.

(b) Invisible Items

In addition to the visible items, many other payments and receipts enter into a country's balance of payments, and these are known as invisible items. This is often called invisible exports in the case of receipts. These are mainly as a result of services rendered by one country for another and include:

(1) Shipping services. Payment has to be made to shipping companies.
(2) Investment abroad. Payments made for banking services and insurance services.
(3) Other visible are:
    i. money spent by tourists;
    ii. money spent by government officials abroad, and
    iii. renting of films.

(c) Capital Movements

Balance of payments is also affected by capital movements. The income from foreign investment is a receipt, but when the original investment was made, it was a payment. There are three reasons for transferring capital:

(1) for investment abroad;
(2) as a loan from one country to another; and
(3) safety.

So, the balance of payments of a country might look like this:

Balance of Payments (₦ million)

Receipts	Amount	Payments	Amount
Visible exports (i.e. export of commodities)	2,250	Visible imports (import of commodities)	1,500
Invisible exports (i.e. export of services)	250	Invisible imports (import of services)	500
Unrequited receipts (i.e. gifts, grants, etc.)	250	Unrequited payments (i.e. gifts, grants, etc.)	500
Capital receipts (i.e. borrowing to or selling of assets to foreigners)	250	Capital payments (i.e. lending to or purchase of assets from foreigners)	500
Total	**3,000**	**Total**	**3,000**

Source: Gimba, M.B.W. (2003). Monetary and International Economics.

A country's balance of payments must always balance, just as both sides of a company's balance sheets must always show the same total. Any difference between income and expenditure after all these four items, (i) trade balance, (ii) invisible items, (iii) capital movements, and (unrequited receipts and payments, have been taken into account, must be made good by some means. The following are some of the means:

1. Loans or credit;
2. Gift
3. Sale of foreign investment, and
4. Movement of gold (as a last resort).

The capital account records foreign investment in Nigeria minus Nigerian investment abroad.

3.8.3 Causes of Balance of Payment Disequilibrium

The net outflow of funds that may accompany a deficit balance of payment or a net inflow of assets that indicate a favourable balance of payment could be traced to variety of sources, such as:

(a) **The Rate of Inflation –** When the rate of inflation is high, two key issues will emerge:

(i) The country's exportable goods become expensive thereby discouraging interested overseas buyers. Conversely, the products of foreign countries appear cheap. Merchants are thus encouraged to buy abroad at the expense of local products.

(ii) Capital flight is a natural occurrence in an era of high inflation rate. While private foreign investors endeavour to take their funds to more stable economies, the local investors too look beyond their shores for a safe haven for their funds.

Both occurrences will result in a net outflow of funds while inflows will suffer.

(b) **Level of Economic Development –** While the developed economies of Europe and Asia have the industrial capacity to absorb temporary market turbulence and even build more facilities, the weak economies of the less developed countries are susceptible to minor market distortions. They need huge long-term but soft loans which must be serviced from time to time.

The sturdiness of the big economies and fragility of the weak economies have bearings on the level of terms of trade and the balance of payments generally.

(c) **Confidence in the Economy –** Confidence is crucial in determining how stable an economy is. It affects largely, the movement of short-term funds. The voting of a shrewd leader as President of a country, the discovery of huge mineral deposits, concerted popular efforts to stamp out corruption in the body politic of a country and many other heartening examples will impart on a higher level of confidence on the economy before international investors.

If the country is stable economically and politically, foreign buyers will look their way. On the other hand, who would like to put his money upfront in a confirmed letter of credit in a country where honour is not taken seriously? Suffice it to say that confidence in the economy will encourage capital inflows while the opposite will starve the economy of foreign patronage and investments.

(d) **Interest Rate –** In a free economy, high interest rate will, other things being equal, attract foreign deposits looking for higher return. If there is no strict control like the Money Laundering Act, hot money (money without home but in search of high return) will flow in to take advantage of the high interest rate. Such movements of funds are always short-term because at the slightest sign of a downturn or economic uncertainty, the money disappears the way it surfaced.

Capital inflow is a good thing because it boosts the balance of payment. If it is hot money, the sudden disappearance will create difficulties in the balance of payment apart from the inflation it can cause.

(e) **Structural Economic Factors –** A few events happen around the world that creates substantial structural impact in the economies of many countries. The cow foot and mouth disease of the United Kingdom opened the market for the poor farmers of cassava in Asia and Africa to boost their income because cassava was discovered as a remedy if added to cattle feeds. The fuel crisis in 1973 when the countries of the Middle East refused to sell petroleum oil to selected countries in solidarity with Egypt in armed conflict with Israel, shifted consumer preferences from big automobiles to the small fuel saving type in such countries.

In the circumstances, while some countries might experience an increase in the volume of balance of payment, others might have to look inwards for the catastrophe that contracted their balance of payment.

(f) **Random Factors –** Occurrences like widespread draught, earthquake, flood, wars; all affect the balance of payment sheet in different ways. The war to unseat Saddam Hussein in Iraq opened a whale of opportunities to manufacturers of ammunitions in the United Kingdom and United States of America as well as post-war construction companies to make money. Ditto for the recent wars in Libya which displaced from power Late Mohammar Gadhaffi, Afghanistan and other trouble spots in Africa. Added to these developments, are bad economic policies or notoriety of leaders of some countries that contract economic interaction with the outside world.

In one way or the other, these factors bare their fangs when the balance of payment of an affected country is compiled.

3.8.4 Measures to correct Balance of Payments Problems

A country faced with adverse or unfavourable balance of payment could try and correct it by taking the following measures:

- Devaluation of local currency

- Effective structural adjustment programme
- Restriction of imports
- Diversification of the economy
- Stimulation of exports
- Foreign exchange restrictions
- Sale of investments abroad
- Deflationary measure

- **Devaluation of local currency –** devaluation means the reduction in the value of the home currency in terms of foreign currencies. With this measure, a country's imports are reduced because the goods will be more costly while at the same time the export will become cheaper and will therefore get wider markets. More money will be realized from exports which will offset the deficit in the balance of payment.

- **Effective structural adjustment programme –** since the imbalance in the balance of payments especially in Nigeria is both structural and fundamental, effective structural adjustment programme could stimulate exports as well as find realistic exchange rate of the currency.

- **Restriction of imports –** in order to correct an adverse balance of payments, a country can restrict importation of many goods into the country through the use of restrictive measures like heavy import duties, quotas, etc.

- **Diversification of the economy –** diversification of the economy with emphasis on agricultural sector could reduce the over-dependence on imported raw materials for agro-allied industries and in general food which could help to correct any balance of payments problem.

- **Stimulation of exports –** when a country encourages the growth of exports by making exports tax-free and or by subsidizing the cost of production of export commodities, it will reduce balance of payment problem. Nigeria's policy of export promotion zones like that of Calabar in Cross River State is towards this objective.

- **Foreign exchange restrictions –** restriction in the use of foreign exchange including basic travel allowances could help in correcting balance of payment problems.

- **Sale of investments abroad –** export of gold and sale of investments overseas is one effective measure of correcting balance of payment problem. This is because this measure could be used to raise foreign exchange to pay debts which the country owes to other countries and organisations (institutions) and by this balance of payment problem can be reduced.

- **Deflationary measure –** by deflationary measure, government can reduce the amount of money in the hands of the public which will make them to demand for less of the commodities. With falling prices of exports, more export goods will be demanded by foreigners. This will increase money realized from export which will be used.

3.8.5 Official Settlements

The official settlements account records the net change in Nigeria's official international reserves. Nigeria's official international reserves are the government's holdings of foreign currency, and the net change in Nigeria's official international reserves is called the official settlement. If Nigeria's official international reserves increase, the official settlement is negative. The reason is that holding foreign money is like investing abroad. Nigeria's investment abroad is a negative item in the capital account. By the same reasoning, if official international reserves decrease, the official settlement is positive.

The balances on these three accounts always sum to zero. That is, to pay our current account deficit either we must borrow more from abroad than we lend abroad or our official international reserves must decrease to cover the shortfall.

3.8.6 Borrowers and Lenders, Debtors and Creditors

A country that is borrowing more from the rest of the world than it is lending to it is called a net borrower. Similarly, a net lender is a country that is lending more to the rest of the world than it is borrowing from it. A net borrower might be going deeper into debt or might simply be reducing its net assets held in the rest of the world.

Prior to 2006, Nigeria had debt over-hang to various international multilateral institutions such as Paris Club, London Club, World Bank and the International Monetary Fund (IMF). The total debt hanging over Nigeria then was over US$30 billion. Nigeria, through diplomatic shuttles made by the former President Olusegun Obasanjo, secured a reprieve which made Nigeria to pay only US$12 billion in full and final settlement of the total debt. This meant that the balance of US$18 billion was waived on the ground that Nigeria had been paying interest on these debts since 1984.

3.9 Financing of International Trade

When Nigeria imports Toshiba Television sets from Japan, it does not pay for those TVs with Naira – it uses Japanese yen. When Italy imports Aso Adire or Aso Oke from Nigeria, it pays for them using Naira and when a French power company buys a Candu reactor from Canada, it pays for it using Canadian dollar. Whenever we buy goods from another country, we use the currency of that country in order to make the transaction. It doesn't make any difference what item is traded – it might a consumer good or a capital good, a building or even a firm.

International trade, borrowing, and lending are financed using foreign currency. A country's international transactions are recorded in its balance of payments accounts. The current account records receipts and expenditures connected with the same and purchase of goods and services, as well as interest income received from and paid to the rest of the world and transfers to and from the rest of the world; the capital account records international borrowing and lending transactions. The official settlements account records the official settlement – the change in official international reserves. The sum of the current account, the capital account, and the official settlements account is always zero.

3.10 Foreign Exchange

This is the exchange of one currency of a country with the currency of another country. For instance, the exchange of Pound sterling of the UK with Nigeria's Naira or United States Dollar with French Franc or Italian Lira with South African Rand, etc. When we buy foreign goods and services or invest in another country, we have to obtain some of that country's currency to make the transaction. When foreigners buy Nigerian-produced goods and services or invest in Nigeria, they have to obtain some Nigerian Naira. We get foreign currency and foreigners get Nigerian Naira from the foreign exchange market.

3.10.1 Foreign Exchange Market

The foreign exchange market is the market in which the currency of one country is exchanged for the currency of another. The foreign exchange market is not a place like Oshodi or Balogun Market in Lagos (Nigeria) or Downtown Flea Market in Canada or Produce Market. The market is made up of thousands of people – importers and exporters, banks, and specialists in the buying and selling of foreign exchange called foreign exchange brokers or dealers in foreign exchange known in Nigeria as bureau de change. The sun barely sets on the foreign exchange market. Dealers around the world are continually in contact by telephone or physically where trillions of foreign currency change hands.

3.10.2 Foreign Exchange Rate

The price at which one currency exchanges for another is called a foreign exchange rate. For example, N155.00 exchanges for US$1.00 while N250.00 exchanges for £1.00. The actions of the foreign exchange brokers or dealers make the foreign exchange market highly efficient. Exchange rates are almost identical around the world. If Naira fell in value against U.S. dollar or Pound sterling, this means that Naira has depreciated. Currency depreciation is the fall in the value of one currency in terms of another currency. However, currency appreciation is the rise in the value of one currency in terms of another currency.

3.10.3 Demand and Supply in Foreign Exchange

The quantity of Nigerian Naira supplied in the foreign exchange market is the amount that traders plan to sell during a given time period at a given price. This quantity depends on many factors, but the ones are: exchange rate, interest rates in Nigeria and other countries and expected future exchange rate.

People supply Naira in the foreign exchange market when they buy other currencies, and they buy other currencies so that they can buy foreign-made goods and services. They also supply foreign currencies and buy Naira so that they can buy foreign assets such as bank accounts, bonds, stocks, businesses and real estate.

The law of supply applies to Naira just as it does to anything else that people plan to sell. Other things remaining the same, the higher the exchange rate, the greater is the quantity of Naira supplied in the foreign exchange market.

On the other hand, the quantity of Nigeria Naira demanded in the foreign exchange market is the amount that traders play to buy during a given time period at a given price. The quantity depends on many factors as in the supply mentioned earlier on. People do not buy Naira because they enjoy them. The demand for Naira is a derived demand. People demand Naira so that they can buy Nigerian-made goods and services (Nigerian exports). They also demand Naira so that they can buy Nigerian assets such as bank accounts, bonds, stocks, businesses, and real estate.

Nevertheless, the law of demand applies to Naira just as it does to anything else that people want. Other things being equal, the higher the exchange rate, the smaller is the quantity of Naira demanded in the foreign exchange market.

3.11 Risks in International Trade

Companies doing business across international borders face many of the same risks as would normally be evident in strictly domestic transactions. For example, the following are typical of risks in international trade (Aggarwal, Reisman and Fuh, 1989):

- Buyer insolvency (purchaser cannot pay);
- Non-acceptance (buyer rejects goods as different from agreed upon specifications);
- Credit risk (allowing the buyer to take possession of goods prior to payment);
- Regulatory risk (e.g., a change in rules that prevents the transaction);
- Intervention (governmental action to prevent a transaction being completed);
- Political risk (change in leadership interfering with transactions or prices); and
- Natural catastrophes, freak weather and other uncontrollable and unpredictable events.

In addition to this, international trade also faces the risk of unfavourable exchange rate movements (and, the potential benefit of favourable movements).

3.12 International Financial Institutions

Wikipedia (2011) look at international financial institutions (IFIs) as financial institutions that have been established (or chartered) by more than one country, and hence are subjects of international law. Their owners or shareholders are generally national governments, although other international institutions and other organisations occasionally figure as shareholders. The most prominent IFIs are creations of multiple nations, although some bilateral financial institutions (created by two countries) exist and are technically IFIs. Many of these are multilateral development banks. The types of international financial institutions are as follows:

(1) Bretton Woods institutions
(2) Regional development banks
(3) Bilateral development banks and agencies
(4) Other regional financial institutions.

3.12.1 Bretton Woods institutions

The best-known IFIs were established after the Second World War to assist in the reconstruction of Europe provides mechanisms for international cooperation in managing the global financial system (Cf. Bretton Woods system). They include the International Bank for Reconstruction and Development (World Bank), the International Monetary Fund (IMF) and the International Finance Corporation (IFC).

Founded	Name	www. Address	Notes	Headquarters
1944	International Monetary Fund IMF)	http://www.imf.org.	Specialized agency of the United Nations	Washington DC
1944	International Bank for Reconstruction and Development (World Bank)	http://www.worldbank.org.	World Bank group specialized agency of the United Nations	Washington DC
1956	International Finance Corporation (IFC)	http://www.ifc.org.	World Bank group	Washington DC
1960	(IDA) International Development Association	http://www.worldbank.org/ida	World Bank group	Washington DC
1966	International Centre for Settlement of Investment Disputes (ICSID)	http://icsid.worldbank.org/ICSID/Index.jsp.	World Bank group	Washington DC
1988	(MIGA) Multilateral Investment Guarantee Agency	http://www.miga.org.	World Bank group	Washington DC
30/10/47	General Agreement on Tariffs and Trade, basis for the creation of World Trade Organisation (WTO) in 1995	http://www.wto.org/english/docs_e/legal_e/06-gatt_e.htm; http:///wto.org.	The GATT is not an organisation. The WTO is not a United Nations agency.	Geneva for the WTO

Source: http://en.wikipedia.org/wiki/International_financial_institutions (downloaded on 28 November, 2011)

The original idea in setting up the Bretton Woods Institutions (BWI) was to provide the finance for reconstructing Europe which was badly damaged during the first and second world wars as contained in the Marshall Plan. The aim could not be sustained in the face of membership by many poor countries emerging from colonized Asia, Latin America and Africa.

The group has its headquarters in Washington DC with offices in the world's financial centres like New York, Paris, London, Tokyo and Abuja. The group is called Bretton Woods Institutions because the agreement to set up the group was signed by 28 countries in Bretton Woods, New Hampshire in the United States of America in 1945.

The World Bank Group also forms the nucleus of modern day international monetary or financial system which raised the American dollar being the strongest and most popular currency after the Second World War, as the international unit of measurement of the currencies of sovereign states.

Hitherto, the standard was gold, which was ditched at the end of the First World War because gold was difficult to procure during the war. The gold standard required any currency printed to be linked to the value of the country's holding of gold reserves. Since gold was not available due to war ravages, many countries resorted to fiduciary
Issues, that is, paper currency not backed by gold. The development caused a great deal of inflation because money (the paper money) far exceeded the quantum price of available goods and services.

The American dollar took over the gold standard in 1944 at the Bretton Woods Conference. By this development, any country's currency had to be aligned in value to the dollar. The arrangement crashed in 1971 when many countries could not maintain the stipulated inflation rate necessary for the dollar parity. From that point, many countries abandoned the dollar standard and allowed their currencies to float in the exchange market.

3.12.2 Regional development banks

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

Founded	Name	www. Address	Notes	Headquarters
1959	(IDB) Interamerican Development Bank	http://www.IADB. org.	Works in the Americas, but primarily for development in Latin America and the	Washington DC

			Caribbean	
1964	(AFDB) African Development Bank	http://www.afdb.org.	Africa	Abidjan
1966	Asian Development Bank (ADB)	http://www.adb.org.	Asia	Manilla
29/5/91	European Bank for Reconstruction and Development (EBRD)	http://www.ebrd.com		London
16/4/56	(CEB) Council of Europe Development Bank	http://www.coebank.org.	Coordinated organisation	Paris
14/11/73	Banque oust-africaine de Développment West African Development Bank (BOAD)	http://www.boad.org.	Union économique et monétaire oust-africaine, Cf.BCEAO Banque centrale des États de l'Afrique de l'Ouest	Dakar
1975	BDEAC Banque de development des États de l'Afrique Centrale, DBCAS Development Bank of Central African States	http://www.bdeac.org.	Communaute economique et monetaire de l'Afrique centrale (CEMAC), Cf. BEAC Banque des États de l'Afrique centrale	Brazzaville, Congo

Source: http://en.wikipedia.org/wiki/International_financial_institutions (downloaded on 28 November, 2011)

3.12.3 Bilateral development banks and agencies

Bilateral development banks are financial institutions set up by individual countries to finance development projects in developing countries and emerging markets. Examples include:

- the Netherlands Development Financie Company FMO, Headquarters in The Hague, one of the largest bilateral development banks worldwide;
- the DEG German Investment Corporation or Deutsche Investitions-und Entwicklungsgesellschaft, a Development Bank; and
- the Agence Française de Développment, Caisse des dépôts.

3.12.4 Other regional financial institutions

Several regional groupings of countries have established international financial institutions to finance various projects or activities in areas of mutual interest. The largest and most import of these is the European Investment Bank.

Founded	Name	www. Address	Notes	Headquarters
1998	ECB European Central Bank	http://www.ecb.int.	The Bank of Central Banks	Frankfurt am Main
17/5/30	Banques des règlements internationaux / BIS Bank of International Settlements (BRI)	http://www.afdb.org.	Africa	Abidjan
1966	Asian Development Bank (ADB)	http://www.adb.org.	Asia	Manilla
29/5/91	European Bank for Reconstruction and Development (EBRD)	http://www.ebrd.com		London
16/4/56	(CEB) Council of Europe Development Bank	http://www.coebank.org.	Coordinated organisation	Paris
14/11/73	Banque oust-africaine de Développment West African Development Bank (BOAD)	http://www.boad.org.	Union économique et monétaire oust-africaine, Cf.BCEAO Banque centrale des États de l'Afrique de l'Ouest	Dakar
1975	BDEAC Banque de development des États de l'Afrique Centrale, DBCAS Development Bank of Central African States	http://www.bdeac.org.	Communaute economique et monetaire de l'Afrique centrale (CEMAC), Cf. BEAC Banque des États de l'Afrique centrale	Brazzaville, Congo

Source: http://en.wikipedia.org/wiki/International_financial_institutions (downloaded on 28 November, 2011)

Since financial markets are basically related to money lending and borrowing, the cost of money, and activities of financial intermediaries, the expansion and contraction of the international financial markets have generally been influenced by the following elements:

(1) natural and social circumstances;
(2) role of participants in the markets whether they are individuals, businesses, financial institutions, governments, or foreign citizens;
(3) development of money and credit instruments;
(4) the volume and price of transactions.

A financial institution is a business firm whose principal assets are financial assets or claims – stocks, bonds, and loans – instead of real assets, such as buildings, equipment, and raw materials. Financial institutions make loans available to customers or purchase investment securities in the financial marketplace. They also offer a wide variety of other financial services, ranging from insurance protection and the sale of retirement plans to the safekeeping of valuables and the provision of a mechanism for making payments, transferring funds, and storing financial information.

The companies and organisations which operate the financial markets are referred to as the financial institutions. They include the banks, insurance companies, stock exchange, security and exchange commission, mutual and financial trusts, etc. These are regarded as the national or local financial institutions which aided trade and commerce.

The international financial institutions are multinational or multilateral financial institutions which aided or stimulated the growth and sustenance of international trade and investment in order to enhance the world economy. These institutions include the World Bank, International Monetary Fund (IMF), African Development Bank, major insurance companies, brokerage firms, and offshore mutual funds, etc. Brief explanations of each of these institutions are made.

3.12.5 International Bank for Reconstruction and Development (World Bank)

It is more popularly known as the World Bank. It stands as the parent body in the World Bank group of banks made up of IBRD, IFC and IDA. Membership is open to any sovereign state, who is already a member of the International Monetary Fund (IMF).

The fundamental difference between IBRD and IMF (Ezesobor, 2009) is that while IBRD grants long-term project loans for core developments in construction, agriculture, water supply, electricity, mining, trade etc. essentially to fight poverty, IMF steps in to provide needed short-term and medium-term funds especially in the balance of payments.

IBRD grants loans to governments or to organisations having their government's guarantee. Loans span over 20 years with 5 years of grace. Like any street bank, IBRM does not sponsor a project 100 percent but expects the borrower to provide some stake of up to 50 percent in the proposed project. Its assistance could also be in the form of consultancy or technical assistance in conducting economic survey or providing expertise. Some of the loans entail the provision of heavy duty equipment which provides juicy export market for American manufacturers.

Largely, the bank's objectives are as follows:

(i) to assist in the reconstruction and development in member countries through project-tied loans;

(ii) to encourage international investments for long-term growth in international trade;

(iii) to attend to the urgent sectoral needs of any country in its loan disbursement.

The bank was designed to pool, borrow, and channel long-term funds from member nations and the major financial markets to the less developed countries.

3.12.6 International Development Association (IDA)

It was established in 1960 by the World Bank to attend to loan requests from poor countries which ordinarily, cannot access loans at conventional servicing rates. Such poor countries were defined as countries with gross national product of US$730 or less.

Interest rates for such loans are usually much lower than the rate of the World Bank and in some circumstances, free of interest provided the loans are guaranteed by the home government.

The Association is managed by staff members of the World Bank although as a separate entity.

3.12.7 International Finance Corporation (IFC)

It was set up in July, 1956 as an affiliate of the World Bank to provide finance to the private sector which will contribute to the development of its member countries provided as stated in the Corporation's pamphlet titled 'How to Work with IFC':

- The project must be located in a developing country, which is a member of IFC;
- It must be in the private sector;
- It must be technically sound;
- It must have a good prospect of being profitable;
- It must be environmentally and socially sound, satisfying IFC environment and social standards as well as those of the host country.

Apart from this core function of project finance, it also offers advisory and technical services to private businesses and governments in developing countries in areas like privatization, business-related public policy and industry-specific issues. The other area of assistance to developing countries is in resource mobilization by helping them to tap into international capital market through investment funds, underwriting, securitization, private placement and other innovative approaches.

3.12.8 International Centre for Settlement of Investment Disputes

It was established in 1966 in Washington as an impartial international agency to remove major impediments to the free flow of international private investments posed by non-commercial risks in the absence of specialized international methods for investment dispute settlement.

The Centre does this noble job by means of conciliation or arbitration at the mutual consent of the eligible parties who are usually private investors and sovereign States. This way, it reduces the investment risks that inhibit foreign direct investments.

It is regarded as an agent of the World Bank Group because the convention that set it up was formulated by the Executive Directors of the World Bank.

There are currently 155 signatory States to the ICSID Convention worldwide (Esezobor, 2009).

3.12.9 Multilateral Investment Guarantee Agency (MIGA)

It was set up under the auspices of the World Bank Group in 1988 to provide insurance or guarantee against certain types of risks including political risks primarily to the private sector.

In essence, it promotes foreign direct investments in emerging economies by providing the guarantee and access to the latest technology and bet practices to establish businesses that can improve the lives of local people. Such guarantees have paved the way for the establishment of businesses by foreign investors in countries that would not have had the opportunities e.g. the construction of expressways with tollgates.

Its services will surely increase during the prevailing global financial crises to help paralyzed financial sectors and ensure well-functioning private sectors.

3.12.10International Monetary Fund (IMF)

The international monetary fund on the other hand serves as the bank for international settlements between various countries involved in international trade by way of assisting countries with deficit balance of payments to settle their international commitments through provision of short-term facilities or reduction in their foreign exchange reserves. The IMF is designed to specifically to assist in contributing significantly to the flow of funds in international money and capital markets.

It was one of the recommendations of the Bretton Woods Conference in 1944. it is a distinct institution from the World Bank.

Its primary function is to provide short-term to medium-term finance to correct temporary difficulties in the balance of payments of any member country; be it a developed country or a poor one without discrimination. It also provides long-term support for adjustment and reform policies aimed at correcting the underlying economic problems.

Article 1 of the Articles of Agreement that set it up enunciated as its objectives, the following:

(i) to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems;

i. to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high level of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy;

ii. to promote exchange rate stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation;

iii. to assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade;

iv. to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in the balance of payments without resorting to measures destructive to national or international prosperity;

v. in accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

3.12.11London Clubs

The club is a cartel of international commercial banks which handles private debts and other commercial debts and operates strictly on commercial terms. They are thus stricter in terms than the Paris Club of Creditors.

Like the latter, the Club also insists on some form of adjustment program moderated by IMF before doing business or before the end of the consolidation period. The common terms for re-scheduling according to IMF Report (1983, quoted in Esezobor, 2009) are as follows:

- Loans falling due over the next one to two years with a short moratorium on arrears.
- 80 percent (though in some cases less) of the debt during the consolidation period and in some cases, the entire amount.
- Interest rate linked to the three to six month London interbank rate for the US$ or the US prime rate (in the case of dollar dominated debt).
- And since 1978, banks almost always require the debtor countries to have an adjustment program with the fund (IMF) before negotiations begin or before the end of the consolidation period.

The London Club debts are largely private trade debts and have two components, namely:

1. Promissory Notes consolidated in January, 1984.
2. Brady Par Bond collateralized with US Treasury bonds, issued during the January, 1992 Agreement.

Default carries stiff consequences like attack on the assets of CBN or NNPC anywhere in the world because Nigeria graciously agreed to waive its sovereign immunity under the terms of the re-scheduling agreement.

Nigeria exited from the London Club of Creditors in the first week of April, 2007 with the payment of US$82 million to repurchase oil warrants amounting to 369,154 at a repurchase price of US$220 per unit. Citigroup Global Markets Limited handled the payments through the Dutch Auction System. Nigeria saved US$34 million in the process.

3.12.12Paris Clubs

It is an informal group of creditor countries with no permanent members who meet to negotiate debt re-scheduling for borrowing countries. Such debts are usually guaranteed by various Export Credit Agencies of the creditor countries. The Club rose from an attempt by a few countries who in 1956, were having difficulties in re-scheduling their individual loans to Argentina. Since the city of Paris provided the forum for the meeting and subsequent similar meetings, the cartel of creditors became known as Paris Club of Creditors.

In their meetings, always informal and decisions taken by consensus, a senior official of the French Treasury presides. The French Treasury also provides the secretariat for the Club. Invited to any meeting for debt re-scheduling with any debtor country are the following as observers:

- The World Bank
- European Union
- International Monetary Fund
- Organisation for Economic Cooperation and Development
- United Nations Conference on Trade and Development

The presence of these organisations ensures reasonable considerations especially for debt-ridden third world countries. Such considerations are often in the form of IMF approved conditionalities founded on Medium Term Economic Strategy (MTES) which Nzotta (1999 quoted in Esezobor, 2009) explained as:

- Reduction of budget deficits, fiscal viability and fiscal discipline.
- Growth and poverty reduction measures.
- Deregulation of interest rates, exchange rates and money markets.
- Removal of subsidies (fuel and fertilizer).
- Complete privatization and commercialization of various public enterprises (NEPA, NITEL, NNPC, Fertiliser Distribution).
- Trade liberalization.

In April, 2006, Nigeria paid off its debt of US$12.214 billion in three tranches after a waiver of US$18 billion under the Olusegun Obasanjo regime. Until then, Nigeria was indebted to the following 15 Paris Club countries:

(1) Austria
(2) United States of America

(3) Switzerland
(4) Germany
(5) Denmark
(6) Italy
(7) Netherlands
(8) Japan
(9) United Kingdom
(10) Spain
(11) Israel
(12) France
(13) Belgium
(14) Russia
(15) Finland

3.12.13African Development Bank

This bank was established on 10th September, 1964 after the meeting of Ministers of Finance in Africa took the recommendation of the United Nations Economic Commission for Africa (ECA) that such a bank was overdue in accelerating the economic development of the African continent.

It commenced operation in July, 1996 with head office in Abidjan, Cote d'Ivoire.

The bank's principal functions are as follows:

(1) to make loans and equity investments for the economic and social advancement of the Regional Member Countries (RMC);

(2) to provide technical assistance for the preparation and execution of development projects and programs;

(3) to promote investment of public and private capital for development purposes;

(4) to respond to requests for assistance in coordinating development policies and plans of RMCs. In its operations, the bank is also required to give special attention to national and multinational projects and programs which promote regional integration.

The Bank's loans are tied to specific projects in major sectors like agriculture, public utilities, transportation, electrification and poverty alleviation endeavours. The maturity tenor for its loans ranges up to 20 years including 5 years grace period. Its interest rate is adjusted twice a year; in January and July to reflect the average cost of funds.

The apex authority is the Board of Governors that approves all loans, guarantees, equity investments and borrowings. It also sets the operational and financial policies as well as the guidelines for borrowing.

Egypt currently has the highest voting power as the highest subscriber of the bank's capital followed by Morocco and Nigeria. In 1982, membership was extended to non-African countries without compromising the "Africanness" of the bank, which is primarily to support the poor countries in Africa. The Presidency of the bank was still retained for Africa while African members retained two thirds of the voting rights.

For purposes of loans, African states were categorised in 1984 into groups A, B and C with group A, the focus of financial assistance. Countries in group A, have per capita income of US$510 or less while countries in group B, have per capita income of between US$511 and US$900. Group C countries have per capita income of over US$900. Interest rates on loans are understandably generally low, between 9.5 percent and 10 percent to make meaningful, financial support for infrastructural developments in poor African countries.

The bank pools its funds from the following sources:

(i) Contributions in capital from member countries;
(ii) Loans and floating of bonds in the international capital market;
(iii) Loans from Bretton Woods Institutions like IBRD, IMF and IFC;
(iv) Tenor placements by international institutions;
(v) Proceeds of interest on loans granted;
(vi) Proceeds of interest on investments in multilateral institutions an Central Banks of member states;
(vii) Bad debts recovered; and
(viii) Solidarity aids and gifts from members and other international bodies.

4.0 CONCLUSION

The overview of international trade was discussed and it was noted that the motivation and the behaviour of parties involved in a trade do not change fundamentally regardless of whether trade is across a border or not.

5.0 SUMMARY

In this unit, we have:

- defined international trade or international business or foreign trade;
- differentiated between domestic and international/foreign trades;
- enumerated the benefits of international trade;
- described the absolute and comparative advantage;
- discussed the meaning of balance of trade and balance of payment;
- explained the concept of foreign exchange;
- described how international trade is finance;
- listed the functions of the risks involve din international trade;
- enumerated and discuss the financial institutions which aids international trade.

In the next unit, you will be introduced to another interesting topic, methods of entry into overseas markets.

6.0 TUTOR MARKED ASSIGNMENT

1. The concepts International Trade, Foreign Trade and International Business are all the same thing. How true is this statement? List the benefits accrued to countries who engage in this form of business.

2. List the international financial institutions you know and discuss briefly the functions perform by each of them.

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UNIT 2 METHOD OF ENTRY INTO OVERSEAS MARKETS

Table of Contents

1.0 INTRODUCTION

In the last unit, we discussed an overview of international trade and this discussion revolved around the concept of international trade, differences between domestic and international trade, benefits of international trade and many others.

In this unit, our discussion will focus on modes of entry into foreign exchange market. The unit will begin by examining the concept of market entry strategies within the control of a chosen marketing mix. It goes to describe the different forms of entry strategy (both direct and indirect exporting and foreign production), and the advantages as well as disadvantages connected with each method. This unit also gives specific details on "counter trade", which is very prevalent in global marketing, and then concludes by looking at the special features of commodity trading with its "close coupling" between production and marketing.

2.0 OBJECTIVES

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

- define the concept of market entry strategies;
- examine the concept within the control of a chose marketing mix;
- describe the different forms of entry;
- the advantages of the methods of entry;
- disadvantages of the methods of entry;
- define and discuss the concept counter trade;
- explain the special features of commodity trading.

3.0 MAIN CONTENT

When a firm or group of firms decides to make inroad or enter into an overseas market, there are a number of options open to them. These options vary with cost, risk and the degree of control which can be exercised over them. The simplest form of entry strategy is exporting using either a direct or indirect method such as agent, in the case of the former or counter trade, in the case of the latter. More complex forms include truly global operations which may involve joint ventures, or export processing zones.

Once a decision has been taken on the form of export strategy, there is need to decide on the specific channels. Many agricultural products of a raw or commodity nature use agents, distributors or involve Government, whereas processed materials (whilst not excluding these), rely more heavily on more sophisticated forms of access.

3.1 Entry into Foreign Market: Basic Issues Involved

The decision of how to enter a foreign market can have a significant impact on the results. An organisation wishing to "go international" faces three major issues:

(i) **Marketing –** there is need to provide answers to the following questions:

- (a) Which countries to enter?
- (b) Which segments of the market to enter?
- (c) How to manage and implementing marketing effort?
- (d) How to enter – whether to involve intermediaries or go in directly?
- (e) What information would assist the firm to successfully enter into the market?

(ii) **Sourcing –** whether to obtain products, make or buy?

(iii) **Investment and Control –** whether to involve in a joint venture or global partner, or acquisition another business in the foreign country?

In making international marketing decisions on the marketing mix, more attention to detail is required than in domestic marketing. Decisions in the marketing area focus on the value chain. The strategy or entry alternatives must ensure that the necessary value chain activities are performed and integrated. For details on the value chain, see table 2.1 below:

Table 2.1 Examples of Elements included in the Export Marketing Mix

Product Support	Price Support	Promotion/Selling Support	Inventory Support	Distribution Support	Service Support	Financial Support
- Product sourcing - Match existing products to markets (air, sea, rail, road, freight) - New products - Product management - Product testing - Manufacturing specifications - Labelling - Packaging - Production control - Market information	- Establishment of prices - Discounts - Distribution and maintenance of pricelists\ - Competitive information - Training of agents/customers	- Advertising - Promotion - Literature - Direct mail - Exhibitions, trade shows - Printing - Selling (direct) - Sales force - Agents commissions - Sale or returns	- Inventory management - Warehousing - Distribution - Parts supply - Credit authorization	- Funds provision - Raising of capital - Order processing - Export preparation and documentation - Freight forwarding - Insurance - Arbitration	- Market information/ intelligence - Quotes processing - Technical aid assistance - After sales - Guarantees - Warranties/ claims - Merchandising - Sales reports, catalogues literature - Customer care - Data processing systems - Insurance - Tax services - Legal services - Translation	- Billing, collecting invoices - Hire, rentals - Planning, scheduling budget data - Auditing

Source: Keegan, W.J. (1989). "Global Marketing Management", 4th edition, Prentice Hall International Editions (quoted in http://www.fao.org/docrep/W5973E/w5973e0b.htm).

Cumming (1986) identified and enumerated five strategies used for entry into new foreign markets. They are:

b. Technical innovation strategy – perceived and demonstrable superior products;
c. Product adaptation strategy – modifications to existing products;
d. Availability and security strategy – overcome transport risks by countering perceived risks;
e. Low price strategy – penetration price; and
f. Total adaptation and conformity strategy – foreign producer gives a straight copy.

In marketing products from less developed countries to developed countries, point (c) poses major problems. Buyers in the interested foreign country are usually very careful as they perceive transport, currency, quality and quantity problems. This is true, say, in the export of cotton, cocoa and other commodities.

Because, in most agricultural commodities, production and marketing are interlinked, the infrastructure, information and other resources required for building market entry can be enormous. Sometimes, this is way beyond the scope of private organisations, so Government may get involved. It may get involved not just to support a specific commodity, but also to help the "public good". Whilst the building of a new road may assist the speedy and expeditious transport of vegetables, for example, and thus aid in their marketing, the road can be put to other uses, in the drive for public good utilities. Moreover, entry strategies are often market by "lumpy investments". Huge investments may have to be undertaken, with the investor paying a high risk price, long before the full utilization of the investment comes. Good examples of this include the building of port facilities or food processing or freezing facilities. In addition, the equipment may not be able to be used for other processes, so the asset specific equipment, locked into a specific use, may make the owner very vulnerable to the bargaining power of raw material suppliers and product buyers who process alternative production or trading options. Nigeria experiences such problem in the exportation of its cassava flour to China. The Chinese buyers often provide the type quality required and if that quality cannot be met by the Nigerian exporter, he would be forced to accept whatever price is proposed by the Chinese importer.

In building a market entry strategy, time is a crucial factor. The building of an intelligence system and creating an image through promotion takes time, effort and money. Brand names do not appear overnight. Large investments in promotion campaigns are needed. Transaction costs also are a critical factor in building up a market entry strategy and can become a high barrier to international trade. Costs include search and bargaining costs. Physical distance, language barriers, logistics costs and risk limit the direct monitoring of trade partners. Enforcement of contracts may be costly and weak legal integration between countries makes things difficult. Also, these factors are important when considering a market entry strategy. In fact, these factors may be so costly and risky that Governments, rather than private individuals, often get involved in commodity systems. This can be seen in the operation of upstream and downstream oil and gas sector. The government is involved through the Nigerian National Petroleum

Corporation (NNPC) because of the enormous cost involved and the other logistics mentioned above. With a monopoly export marketing board, the entire system can behave like a single firm, regulating the mix and quality of products going to different markets and negotiating with transporters and buyers. Whilst the Corporation can experience economies of scale and absorb many of the risks listed above, they can shield producers from information about, and from buyers. They can also become the "fiefdoms" of vested interests and become political in nature. This position particular suits the present situation in Nigerian when NNPC is being used as a cover to conceal certain information or facts in order to aid government's desire to remove fuel subsidy in the country. For instance, before the close down of marketing boards in Nigeria, they have become menace to the producers of agricultural commodities such as cocoa, cotton, etc. They then result in giving reduced production incentives and cease to be demand or market oriented, which is detrimental to producers.

Normal ways of expanding the markets are by expansion of product line, geographical development or both. It is important to note that the more the product line and/or the geographic area are expanded the greater will be the managerial complexity. New market opportunities may be made available by expansion but the risks may outweigh the advantages, in fact, it may be better to concentrate on a few geographic areas and do things well. This is typical of the horticultural industry of Kenya an Zimbabwe. Traditionally, these have concentrated on European markets where the markets are well known. Ways to concentrate include concentrating on geographic areas, reducing operational variety (more standard products) or making the organisational form more appropriate. In the latter case, attempt is made to "globalize" the offering and the organisation to match it. This is true of organisations like Coca Cola and MacDonald's. Global strategies include "country-centred" strategies (highly decentralized and limited international coordination), "local market approaches" (the marketing mix developed with the specific local (foreign) market in mind) or the "lead market approach" (develop a market which will be a best predictor of other markets). Global approaches give economies of scale and the sharing o costs and risks between markets.

Self Assessment Exercise 2.1

Briefly discuss the basic issues involved in entry into foreign market.

3.2 Entry Strategies

There are a variety of ways in which organisations can enter foreign markets. The three main ways are by direct or indirect export or production in a foreign country:

(1) Exporting
(2) Piggybacking
(3) Counter Trade
(4) Foreign Production
(5) Licensing
(6) Joint Ventures

(7) Export Processing Zones

3.2.1 Exporting

Exporting is the most traditional and well established form of operating in foreign markets. Exporting can be defined as the marketing of goods produced in one country into another. Whilst no direct manufacturing is required in an overseas country, significant investments in marketing are required. The tendency may be not to obtain as much detailed marketing information as compared to manufacturing in marketing country; however, this does not negate the need for a detailed marketing strategy.

Organisations are faced with a number of strategy alternatives when deciding to enter foreign markets. Each one has to be carefully weighed in order to make the most appropriate choice. Every approach requires careful attention to marketing, risk, matters of control and management. A systematic assessment of the different entry methods can be achieved through the use of a matrix shown in the table below:

Table 2.2 Matrix for Comparing Alternative Methods of Market Entry

Entry mode								
Evaluation criteria	**Indirect export**	**Direct export**	**Marketing subsidiary**	**Counter trade**	**Licensing**	**Joint venture**	**Wholly owned operation**	**EPZ**
Company goals								
Size of Company								
Resources								
Product								
Remittance								
Competition								
Middlemen characteristics								
Environmental Characteristics								
Number of Markets								
Market								
Market feedback								
International marketing learning								
Control								
Marketing costs								
Profits								

Investment								
Administration personnel								
Foreign problems								
Flexibility								
Risk								

Source: Keegan, W.J. (1989). "Global Marketing Management", 4th edition, Prentice Hall International Editions (quoted in http://www.fao.org/docrep/W5973E/w5973e0b.htm).

The advantages of exporting are:

- manufacturing is home based thus, it is less risky than overseas-based;
- gives an opportunity to "learn" overseas markets before investing in bricks and mortar;
- reduces the potential risks of operating overseas.

The disadvantage is mainly that one can be at the "mercy" of overseas agents and so the lack of control has to be weighed against the advantages. For example, in the exporting of African horticultural products, the agents and Dutch flower auctions are in a position to dictate to producers.

A distinction has to be drawn between passive and aggressive exporting. A passive export awaits orders or comes across them by chance; an aggressive exporter develops marketing strategies which provide a broad and clear picture of what the firm intends to do in the foreign market. Pavord and Bogart (1975) found significant differences with regard to the severity of exporting problems in motivating pressures between seekers and non-seekers of export opportunities. They distinguished between firms whose marketing efforts were characterized by no activity, minor activity and aggressive activity.

According to them, those firms who are aggressive have clearly defined plans and strategy, including product, price, promotion, and distribution and research elements. Passiveness versus aggressiveness depends on the motivation to export. In countries like Tanzania and Zambia, which have embarked on structural adjustment programmes, organisations are being encouraged to export, motivated by foreign exchange earnings potential, saturated domestic markets, growth and expansion objectives, and the need to repay debts incurred by the borrowings to finance the programmes. The type of export response is dependent on how the pressures are perceived by the decision maker. Piercy (1982) highlights the fact that the degree of involvement in foreign operations depends on "endogenous versus exogenous" motivating factors, that is, whether the motivations were as a result of active or aggressive behaviour based on the firm's internal situation (endogenous) or as a result of reactive environmental changes (exogenous).

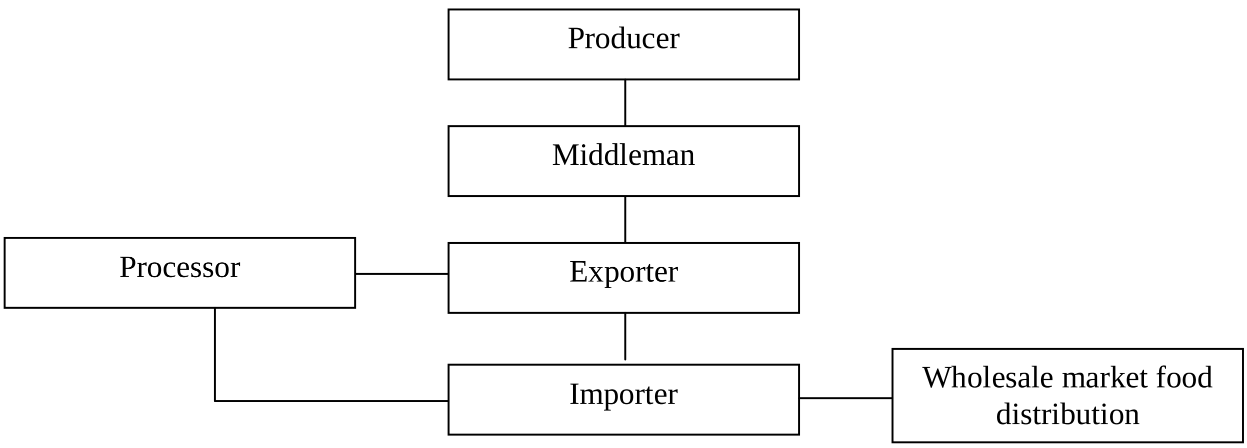
If the firm achieves initial success at exporting quickly all the good, but the risks of failure in the early stages are high. The "learning effect" in exporting is usually very quick. The key is to learn how to minimize risks associated with the initial stages of market entry and commitment – this process of incremental involvement is called "creeping commitment". See example of this in table 2.3 below.

Exporting methods include direct or indirect export. In direct exporting, the organisation may use an agent, distributor, or overseas subsidiary, or act via a Government agency. In effect, the Grain Marketing Board in Zimbabwe, being commercialized but still having Government control, is a Government agency. The Government, via the Board, is the only permitted maize exporters. Bodies like the Horticultural Crops Development Authority (HCDA) in Kenya may be merely a promotional body, dealing with advertising, information flows and so on, or it may be active in exporting itself, particularly giving approval (like HCDA does) to all export documents.

In directing exporting, the major problem is that of marketing information. The exporter's task is to choose a market, find a representative or agent, set up the physical distribution and documentation, promote and price the product. Control, or the lack of it, is a major problem which often results in decisions on pricing, certification and promotion being in the hands of others. Certainly, the phytosanitary requirements in Europe for horticultural produce sourced in Africa are getting very demanding. Similarly, exporters are price takers as produce is sourced also from the Caribbean and Eastern countries. In the months June to September, Europe is "on season" because it can grow its own produce, so prices are low. As such, producers are better supplying to local food processors. In the European winter, prices are much better, but product competition remains.

According to Collett (1991), exporting requires a partnership between exporter, importer, government and transport. Without these four coordinating activities, the risk of failure is increased. Contracts between buyer and seller are a must. Forwarders and agents can play a vital role in the logistics procedures such as booking air space and arranging documentation. A typical coordinated marketing channel for the export of Kenyan horticultural produce is given in table 2.4 below.

Table 2.4: The Export Marketing Channel for Kenyan Horticultural Products



Exporting can be very lucrative, especially if it is of high value added produce. For example, in 1992/1993, Zimbabwe exported 5,338.38 tonnes of flower, 4,678.18 tonnes of horticultural produce and 12,000 tonnes of citrus at a total value of about US$22,016.56 million. In some cases, a mixture of direct and indirect exporting may be achieved with mixed results. For example, the Grain Marketing Board of Zimbabwe may export grain directly to Zambia, or may sell it to a relief agency like the United Nations, for feeding the Mozambican refugees in Malawi. Payment arrangements may be different for the two transactions.

It is interesting to note that Korey (1986) warned that direct modes of entry may be less and less available in the future. Growing trading blocks like the European Union (EU) or EFTA means that the establishment of subsidiaries may be one of the only ways forward in future. Indirect methods of exporting include the use of trading companies (very much used for commodities like cotton, soya, cocoa), export management companies, piggybacking and counter trade.

(a) Piggybacking

Piggybacking is an interesting development. The method means that organisations with little exporting skill may use the services of one that has. Another form is the consolidation of orders by a number of companies in order to take advantage of bulk buying. Normally these would be geographically adjacent or able to be served, say, on an air route.

The fertilizer manufacturers of Zimbabwe, for example, could piggyback with the South Africans who both import potassium from outside their respective countries.

(b) Counter Trade

By far the largest indirect method of exporting is counter trade. Competitive intensity means more and more investment in marketing. In this situation, the organisation may expand operations by operating in markets where competition is less intense but currency based exchange is not possible. Also, countries may wish to trade in spite of the degree of competition, but currency again is a problem. Counter trade can also be used to stimulate home industries or where raw materials are in short supply. It can, also, give a basis for reciprocal trade like what took place in 1984 during the military regime of Buhari/Idiagbon in order to free Nigeria from its debt overhang inherited from the Shagari civilian administration in December, 1983. Counter trade is the modern form of barter, except that the contracts are not legal and it is not covered by the General Agreement on Tariff and Trade (GATT). It can be used to circumvent import quotas.

Counter trade can take many forms. Basically, two separate contracts are involved, one for the delivery of and payment for the goods supplied and the other, for the purchase of and payment for the goods imported. The performance of one contract is not contingent on the other although the seller is in effect accepting products and services from the importing country in partial or total settlement for his exports. There is a broad agreement that counter trade can take various forms of exchange like barter, counter purchase, switch trading and compensation (buyback). For example, in 1986, Albania began offering items like spring water, tomato juice and chrome ore in exchange for a contract to build a US$60 million fertilizer and methanol complex. Information on potential exchange can be obtained from embassies, trade missions or the European Union trading desks.

Barter is the direct exchange of one good for another, although valuation of respective commodities is difficult, so a currency is used to underpin the item's value.

Barter trade can take a number of formats. Simple barter is the least complex and oldest form of bilateral, non-monetarised trade. Often it is called "straight", "classical" or "pure" barter. Barter is a direct exchange of goods and services between two parties. Shadow prices are approximated for products flowing in either direction. Generally, no middlemen are involved. Usually, contracts for no more than one year are concluded, however, if for longer life spans, provisions are included to handle exchange ratio fluctuations when world prices change.

Closed end barter deals are modifications of straight barter in that a buyer is found for goods taken in barter before the contract is signed by the two trading parties. No money is involved and risks related to product quality are significantly reduced.

Clearing account barter, also termed clearing agreements, clearing arrangements, bilateral clearing accounts or simply bilateral clearing, is where the principle is for the trades to balance without either party having to acquire hard currency. In this form of barter, each party agrees in a single contract to purchase a specified and usually equal value of goods and services. The duration of these transactions is commonly one year, although occasionally they may extend over a longer time period. The contract's value is expressed in non-convertible, clearing account units (also termed clearing dollars) that effectively represent a line of credit in the central bank of the country with no money involved.

Clearing account units are universally accepted for the accounting of trade between countries and parties whose commercial relationships are based on bilateral agreements. The contract sets forth the goods to be exchanged, the rates of exchange, and the length of time for completing the transaction. Limited export or import surpluses may be accumulated by either party for short periods. Generally, after one year's time, imbalances are settled by one of the following approaches: credit against the following year, acceptances of unwanted goods, payment of a previously specified penalty or payment of the difference in hard currency.

Trading specialists have also initiated the practice of buying clearing dollars at a discount for the purpose of using them to purchase saleable products. In turn, the trader may forfeit a portion of the discount to sell these products for hard currency on the international market. Compared with simple barter, clearing accounts offer greater flexibility in the length of time for drawdown on the lines of credit and the types of products exchanged.

Counter purchase, or buyback, is where the customer agrees to buy goods on condition that the seller buys some of the customer's own products in return (compensatory products). Alternatively, if exchange is being organised at national government level, then the seller agrees to purchase compensatory goods from an unrelated organisation up to a pre-specified value (offset deal). The difference between the two is that contractual obligations related to counter purchase can extend over a longer period of time and the contract requires each party to the deal to settle most or all of their account with currency or trade credits to an agreed currency value.

Where the seller has no need for the item bought, he may sell the produce on, usually at a discounted price, to a third party. This is called switch deal. In the past, a number of tractors have been brought into Zimbabwe from East European countries by switch deals.

Compensation (buybacks) is where the supplier agrees to take the output of the facility over a specified period of time or to a specified volume as payment. For example, an overseas company may agree to build a plant in Zambia, and output over an agreed period of time or agreed volume of produce is exported to the builder until the period has elapsed. The plant then becomes the property of the home country, Zambia.

Khoury (1984) categorises counter trade as follows in figure 2.5 below:

One problem is the marketability of products received in counter trade. This problem can be reduced by the use of specialized trading companies which, for a fee ranging between 1 and 5 percent of the value of the transaction, will provide trade related services like transportation, marketing, financing, credit extension, etc. These are ever growing in size.

Counter trade has the following disadvantages:

- It is not covered by GATT so "dumping" may occur;
- Quality is not of international standard so costly to the customer and trader;
- Variety is low so marketing of the product is limited;
- Difficult to set prices and service quality;

- Inconsistency of delivery and specification;
- Difficult to revert to currency trading – so quality may decline further and therefore product is harder to market.

To work round the above demerits of counter trade, Shipley and Neale (1988) suggested the following:

- Ensure the benefits outweigh the disadvantages;
- Try to minimize the ratio o compensation goods to cash – if possible inspect the goods for specifications;
- Include all transactions and other costs involved in counter trade in the nominal value specified for the goods being sold;
- Avoid the possibility of error of exploitation by first gaining a thorough understanding of the customer's buying systems, regulations and politics;
- Ensure that any compensation goods received as payment are not subject to import controls.

3.2.2 Foreign Production

Besides exporting, other market entry strategies include licensing, joint ventures, contract manufacture, ownership and participation in export processing or free trade zones.

(a) Licensing

Licensing is defined as "the method of foreign operation whereby a firm in one country agrees to permit a company in another country to use the manufacturing, processing, trademark, know-how or some other skill provided by the licensor". It is quite similar to the "franchise" operation. Coca Cola is an excellent example of licensing. In Zimbabwe, United Bottlers have the license to make Coke.

Licensing involves little expense and involvement. The only cost is signing the agreement and policing its implementation. License gives the following advantages:

- good way to start in foreign operations and open the door to low risk manufacturing relationships;
- linkage of parent and receiving partner interests means both get most out of marketing effort;
- capital not tied up in foreign operation; and
- options to buy into partner exist or provision to take royalties in stock.

The disadvantages are:

- limited form of participation – to length of agreement, specific product, process or trademark;
- potential returns from marketing and manufacturing may be lost;

- partner develops know-how and so license is short;
- licensees become competitors – overcome by having cross technology transfer deals; and
- requires considerable fact finding, planning, investigation and interpretation.

Those who decide to license ought to keep the options open for extending market participation. This can be done through joint ventures with the licensee.

(b) Joint Ventures

Joint ventures can be defined as “an enterprise in which two or more investors share ownership and control over property rights and operations”. Joint ventures are a more extensive form of participation than either exporting or licensing. In Zimbabwe, Olivine industries have a joint venture agreement with H.J. Heinz in food processing.

Joint ventures give the following advantages:

- sharing of risk and ability to combine the local in-depth knowledge with a foreign partner with know-how in technology or process;
- joint financial strength;
- may be only means of entry; and
- may be the source of supply for a third country.

They also have disadvantages which are listed below:

- partners do not have full control of management;
- may be impossible to recover capital if need be;
- disagreement on third party markets to serve; and
- partners may have different views on expected benefits.

If the partners carefully map out in advance what they expect to achieve and how, then many problems can be overcome.

Ownership: The most extensive form of participation is 100 percent ownership and this involves the greatest commitment in capital and managerial effort. The ability to communicate and control 100 percent may outweigh any of the disadvantages of joint ventures and licensing. However, as mentioned earlier, repatriation of earnings and capital has to be carefully monitored. The more unstable the environment the less likely is the ownership pathway an option.

These forms of participation: exporting, licensing, joint ventures or ownership, are on a continuum rather than discrete and can take many formats. Anderson and Coughlan (1987) summarize the entry mode as a choice between companies owned or control methods – “integrated” channels – or “independent” channels. Integrated channels offer the advantages of planning and control of resources, flow of information, and faster market penetration, and are a visible sign of commitment. The disadvantages are that they incur many costs (especially marketing), the risks are high, some may be more effective than others (due to culture) and in some cases their credibility amongst locals may be lower than that of controlled independents. Independent channels offer lower performance costs, risks, less capital, high local knowledge and credibility. Disadvantages include less market information flow, greater coordinating and control difficulties and motivational difficulties. In addition, they may not be willing to spend money on market development and selection of good intermediaries may be difficult as good ones are usually taken up anyway.

Once in a market, companies have to decide on a strategy for expansion. One may be to concentrate on a few segments in a few countries – typical are cashew nuts from Tanzania and horticultural exports from Zimbabwe and Kenya – or concentrate on one country and diversify into segments. Other activities include country and market segment concentration – typical of Coca Cola or Gerber baby foods, and finally country and segment diversification. Another way of looking at it is by identifying three basic business strategies: stage one – international, stage two – multinational (strategies correspond to ethnocentric and polycentric orientations respectively) and stage three – global strategy (corresponds with geocentric orientation). The basic philosophy behind stage one is extension of programmes and products, behind stage two is decentralization as far as possible to local operators and behind stage three is an integration which seeks to synthesise inputs from world and regional headquarters and the country organisation. Whilst most developing countries are hardly in stage one, they have within them organisations which are in stage three. This has often led to a "rebellion" against the operations of multinationals, often unfounded.

(c) Export Processing Zones

Whilst not strictly speaking an entry-strategy, EPZs serve as an "entry" into a market. They are primarily an investment incentive for would-be investors but can also provide employment for the host country and the transfer of skills as well as provide a base for the flow of goods in and out of the country. One of the best examples is the Mauritian EPZ founded in the 1970s, Lagos Free Trade Zone founded in 2009, etc.

Self Assessment Exercise 2.2

What are the advantages and disadvantages of barter, counter trade, licensing, joint venture and export processing zones as market entry strategies?

3.3 Special Features of Commodity Trade

As has been pointed out earlier, the international marketing of agricultural products is a "close coupled" affair between production and marketing and end user. Certain characteristics can be identified in market entry strategies which are different from the marketing of say cars or television sets. These refer specifically to the institutional arrangements of linking producers and processors/exporters and those between exporters and foreign buyers/agents.

3.3.1 Institutional Links between Producers and Processors/Exporters

One of the most important factors is contract coordination. Whilst many of the details vary, most contracts contain the supply of credit/production inputs, specifications regarding quantity, quality and timing of producer deliveries and a formula or price mechanism. Such arrangements have improved the flow of money, information and technologies, and very importantly, shared the risk between producers and exporters.

Most arrangements include some form of vertical integration between producers and downstream activities. Often processors enter into contracted outgrower arrangements or supply raw inputs. This institutional arrangement has now, incidentally, spilled over into the domestic market where firms are wishing to target higher quality, higher priced segments.

Producer trade associations, boards or cooperatives have played a significant part in the entry strategies of many exporting countries. They act as a contact point between suppliers and buyers, obtain vital market information, liaise with Governments over quotas etc. and provide information, or even get involved in quality standards. Some are very active, witness the Horticultural Crops Development Authority (HCDA) of Kenya and the Citrus Marketing Board (CMD) of Israel, the latter being a Government agency which specifically got involved in supply quotas. An example of the institutional arrangements involved is given in the table below.

Table 2.3: Institutional arrangements linking Producers with Processors/Exporters

Commodity	Market coordination	Contract coordination	Ownership interaction	Association coordination	Government coordination	Marketing risk reduction
Kenya vegetables	X	X	X			X
Zimbabwe horticulture	X			X	X	X
Israel fresh fruits						
Thailand tuna		XX		X	X	X
Argentina beef		X		X		X

Key: XX = Dominant linkage

Source: Pavord and Bogart (1991). "Quoted in The Export Marketing Decision" S.A. Hara in S. Carter (ed. "Export Procedures", Network and Centre for Agricultural Marketing Training in Eastern and Southern Africa.

3.3.2 Institutional Links between Exporters and Foreign Buyers/Agents

Linkages between exporters and foreign buyers are often dominated by open market trade or spot market sales or sales on consignment. The physical distances involved are also very significant. Most contracts are of a seasonal, annual or other nature. Some products are handled by multinationals, others by formal integration by processors, building up import/ distribution firms. In the case of Kenyan fresh vegetables familial ties are very important between exporters and importers. These linkages have been very important in maintaining market excess, penetrating expanding markets and in obtaining market and product change information, thus reducing considerably the risks of doing business. In some cases, Government gets involved in negotiating deals with foreign countries, either through trade agreements or other mechanisms. Zimbabwe's imports of Namibian mackerel were the result of such a Government negotiated deal. Table 2.4 gives examples of linkages between exports and foreign buyers/agents.

Table 2.5 Linkages between Exporters and Foreign Buyers/Agents

Commodity	**Market coordination**	**Contract coordination**	**Ownership interaction**	**Association coordination**	**Government coordination**	**Marketing risk reduction**
Kenya vegetables	X	X	X			X
Zimbabwe horticulture		X		X	X	X
Israel fresh fruits	X	X				X
Thailand tuna	X	XX	XX	X		X
Argentina beef	XX	X	XX	X	X	X

Key: XX = Dominant linkage

Source: Pavord and Bogart (1991). "Quoted in The Export Marketing Decision" S.A. Hara in S. Carter (ed. "Export Procedures", Network and Centre for Agricultural Marketing Training in Eastern and Southern Africa.

Once again, it cannot be over-emphasised that the smooth flow between producers, marketers and end users is essential. However, it must also be noted that unless strong relationships or contracts are built up and product qualities maintained, the smooth flow can be interrupted should a more competitive supplier enter the market. This also can occur by Government decree or by the erection of non-tariff barriers to trade. By improving strict hygiene standards a marketing chain can be broken, however strong the link, by say, Government.

This, however, should not occur, if the link involves the close monitoring and action by the various players in the system, who are, through market intelligence, of any possible changes.

4.0 CONCLUSION

We note from discussion in this unit that, in most agricultural commodities, production and marketing are interlinked, the infrastructure, information and other resources required for building market entry can be enormous. Sometimes, this is way beyond the scope of private organisations, so Government may get involved. It may get involved not just to support a specific commodity, but also to help the "public good".

5.0 SUMMARY

In this unit, we have defined the concept of market entry strategies, examined the concept within the control of a chose marketing mix, described the different forms of entry, enumerated the advantages of the methods of entry, listed the disadvantages of the methods of entry, defined and discussed the concept 'counter trade' and explained the special features of commodity trading.

6.0 TUTOR MARKED ASSIGNMENT

1. Describe briefly the different methods of foreign market entry.

2. Review the general problems encountered when building market entry strategies for agricultural commodities with examples drawn from any African country of your choice.

7.0 REFERENCES AND FURTHER READINGS

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UNIT 3 INCOTERMS

CONTENTS

1.0 INTRODUCTION

In this last unit, we examined in detail the procedures for importing and exporting as well as sources of finance available to an importer and exporter for dealing in international trade.

Generally, when goods are to be shipped, the first hurdle is to specify correctly in the contract, the type and quality as well as the quantity and how the goods are to be packed. The second hurdle is to agree between the buyer (importer) and the seller (exporter) the method of payment. In the latter case, discussion will centre on whether the shipment should be on payment in advance or open account or documentary collection or documentary letter of credit. The third item of discussion between both parties would be the terms of trade so that each party would know the limits of his responsibilities.

This unit is therefore concerned with the terms of contract for shipment of goods published by the International Chamber of Commerce (ICC) in their publication No. 460 or No. 461 / 90 titled ‘ICC Guide To Incoterms, 2000’ to enable all participants worldwide to understand uniformly, their meanings and the responsibilities of both the exporter and importer on their own.

2.0 OBJECTIVES

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

- List the common terms and the less common terms;
- Define each of these terms;
- Explain the responsibilities of the importer and exporter on each of the terms.

3.0 MAIN CONTENT

3.1 Definition of Incoterms

Madu (2011) defined Incoterms as the terms of sale used in international trade. Esezobor (2009) also defined Incoterms as the necessary commercial terms explaining parties' rights, liabilities and obligations in international trade.

Incoterms has specifically clarified the obligations for delivery of goods in international contracts. This means that, to be able to draft binding contracts, buyers and sellers can be sure of defining their responsibilities simply by making reference to the ICC Incoterms, thereby eliminating the possibility of misunderstanding, disputes and litigations.

ICC merely standardised the definitions and responsibilities so that both parties and supporting institutions in the contract would understand and interpret these terms, 13 in all, the same way. In doing so, the exporter knows precisely where his responsibilities begin and end in order to be able to price his goods appropriately. The importer, on his part, appreciates the ambits of his responsibilities as well, to enable him to ascertain his selling price and make profit.

3.1.1 Issues Addressed by Incoterms

Madu (2011) observed that different trade rules apply to different countries, therefore, importers and exporters while drawing up their contract discuss and agree on what should apply to transactions. Any rule accepted supercedes provisions of the Incoterms. However, if this agreement is not reached, the interpretation will depend on Incoterms. The issues addressed by Incoterms centred on the following:

- Buyers Option Regarding Destination of Goods
- Packaging
- Inspection of Goods

(a) Buyers Option Regarding Destination of Goods

In international trade transactions, the buyer has the option to name the precise destination of the goods. If however, the buyer fails to utilise this option, the seller chooses one which best suits his purpose at the buyer's risk. Naturally, the buyer also bears the risk if he/she names a destination.

(b) Packaging

This is a very important aspect of an international transaction. As a result, packaging depends on the type of commodity and type of transportation envisaged. However, for avoidance of any doubts, parties to a transaction should prescribe in their contract the type of packaging required and this must be adhered to.

(c) Inspection of Goods

The issue of pre-shipment and destination inspection became very necessary as a result of the desire by the seller and buyer to protect themselves. The buyer wants to make sure that what is being shipped meets his specification. At the same time, an inspection certificate protects the seller from a fraudulent buyer who may wish to defraud by claiming that the goods received were below specified standard. Payment for this service depends on who calls for it. In most cases, the buyer in whose interest the inspection is organised will bear the cost. But if the inspection is done to enable the seller meet an internal regulation in his country, then the seller has to bear the cost.

3.1.2 Incoterms and the Contract of Carriage

Incoterms only relate to trade terms used in the contract of sale and therefore do not deal with similar terms that relate to contracts of carriage. The contract of carriage determines the obligations of the shipper or the sender with respect of handing over the goods for carriage to the carrier.

The terms FOB (Free on Board), CFR (Cost and Freight), for instance, determines point of delivery by seller and what obligations are borne by each party to the transaction. These terms are the very traditional ones used in Nigeria.

3.1.3 Trade Financing and Incoterms

Having stated the importance of incoterms in international trade, it is needless emphasising that a financier must scrutinize the sales contract of his customer to ensure that all the terms are properly chosen. This is important because at the end of the day the collateral security is the underlying goods. If payment is not received, there will be no export proceeds to liquidate the bank's exposure.

3.2 Common Incoterms

The common incoterms are as follows:

1. Free on Board (FOB)
2. Cost and Freight (C&F or CFR)
3. Cost, Insurance and Freight (CIF)

4. Free Alongside Ship (FAS)
5. Ex-Warehouse or Ex-Works (EXW)

These are discussed below:

1. Free on Board (FOB)

The exporter under this term is expected to procure the ordered goods, transport them carefully and arrange for the insurance up to the point of loading into the carrying vessel. Suffice it to say that the exporter's responsibility ends on delivering the goods to the carrier duly agreed with the importer. To avoid unnecessary complications, the exporter should be clear as to which port to transport his goods. The way to be sure of the port is to insist in the initial discussion with the importer, that the port should be stated along the FOB e.g. FOB Lagos. If it is FOB say Nigerian Port, circumstance might warrant the use of Koko Port in Delta State, about 600 kilometres from Lagos, possibly the location of the exporter's factory. Using Lagos rather than Koko would mean complications and added costs to the exporter. The importer on his part, must arrange to pay to the Captain of the vessel, the cost of freight and arrange for the insurance of the goods during the voyage. To clear the goods on arrival in his country and freight them to his usage point will also be his responsibility. Please note that all insurance under importation to Nigeria must be arranged here in Nigeria and appropriate import license must be obtained for some products. Lastly, the importer must pay all clearing duties to enable him to clear his goods.

2. Cost and Freight (C&F or CFR)

The exporter's price list under this term includes the cost of the goods, cost of delivery to the port and cost of freight to the buyer's stated country. The destination must be stated and the clean bill of lading marked "Goods on board, freight paid". The importer in turn, arranges the marine insurance over the goods.

This term of shipment suits the Nigerian importer perfectly because, by the existing fiscal policy, the marine insurance over imported goods as noted above must be procured here in Nigeria. He must also ensure he has the necessary import license and arrange to pay relevant clearing taxes so that he can clear the goods on arrival.

3. Cost, Insurance and Freight (CIF)

By this term, the exporter contracts to obtain the goods ordered (he manufactures them in most cases), takes them to the wharf, pays to the vessel owners, the cost of the freight to a named port in the importer's country or any other country of the importer's choice and also provides the insurance over the goods. The insurance must bear a date earlier than the clean on board bill of lading which must also be marked "Freight Paid". Expectedly, CIF would mean higher costs to the importer who is relieved of all worries until the goods arrive his choice of destination. He should also confirm that his country's import regulations allow the exporter to provide the insurance and that he, the importer meets all the current import regulations especially that on import license. The importer clears the goods on arrival at the port at his cost.

4. Free Alongside Ship (FAS)

As duly arranged under this shipping term, the exporter obtains the ordered goods and delivers them to an authorised point at the quayside of the nominated ocean liner. Immediately, he contacts the buyer or his accredited representative by phone or any other electronic device and tenders the commercial invoice as well as the evidence that the goods have been delivered there. The evidence could be the shed or dock receipt. That ends the liability for the exporter.

The buyer must arrange without delay, to pay for the freight, which is by tagging of the product to the ocean liner. Where appropriate, he also contracts the insurance and pays all other wharf duties.

On arrival in his country, he ensures he has the necessary import license for the product, pays all necessary taxes and duties and clears the goods at his cost. Heavy duty items like timber logs and cased military equipment are shipped this way.

5. Ex-Warehouse or Ex-Works (EXW)

This time around, the buyer must arrange to take delivery of the goods from the named warehouse of the exporter whose only liability is to package the ordered goods as contracted. After doing that bit, the exporter must contact the buyer by the quickest means also tender the commercial invoice to facilitate the buyer's take-over.

The buyer does not necessarily have to be present to take the goods to the port. He could introduce his accredited representative to the exporter and spell out his powers in writing under a power of attorney. Between himself and the representative, the packaged goods must be transported to the wharf, necessary duties and taxes paid and the goods loaded into a vessel, all at his cost. If appropriate, he must also obtain insurance over the goods. For the avoidance of doubt, he should check to see that the bill of lading has been marked "Freight Paid" so that he does not face the embarrassment of being called upon to pay for the freight at port of destination.

If he personally attended to the shipment, he would fly back with all the shipping documents to await the arrival of the vessel. On arrival of the goods, the importer who must have met all the import regulations of his country would only have to pay the necessary duties and taxes to clear the goods and deliver to his workshop.

This incoterm can also be used in trading within the same country.

3.3 Less Common Incoterms

The less common incoterms are made up of the following:

1. Delivered ex-ship (DES)
2. Delivered ex-goods quay (DEQ)
3. Carriage and Insurance Paid to a named place (CIP)
4. Carriage to a named place (CPT)
5. Free Carrier (FCA)
6. Delivery at Frontier (DAF)
7. Delivered Duty Unpaid (DDU)
8. Delivered Duty Paid (DDP)

1. Delivered ex-ship (DES)

The port of destination must be named to avoid confusion. The exporter assumes the responsibilities as in CIF and takes a step further to clear the goods in the buyer's country, loads them into a van and formally hands over to the buyer. He could elect to either insure the goods or not but importantly, he must be mindful that the buyer is waiting to take delivery of the goods as contracted ex-the carrying ocean liner. On point of common sense, he will normally insure the goods and extend the insurance up to the time of delivery to the buyer so that he would be sure to get paid without squabbles.

The clean-on-board bill of lading should be marked 'freight paid' while the insurance should be dated earlier than the bill of lading. Dating the insurance earlier than the bill of lading is fool-proof that claims could be put up for damages even at the point of loading.

The importer takes delivery of the goods already loaded on a truck and paid for, for onward discharge in his warehouse. He had been saved all the strictures of port clearing if in Nigeria but his import documentation should be handy for easy passage to his warehouse.

2. Delivered ex-goods quay (DEQ)

This is a convenient shipping term for the importer because the exporter takes charge of the following responsibilities:

- Manufactures or obtains the ordered goods.
- Procures the necessary export license as well as the import license because of the role he must play in the importer's country as we shall see shortly.
- Arranges for the carriage of the goods to the wharf, pays necessary duties and taxes and loads the goods into a carrier.

- Pays the carrier and ensures the bills of lading are so marked i.e. prepared or freight paid.
- He forwards a set of the shipping documents by courier to the importer and gives him the likely date the vessel will berth in the named port as agreed.
- On arrival of the vessel in the importer's country, he clears the goods and satisfies all customs formalities including tendering the import license if required.
- He pays for the offloading of the goods into any vessel of the importer's choice.
- He could elect to insure the goods or not because his responsibilities only terminate after handing over the goods on board a truck in the importer's country.
- It is also possible by prior agreement to shirk part of the responsibilities in the importer's country e.g. "DEQ Customs Duty Unpaid".

The importer takes over the goods on delivery as stated above.

The difference between DES and DEQ lies in the aspect of insurance. While in DES, there must be insurance, it is at the discretion of the exporter under DEQ. Either way, the importer only accepts responsibility for the goods after they are cleared and loaded on a truck.

Furthermore, while in DEQ some of the responsibilities as noted in the last bullet point could be mutually waived; there is no room for that in DES.

3. Carriage and Insurance Paid to a named place (CIP)

The exporter procures the goods ordered and the necessary export license. He conducts the movement of the goods as in CIF incoterm. The difference between the two is that while CIF terminates at the named port, CIP could involve transshipment to a named commercial city away from the seaport. It is the duty of the exporter to ensure that appropriate extension of the insurance is taken to cover the whole journey. The importer takes control from the point of delivery at the named place; saved from the hassles of clearing at the wharf and the hazards of freighting the goods over land and to the named place. Quite naturally, this method would be expensive to he importer.

4. Carriage to a named place (CPT)

This is also similar to C and F incoterm except that while C and F terminate at the wharf, CPT terminates in a named place which could be further than the wharf. Thus, the importer must provide his insurance and import license where necessary. He must also take over the goods from the point of delivery.

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5. Free Carrier (FCA)

From the point of view of the exporter, this is a soft Incoterm because his responsibilities end with the moving the ordered goods to the named warehouse or container depot in his own country. To do this, he must first obtain the necessary export license. As evidence that he has fulfilled his part of the contract, he must send by courier or by electronic media, the container bill of lading or multi-modal transport document along with the commercial invoice.

The buyer on his part would arrange the movement of the goods from the named warehouse or contained depot to the sea port, pay the necessary duties and taxes as well as provide his insurance for the goods. Needless to say that he should have the import license to avoid running into a brick wall in his country. Special products like chemicals and heavy duty military hardware that require expert packaging may be handled this way.

6. Delivery at Frontier (DAF)

This shipping term comes handy when goods are being moved by land by the exporter to a named frontier in the importer's country e.g. from Lagos to Accra. To do this, the exporter obtains the export license where applicable and pays for the cost of land freight and insurance as well as customs duties and taxes to the named frontier. He forwards the commercial invoice, insurance policy and waybill to the importer by the quickest means. He could send the electronic version if available. The importer, armed with the necessary import license takes over the goods at the named frontier. He must pay all further costs of freight, extended insurance, customs duties and taxes until the goods are delivered in his work place.

7. Delivered Duty Unpaid (DDU)

DDU is also similar to CIF in terms of spread of responsibilities between the exporter and importer and the fact that the place of destination must be named e.g. DDU Lagos. This term specifically makes it clear that the exporter is not responsible for the payment of import duties or taxes in the importer's country.

All the exporter needs to provide the importer are the shipping documents called for in the contract by the quickest means. The electronic version of shipping documents is now getting more popular. The importer armed with the import license pays all relevant costs, duties and taxes to clear the goods and ship them to his warehouse.

8. Delivered Duty Paid (DDP)

Similar to DDU, the place of destination must also be named. The exporter in addition to bearing all costs of obtaining and moving the goods by an ocean liner, also contracts to pay the insurance and all the import costs, duties and taxes in the buyer's country. The importer only takes delivery at the wharf after all the import formalities have been met. It is possible for a smart exporter to include in the contract, his non-responsibility for specific costs like quarantine, VAT etc. in which case, the Incoterm would be amended to read e.g. DDP Quarantine Unpaid, Lagos Port.

3.4 Incoterms and the Contract of Carriage

Incoterms only relate to trade terms used in the contract of sale and therefore do not deal with similar terms that relate to contract of carriage. The contract of carriage determines the obligations of the shipper or the sender with respect to handing over the goods for carriage to the carrier. The terms FOB (Free on Board), CFR (Cost and Freight), for instance, determines point of delivery by seller and what obligations are borne by each party to the transaction. These terms are the very traditional ones used in Nigeria.

3.5 Trade Financing and Incoterms

Having stated the importance of Incoterms in international trade, it is needless emphasising here that a financier must scrutinize the sales contract of his customer to ensure that all the terms are properly chosen. This is important because at the end of the day the collateral security is the underlying goods. If payment is not received, there will be no export proceeds to liquidate the bank's exposure.

3.6 Risks in Choice of Incoterms

If a contract is FOB, the risk for the exporter is less because his responsibility ends as soon as the goods are onboard ship. FOB is the most commonly used term in Nigeria. Terms like FAS and Ex-works are even safer and more convenient. The practice in Nigeria which is similar to Ex-works is DIS (Delivery in Store). The customer under this arrangement simply delivers to a designated warehouse and forwards all the documents called for in the contract to get paid.

Financiers also prefer these arrangements to the rest e.g. CFR (Cost and Freight) or CIF (Cost Insurance Freight). The risk inherent in these arrangements are the time lag and the fact that even after putting the goods on board, the seller not only pays the freight but has responsibility until the goods get to the port of destination. All these underscore the point that a lender has to analyze the customers' contract to ensure the safety of his funds. The same applies to the seller who has to study the incoterms and opt for terms that gives him less risk. FOB contracts are the best in the absence of FAS and Ex-works.

3.7 Incoterms and Documentation

In documentary operations, the importance of Incoterms cannot be overemphasised. This is because many discrepancies that arise in documentary operations result from either wrong application of Incoterms or lack of understanding of it.

In the first place, whatever term that has been chosen must be stated on the commercial invoice. Secondly, the choices of terms determine the freight notation on the Bill of Lading. If a shipment is based on FOB, then the Bill of Lading will have a freight notation that reads “Freight Collect” or “Freight Payable at Destination”. On the other hand, if the shipment is on a CFR contract then the Bill of Lading will carry a freight notation “Freight Prepaid”. The commercial invoice should be carefully studied because a trader might use a CFR price for FOB transaction or vice versa.

It is pertinent to note that if the contract is FOB, CFR or any other Incoterms, all the documents must bear the same terms. If some documents bear FOB and others CFR or CIF then that is a discrepancy which can make an exporter to lose all or part of his export proceeds. We are aware that in a documentation procedure, documents in addition to conforming with the terms and conditions of the respective contract/credits, also have to agree with one another.

As is the case in other ICC publications, merchants who wish to use these rules should specify that their contract will be governed by the current edition of Incoterms. In addition, contracting parties who wish to have the possibility of resorting to ICC arbitration in the event of a dispute should specifically and clearly agree on ICC arbitration in their contract.

4.0 CONCLUSION

ICC had assisted in no small measure to facilitation of trade and commerce internationally by draft binding contracts between buyers and sellers so that they can be sure of their responsibilities, thereby eliminating the possibility of misunderstanding, disputes and litigations.

5.0 SUMMARY

In this unit, we have

- Listed the common terms and the less common terms;
- Defined each of these terms;
- Explained the responsibilities of the importer and exporter on each of the terms.

6.0 TUTOR MARKED ASSIGNMENT

1. A new trader looking forward to selling his palm kernel products to Italy has called to ask your advice on how best to sell his products without incurring costs beyond putting the goods together and taking them to the wharf.

   (a) What advice would you give him and why?
   (b) Explain to the trader the fundamental issues he must agree with the Italian buyers before entering into a contract to sell.

2. (a) Distinguish between CIF and DES and also between DES and DEQ.

(b) In what way can an exporter use DEQ to his advantage?
(c) Itemise only, the INCOTERMS recognized by ICC.

3. Select any four INCOTERMS and state the responsibilities of parties to each of them.

4. INCOTERMS are the necessary technical logjams that obliterate parties' rights in international commercial arbitrations.

   (a) Do you agree with this statement and why?
   (b) State your understanding of the relevance of incoterms according to the relative provisions of UCP 500.
   (c) State the effects of the following incoterms in parties' duties, liabilities and responsibilities in international trade:
      (i) FRC
      (ii) DCP
      (iii) DES
      (iv) DAF
   (d) Itemise five incoterms you expect to find on trade documents involving Merchants located between Mali and Nigeria. ***(Q.5, October, 2000, CIBN)***

7.0 REFERENCES AND FURTHER READINGS

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UNIT 4 SHIPPING / TRANSPORT AND OTHER DOCUMENTS USED IN INTERNATIONAL TRADE

CONTENTS

1.0 INTRODUCTION

The word "shipping" as used in this unit did not connote strictly the movement of goods by sea liner alone. Rather, it is used in a general sense to include freighting of goods, not only by sea but by land as well as by air.

Esezobor (2009) noted that shipping documents are important in any cross-border trade because they evidence the dispatch of any order and to some extent, are title documents to any shipment. For example, a set of stamped and signed bill of landing amongst others can enable the holder to clear the goods represented at the wharf. Shipping documents are also important to the banks because banks generally and also recognized in Article 5 of Uniform Customs and Practice, ICC Publication No. 600L, "deal with documents and not goods, services and/or other performances to which the documents may relate".

In this unit, we shall dwell extensively on all the documents required to facilitate the movement of goods across boarder.

2.0 OBJECTIVES

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

(i) list and explain all the basic transport / shipping documents required for international trade;
(ii) list and discuss other documents that are required to facilitate international business between individuals, business and governments of the world.

3.0 MAIN CONTENT

3.1 Basic Transport / Shipping Documents

As a minimum, shipping/transport documents refer to all of the following:

(i) Invoices
(ii) Insurance documents
(iii) Transport documents.

This list is by no means exhaustive as you will note in this study. There is therefore the need to study extensively the above three key shipping / transport documents.

3.1.1 Invoices

There are three types of invoices, namely:

- Pro-forma invoice
- Commercial invoice
- Consular invoice

(a) Pro-forma invoice

The prospective exporter sends this form, a pro-forma invoice, to the buyer at the beginning of the discussion of what to buy, prices and other details like discount. The pro-forma invoice is normally included in the catalogue which shows the various products, colours and prices from the exporter's table. In the first instance, it is an invitation to the buyer to place an order with the seller.

Secondly, the pro-forma invoice helps the buyer to apply for an import license for the product of his choice if that is the regulation in his country. For example, a buyer needs a special import license to import firearms into Nigeria.

Thirdly, the pro-forma invoice is the main document that would be submitted to a bank to enable it to bid for foreign exchange to open a documentary letter of credit.

One can easily mistake a pro-forma invoice for a commercial invoice but a careful examination will show that the pro-forma invoice unlike the commercial invoice is always stamped as such.

(b) Commercial invoice

It is a key document issued by the exporter and it shows the details of the goods sold by him. In this sense, it goes beyond a receipt because apart from the particular of the buyer and seller, it shows the details of packaging and terms of sale like FOB, C&F, CIF etc.

All the above details will normally tally with the existing contract between the seller and buyer to avoid rejection especially under documentary letters of credit and collections.

A commercial invoice issued by a Nigerian exporter may be required to be attested to by the local Chambers of Commerce and Industry as to the price, standard, quality and origin of the goods by the applicant under a documentary letter of credit.

Under Article 18 of Uniform Customs and Practice, ICC Publication No. 600L, commercial invoices need not be signed but must be made out in the name of the applicant who in documentary letters of credits, is the buyer.

The following draft commercial invoice speaks for itself.

COMMERCIAL INVOICE

<table>
<tr><td colspan="2" rowspan="3">Seller (name, address, VAT reg. No (1)</td><td colspan="2">Invoice</td><td colspan="2">Sheet No</td></tr>
<tr><td colspan="2">Invoice date (tax point)</td><td colspan="2">Seller’s Reference</td></tr>
<tr><td colspan="2">Buyer’s Reference</td><td colspan="2">Other Reference</td></tr>
<tr><td colspan="3" rowspan="3">Consignee VAT No.
(2)</td><td colspan="3">Buyer (if not consignee)</td></tr>
<tr><td colspan="3"></td></tr>
<tr><td colspan="2">Certificate of Origin</td><td>Country of Destination</td></tr>
<tr><td>Vessel/flight No. and date</td><td colspan="2">Port/Airport of loading</td><td colspan="3" rowspan="2">Terms of delivery and payment
(3)</td></tr>
<tr><td>Port/airport of discharge</td><td colspan="2">Place of delivery</td></tr>
<tr><td>Shipping Marks;
(4)</td><td>Container No.</td><td>Package/Description of goods</td><td>Commodity Code</td><td>Total gross wt. kg</td><td>Total Cube</td></tr>
<tr><td colspan="3"></td><td colspan="3">Total net weight (kg)</td></tr>
<tr><td>Item/Packages</td><td colspan="2">Gross/net/cube Description</td><td>Quantity</td><td>Unit Price
(5)</td><td>Amount
(6)</td></tr>
<tr><td colspan="3" rowspan="4">Details of freight and Insurance

(8)</td><td colspan="3">Invoice Total (7)</td></tr>
<tr><td colspan="3">Name of Signatory</td></tr>
<tr><td colspan="3">Place and Date of Issue</td></tr>
<tr><td colspan="3">Signature 1 (A)</td></tr>
</table>

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

(1) (a) The seller or beneficiary in a documentary credit.
(b) Bottom right – the signature of the seller or representative.
(2) The buyer.
(3) Shipping terms, incoterms.
(4) Description of goods as stated in the credit.
(5) Unit price for the ordered goods.
(6) Derived from the quantity multiplied by the unit price.
(7) Amount payable by the buyer as contracted.

(8) Such details of freight and insurance will arise under CIF, CIP, etc.

In the United Kingdom, a public agency called the Simpler Trade Procedures Board (SITPRO) has the responsibility to standardise and simplify the documentation of export procedures. They do this through the use of a Master Document which contains all the details of an export contract from which the shipping documents are prepared. SITPRO also assists exporters to prepare the shipping documents into computer diskettes by using their software called SPEX system. It's equivalent in Nigeria is called Nigerian Committee for Trade Procedures and Documentation (NITPRO).

(c) Consular invoice

The consular invoice is issued for a fee by the buyer's embassy or consulate in the seller's country. It serves two purposes (Esezobor, 2009), namely+

- To confirm that the seller's prices are not deliberately low as to promote dumping of goods in the buyer's country.
- To facilitate the calculation of import duty on the goods on arrival at the buyer's country.

Where the exporter's commercial invoice is required to be signed by the importing country's consulate, it is called 'legalized invoice'. Rather than consular invoice, some countries prefer inspection certificates issued by professional visible trade inspectors like COTECNA – OMIC Group.

3.1.2 Insurance documents

The terms of shipment otherwise called INCOTERMS determine who, between the buyer and seller takes responsibility for the insurance of the goods from the point of loading into a carrier up to when the buyer takes delivery. Recall that with CIF, the seller bears the cost of the goods and loading into a carrier and further pays for the insurance and freight.

There is a lot of difference between insurance policy, insurance certificate and insurance cover.

An insurance policy is a comprehensive evidence of contract signed by the insurance company and upon which, a legal action can be taken when necessary.

An insurance certificate often refers to an existing open insurance policy. The way it works is that for a regular seller, he takes an insurance policy with an insurance company and for each sale, issues an insurance certificate; a copy of which is sent to the insurance company for their adoption.

Insurance cover notes are issued by brokers as interim evidence that an insurance contract is underway. Article 28(c) of UCP No. 600L recommends that such cover notes "will not be accepted".

From the banker's point of view, the insurance document should cover the following:

- It should be an "all risks" which insures marine risks, fire including smoke damage, damage caused in loading, transshipment or offloading and theft excluding pilferage by the crew.

- The insurance document should be signed by the insurer and must bear the name of the insured.

- As noted already, cover notes issued by brokers are not acceptable.

- The insurance should be dated before the bill of lading or any other transport document used.

- Under a letter of credit, the insurance must state the cover to be CIF or CIP and where otherwise, 110% of the gross amount of the invoice value should be issued.

- The insurance must be expressed in the same currency of a letter of credit and should tally with the contents and context of other shipping documents.

- Insurance certificates issued under an open insurance cover pre-signed by an insurance company or underwriter or their agents are acceptable – Article 28(a) and (d) of UCP, ICC No. 600L.

- The duration of the insurance should be reasonable for the type of transactions.

- Place where claims are payable, should be stated.

Lastly, it must be noted that under the prevailing Exchange Control Regulations in Nigeria, the insurance for goods bought abroad must be contracted here in Nigeria.

The following is a sketch of a standard insurance certificate:

<table>
<tr><td>Name and address of Insurance Co.
(1)</td><td>Registration no.</td></tr>
<tr><td rowspan="2">Name and address of Assured
(2)</td><td>Date</td></tr>
<tr><td>Exchange Rate</td></tr>
<tr><td>Sum Insured: (3)
(in words):</td><td>Certificate no.
Policy no. (6)</td></tr>
<tr><td>Receiver:
(in words): (4)</td><td>Vessel (7)
Voyage (8)</td></tr>
<tr><td>Conditions
(5)</td><td>Interest
(9)
1(A)</td></tr>
<tr><td></td><td>Authorised Representative</td></tr>
<tr><td colspan="2">In the event of loss or damage which may give rise to a claim under this Certificate, notice must be given immediately to ………………………………………

Any lawful claim shall be settled by ………………………………………………………. at the above-stated address upon surrender of this Certificate together with supporting documents in accordance with the instructions stated overleaf.

This certificate is valid for six months only.</td></tr>
</table>

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

Key:

(1) (a) The details of the insurance company.
    (b) The authorised representative of the insurer.
(2) Details of the Nigerian Importer.
(3) Value of the import converted to naira at the exchange rate stated.
(4) Premium, the importer would pay to secure the insurance. The method of calculation is beyond the scope of this material.
(5) It is the 'Clause A' stated at the back of this form. It specifies the risks covered in the insurance.
(6) This certificate shows that it is drawn from a substantive policy; the references of both provided.
(7) The name of the carrier.
(8) The journey from the port of loading to port of discharge.
(9) The details of the goods being insured.

3.1.3 Transport documents.

The transport documents are also important in trade and commerce especially international business. These documents consist of:

1. Bill of Lading

2. Sea Waybills
3. Air Transport Document
4. Road, Rail or Inland Water Way Transport Documents
5. Courier and Post Receipts or Certificate of Posting
6. TIR Carnets

They are discussed below:

1. Bill of Lading

It is the evidence of receipt of goods for shipment by a shipping company from an exporter. It is issued in sets of two or three; each of them a negotiable document of title to clear the goods at the wharf provided it is signed by the shipper and the freight, duly paid. The description and state of the goods are clearly given in the bill of lading called "blading" for short. Where there is no derogatory remark as to the condition of the goods, the blading is described as clear. A claused, foul or dirty bill of lading is an indication that something is amiss with the goods e.g. the "case is broken" or "ten out of fifteen drums leaking".

A bill of lading is always either marked "received for shipment" or "shipped on-board". The former means the carrier has received the goods for shipment at a later date while the latter means the goods have already been loaded on board the vessel.

A bill of lading could be drawn to "order" rather than in the name of the consignee. Such a set of bill of lading, once endorsed by the exporter becomes a negotiable document which could be used by the bearer to clear the goods on arrival at the port. It is also possible to draw the bill of lading in the name of the consignee. In the circumstance, the consignee must produce a set of it with sufficient evidence of identification at the port to clear the goods.

The following sketch of a bill of lading will help to explain further, the importance.

<table>
<tr><td colspan="4">Shipper (1) B / L No.
Booking Ref:
Shipper's Ref:
Consigned to (2) E A(1A) CONTAINERS</td></tr>
<tr><td colspan="3">Notify Party/Address
(3)</td><td>Place of receipt
(4)</td></tr>
<tr><td colspan="2">Vessel and Voyage No.
(5)</td><td>Port of Loading
(6)</td><td>Place of Delivery
(7)</td></tr>
<tr><td colspan="4">Part of Discharge
(8)</td></tr>
<tr><td>Marks and container Nos.
(9)</td><td>No and kind of packages / description of goods
(10)</td><td>Gross weight (kg)
(11)</td><td>Measurement
(11)</td></tr>
<tr><td colspan="4">ABOVE PARTICULARS AS DECLARED BY SHIPPER
Total No. of Containers / Packages Collections of Shipment
Movement (13)
Freight and Charges (indicate whether prepaid or collect (12) Place and Date of Issue (15)
Origin Inland Haulage charge …………..
In witness of the contract herein
Ocean Freight ………………………………… Contained the no. of original stated
Original Terminal/LCL Service Charge ……... opposite …………………………
Destination Terminal Haulage/LCL Service charge (16)
Destination Inland Haulage Charge ………… for the Carrier ……………………………
(14)
Number of Original Bills of Lading E A CONTAINERS</td></tr>
</table>

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

(1) (a) The exporter and the address.
 (b) The shipping company.
(2) Could be consigned to 'order' or to 'buyer' as stated above.
(3) The buyer and their address.
(4) Where the goods were received.
(5) Name of carrier and voyage no. e.g. OLOKUN 8 / 03.
(6) The port used by the exporter to ship the goods.
(7) Destination.
(8) The port nominated by the buyer for discharge.
(9) and (10) Explicit.

(11) Description of size or weight.
(12) All prepayments by the exporter and those costs to be paid by the importer must be marked in accordance with the contract.
(13) The conditions of shipment will state the conditions of the goods received and other conditions of carriage stated at the back of the bill of lading. These conditions are quite tedious to read because they are always written in small or tiny letters and are beyond our immediate study for now.
(14) Always two or three sets are issued. More sets could be issued for administrative purposes but they would not be signed.
(15) The city of issue and date.
(16) Signature of an authorised agent of the shipping company.

Types of Bills of Lading

Bills of Lading are of different types. They include:

(i) Clean On-board Marine or Ocean Liner Bill of Lading
(ii) Combined Transport Bills of Lading / Through Bill of Lading / Multi Modal Transport Document
(iii) Transshipment Bill of Lading
(iv) Charter Party Bill of Lading
(v) Short Form Bill of Lading
(vi) Container Bill of Lading
(vii) Claused or Dirty or Foul Bill of Lading

(i) Clean On-board Marine or Ocean Liner Bill of Lading

This is about the best form of bills of lading because the goods are certified right for shipment and already laden on board the carrying vessel.

(ii) Combined Transport Bills of Lading / Through Bill of Lading / Multi Modal Transport Document

By virtue of the provisions in some incoterms like CIP, CPT, DDP and the officially unrecognized Franco Domicile, it is possible that in a delivery journey that might involve both sea and land, rather than negotiate for a separate bill of lading for the sea journey and land waybill for the land journey, one single transport document is issued for the entire journey. Such a single transport document could be either a Combined Transport Bill of Lading or Through Bill of Lading or the more recent Multi Modal Transport Document.

An example is where a manufacturing company in the hinterland like Okpella Cement Factory arranges in any of the above-stated incoterms to buy heavy duty operational equipment. Okpella is a town in Edo State but close to the border with Kogi State in the northern frontier of Edo State.

The equipment being bought from the United Kingdom could arrive either Lagos, Warri or Port Harcourt ports and still the responsibility of the exporter to be freighted by protected trailers to the premises of Okpella Cement Factory. In the two journeys by sea and land, only one transport document as already explained would need to be provided by the exporter. The buyers (importers) would only take delivery at their premises as duty contracted.

Multi Modal Transport Document is a more involving document than either Combined Bill of Lading or Through Bill of Lading. While the last two always relate to sea freight being bills of lading, Multi Modal Transport Document could cover freight by sea, land and air and more importantly, is recognized by UCP No. 600L in Article 19. This article states that as far as documentary letters of credits are concerned, Multi Modal Transport Document must cover at least two different modes of transport, without restricting which the two different modes could be.

(iii) Transshipment Bill of Lading

The unique thing about Transshipment Bill of Lading is that it covers a voyage where at a certain port, the goods have to be off-loaded the ocean liner into another ship for the final journey to he contracted port of delivery.

This could arise where the second port had not been dredged to accommodate ocean liners; some of which, especially those that carry auto trucks, are as big as half a football field in area and up to five decks below the surface of the water.

An example is where goods are being shipped to Epe from Germany through this means. At Tin Can Island Wharf in Lagos, a smaller vessel suited for the lagoon would be contracted for the short journey to Epe, both in Lagos State. Both journeys would be covered by the Transshipment Bill of Lading.

(iv) Charter Party Bill of Lading

It is not unusual that when a merchant hires a ship, he accepts goods for delivery at ports convenient for his voyage when there is unutilized capacity on board. Such a hirer will issue as receipt, his version of bill of lading. This version is called Charter Party Bill of Lading. Expectedly, this sub-contract would be subject to the main contract between the hirer and the vessel owners hence the Charter Party Bill of Lading is always so marked.

Banks don't like to be drawn to the rigours of studying two bulky contracts hence at best; they treat such bills of lading as not documents of title of the imported goods. Article 22(b) of UCP No. 600L recognizes banks to handle such bills without responsibility. In a serious importation, the importer is advised to give attention to the adequacy of the marine insurance over the goods being freighted through this means.

(v) Short Form Bill of Lading

In content, this is similar to a charter party bill of lading because at every stage of the contract, reference is made to another document which constitutes the main contract. In as much as it is issued by the vessel owner or the agent, it is considered a document of title to the goods.

(vi) Container Bill of Lading

If goods are delivered to a carrier in packed and sealed containers, the receipt so issued is called Container Bill of Lading.

A trip to Apapa Wharf will show that most goods shipped by sea arrive Lagos in containers for convenience and safety.

A Container Bill of Lading suits incoterms like CIP, CPT etc. so that the exporter can take responsibility in freighting the containers from his container depot to another contracted container depot in a foreign country.

(vii) Claused or Dirty or Foul Bill of Lading

Some products like whisky and brandy are packed in protected cases and must be piled up in an upright position to avoid leakage. Yams, for instance, are packed in wooden, hugely aerated cases and handled delicately to avoid breakage. Fish is transported fresh, iced and in cartons and in well-regulated refrigerators to keep the fish firmly iced. These products like all other items of international trade, must be delivered to the carrier in the best of forms to warrant the issue of a Clean Bill of Lading.

In the event that there is a damage or leakage, the carrier protects itself against possible future legal action by issuing a Claused or Dirty or Foul Bill of Lading. A bank saddled with the latter must aggressively review its credit exposure under such an importation to avoid imminent debt classification.

The Position of Banks When Handling Bills of Lading

- If the bill of lading is a charter party bill of lading or short form bill of adding or received for shipment bill of lading, extra care is required. While the bank could handle the first of the three under documentary letter of credit without responsibility, there might be complications if the credit was financed by the bank.

- In all cases, the bank should state in the initial outward credit that the transport document required is a Clean On-Board Ocean Liner Bill of Lading and insist on it throughout. Any deviation should be a subject of amendment and the product cost should be so renegotiated.

- Is the bill of lading clean or foul? It should be clean to avoid a messy importation. Article 27 of UCP 600L states that “a bank will only accept a clean transport document”.

- If the signed bill of lading says there are two sets, the bank should hold at least one of the sets, while the exporter retains one. It is a negotiable document and must only be released to the importer after appropriate endorsement and stamping when all the security details for an advance for the importation had been met.

- Most bills of lading are issued to ‘order’ and as such, must be signed by the exporter.

- Carefully confirm that any alteration was signed by the carrier or the agent.

- The bill must be marked “freight paid” if incoterms like C&F or CIF were the subject of the transport terms.

- Check that the date on the bill is not later than the “last shipment date” under a documentary credit. If it is, treat it as a serious subject for necessary amendment under instruction from the customer who should be told to ask for a price review from the exporter.

- Check too, the other shipping documents to confirm that the goods shipped agree with the details therein.

- Statements like goods loaded on deck rather than on board are signs of defect in the freight contract and it should be taken up with the exporter.

2. Sea Waybills

A sea waybill is also a transport document like a bill of lading. It is different from the latter because it is not a document of title and is not negotiable.

That notwithstanding, it is preferred under trading in open account where urgency and less formality are crucial. Where the buyer and seller agree on it, the carrier issues a sea waybill without the formality of a bill of lading. On arrival of the goods in the importer’s country, the importer is contacted either by phone or recorded delivery. He clears the goods with or without the sea waybill but on proper identification e.g. international passport, the number of which must have been given to the shipping company as added security.

Compared with bills of lading which can inflict hardship if lost or stolen, the sea waybill appears safer and faster if nothing goes wrong with the identification of the importer.

Sea waybills are issued in the same way as bills of lading except that they are never issued to order.

In accordance with Article 21(aii) of UCP No. 600L, bans should ensure “that the goods have been shipped on board a named vessel at the port of loading ….” as the main precaution to accepting it.

3. Air Transport Document

For movement of goods by air, air transport document is issued as bill of lading is issued for sea freight. Where goods are urgent, delicate or perishable, air freight is advised because the shipment is done within a couple of hours even in the longest of air routes.

The air transport document like sea waybill, is neither negotiable nor a document of title. Thus, the consignee would need to identify himself satisfactorily before he clears the goods. Alternatively, the goods can be consigned to the bank handling the credit or collection. Under Article 23 of UCP No. 600L, the carrier or his named agent must sign the document. The document duly dated, must also indicated that the goods have been accepted. It must also state the airport of departure and airport of destination for the avoidance of doubt. The article also recognized transshipment. Until UCP 600L, it was right to refer to this document as Air Waybill; not any more since the UCP revision recognized it as Air Transport Document.

4. Road, Rail or Inland Water Way Transport Documents

These transport documents are all recognized under Article 24 of UCP No. 600L. Where goods are moved by land, road transport document would be issued. Rail transport document would go for transportation by railway while inland waterway transport document would be issued for movement of goods by water within the same country e.g. from Onitsha to Lokoja by River Niger or from Yola to Makurdi by River Benue.

These transport documents are not negotiable and are also not documents of title. They must be signed and dated by the carrier or his named agent. Place of shipment and destination must be stated. Personal identification of the consignee would be obtained before delivery of the ordered goods.

The article referred to allows for transshipment if these documents are used in a documentary letter of credit.

5. Courier and Post Receipts or Certificate of Posting

As expected, courier receipts would be issued by courier companies while the Post Office (NIPOST) will issue post receipts for consignments handled. Both are accepted as transport documents in documentary letters of credit – Article 25 of UCP No. 600L.

It should be noted however, that they are not negotiable and do not indicate any claim to title over the goods. Like all transport documents apart from bills of lading, the consignee must tender a satisfactory means of identification to take delivery of the goods.

Like in other transport documents, the receipt or certificate must be signed, stamped and dated by the carrier or named agent in the place of shipment.

In documentary letters of credit, banks must ensure that any of the transport documents "meet the stipulations of the Credit".

6. TIR Carnets

In Europe and parts of Asia, it is common to see "TIR" written on trucks and containers. In the countries that contribute to the TIR system, trucks or containers are thoroughly checked and sealed up to facilitate passage in member countries where the agreement between the member countries, no duty is paid.

3.2 Other Transport / Shipping Documents

The other transport/shipping documents are as follows:

(1) Financial documents
(2) Certificate of Origin
(3) Risk Assessment Report (RAR)
(4) Packing List/Weight Certificate
(5) Blacklist Certificate
(6) Combined Certificate of Origin, Standard and Quality
(7) Certificate of Analysis

These are discussed below.

(1) Financial documents

The financial documents referred to are of two types, namely:

(a) Bill of Exchange
(b) Foreign Draft.

Personal cheques are uncommon in international trade because the provision relating to 'protest' in bills of exchange does not apply to them. Similarly, promissory notes are weak as an instrument for collecting the proceeds of international trade.

It is appropriate to dwell further on these two key financial instruments.

(a) Bill of Exchange

It is defined in the Bill of Exchange Act, Cap 35, 1990 as:

"*an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed, to pay on demand, or at a fixed or determinable future time, a sum certain in money, to or to the order of a specified person or to bearer*".

There are broadly, two types. The first is a **Sight Bill of Exchange** which requires immediate payment at sight or on presentation. It does not allow room for credit terms and it does not have to be accepted to await the full run of the tenor or days of credit because it does not provide for it.

Hypothetical Example

To: Mr. Chika Okokon 1, Broad Lane, Lagos	Stamp Duty	1st April, 2008 US$55,000 U. S. $55,000.00
At sight, pay to me for value received, fifty five thousand U.S. dollars.		
		(Signed) El Spinks Chicago Route 213 Illinois

The drawer, El Spinks is the exporter and the creditor while Mr. Chika Okokon is the importer, the debtor; the drawee, in this bill.

It is this type of bill of exchange that will be top of the shipping documentation received under sight documentary collections or sight documentary letters of credit. The understanding is that the shipping documents should only be released to the importer if he pays in accordance with the bill of exchange.

The second type is called **Tenor or Usuance Bill of Exchange**. This one recognizes that the exporter had agreed some credit term with the importer to enable the latter to sell the good before making payment. Such a bill must first be accepted by the drawee as evidence that he actually owes the drawer. At the expiration of the tenor, the bill is presented through the clearing for settlement. Alternatively, a hard-up exporter could discount the accepted bill to obtain funds to keep his business going. Discounting means receiving the value of the bill less interest and other charges for the tenor from an obliging bank or finance house.

Hypothetical Example

To: El Spinks
Chicago Route 213
Illinois.

Stamp Duty

1st April, 2008
US$60,250

U. S. $55,000.00

At sight, pay to me for value received, sixty thousand, two hundred and fifty U.S. dollars.

(Signed)
Chika Okokon
1 Broad Lane,
Lagos

ACCEPTED Payable at
XYZ Manhattan Bank Plc,
Chicago Route Branch,
Account No. 0123456789
(Signed)
El Spinks

In this second hypothetical example, Chika Okokon is the exporter and thus the drawer of the bill. El Spinks is the drawee, the debtor or the importer.

The inference from both hypothetical examples is that both merchants sell their respective products to each other. The American, El Spinks would perhaps sell the machines or the machine parts the Nigerian, Chika Okokon needs. At other times and even simultaneously, Chika Okokon would be freighting his natural products like processed rubber or palm products or shrimps to El Spinks as mutually contracted.

Should the bill of exchange, any of them, be dishonoured at any time, the dishonour could be referred to the Case of Need of the offended party. Please refer to Documentary Bills for Collection for details on Case of Need.

(b) Foreign Draft

A draft is a special bill of exchange drawn by a bank on another bank for the purpose of making payment either for self or on behalf of customers. The draft drawn by a bank on its branch is not a bill of exchange because it does not satisfy part of the definition which states inter alia:

- "*addressed by one person to another*".

The head office and branches of the same bank are all one person e.g. First Bank of Nigeria Plc. However, in international payments, branches of a bank in other country are treated as separate legal entities from their home office as in Article 3 of UCP 600L. Through the process of correspondence arrangement, banks in different countries keep bank accounts for each other which like customers; they are issued cheques books except that the cheques books are a bit different to serve as drafts.

Rather than the importer paying against or accepting a bill of exchange drawn by the exporter, the instruction for payment might be "pay by a bank draft drawn on a first class bank in my country". All the buyer has to do to meet this condition, is to meet the foreign exchange requirements and pay the local equivalent of the value of the importation plus necessary charges to his bankers who in turn, will issue a foreign draft on their correspondent bank in the exporter's country for the account of the exporter.

Instead of a bill of exchange that could be dishonoured and create all sorts of complications in a credit or collection, a foreign draft is virtually as good as crisp currency notes fresh from the mint.

(2) Certificate of Origin

It is a statement expressed in a form as to the origin or source of the product under the process of shipment. The standard form is completed from the details of the credit or collection and submitted to the accredited Chambers of Commerce and Industry for signature.

Some countries especially of the Middle East origin, always insist that the certificate of origin should be legalized. That would entail taking the certificate to the Embassy of the country for necessary attestation for a small fee.

The main purpose of certificate of origin is to enable the importing country to know the source of the goods coming in perhaps for political reasons and also to facilitate the calculation of the import duties for the product.

(3) Risk Assessment Report (RAR)

It is issued by scanning and risk assessment companies under the regime of destination inspection. This document effectively replaced the previous Certificate of Inspection with effect from January 1, 2006. The latter was issued by inspection agents employed by the Federal Government of Nigeria to attest to the quality and fair price of goods being shipped to Nigeria at the exporting country.

The companies handling this service now are Globascan, Cotecna and Society Generale du Surveillance.

Nigeria Customs Service (NCS) uses RAR to levy import duty using ASYCUDA, a software developed by United Nations Conference on Trade and Development (UNCTAD) on subject.

(4) Packing List/Weight Certificate

A packing list shows the details of the packing order as well as the weight content which of necessity, must tally with the other shipping documents. Packing list helps the Customs and Excise Department in applying the import duties where applicable.

(5) Blacklist Certificate

For political reasons, some countries insist that all imports must bear this certificate in order to be sure that they are not indirectly patronizing the economy of their enemies, so to say.

It is expected that with increasing globalization and concerted efforts at United Nations and other international levels to resolve all pockets of conflict round the world, this certificate will slowly but surely be extinct, in no time.

(6) Combined Certificate of Origin, Standard and Quality

It is either issued independently or appended to the commercial invoice already issued by the exporter by an independent third party to vouch for the origin, standard and quality of the visible exports.

In Nigeria’s exchange control regulations, this certificate must be one of the shipping documents required under any credit or collection. The exporter arranges for it.

It helps in the calculation of import duties by the Customs and Excise Department.

(7) Certificate of Analysis

It is a certificate that must be issued by the accredited representative of the importer in the exporter's country to confirm in the main, the technical or chemical soundness of the medicine or food-related products being imported into the country. In the circumstance, any importation contract must specify this certificate as one of the documents to evidence the shipment in accordance with the prevailing exchange control requirements in Nigeria. the Federal Government agencies like National Food, Drugs Administration and Control (NAFDAC) and Standards Organisation of Nigeria (SON) have representatives abroad who issue the certificate for a small fee after conducting all necessary tests.

4.0 CONCLUSION

Any prospective international merchant should endeavour to know at least the main shipping documents which had just been listed and discussed above. Their importance in international business cannot be overemphasised because they evidence executed orders and thus serve in various ways, as evidence of title to ordered goods.

5.0 SUMMARY

In this unit, we have

- listed and explained all the basic transport / shipping documents required for international trade;
- enumerated and discussed other documents that are required to facilitate international business between individuals, business and governments of the world.

6.0 TUTOR MARKED ASSIGNMENT

1. (a) Describe the various types of invoice and state their uses.
   (b) What are the types of insurance documents? What precautions must a bank take when handling insurance documents?

2. (a) Distinguish between:
      (i) A through bill of lading and transshipment bill of lading;
      (ii) A clean bill of lading and claused bill of lading;
      (iii) A charter party bill of lading and short form bill of lading.

   (b) What precautions must a bank take when handling bills of lading?

3. (a) Differentiate between a sight bill of exchange and a tenor bill of exchange.
   (b) Why are private cheques not popular in international trade?

4. (a) Distinguish between a Sea Waybill and Bill of Lading.
   (b) State the conditions under which a Sea Waybill may be preferred by a merchant to a Bill of Lading?
   (c) State the features of a Sea Waybill in conformity with Article 24 of the Uniform Customs and Practice Publication 500. ***(Q. 5, April 2000, CIBN)***

5. In relation to transport documents used in international trade, define the following:
   (i) Combined Transport Bill of Lading;
   (ii) Transshipment Bill of Lading;
   (iii) Container Bill of Lading;
   (iv) Marine Bill of Lading;
   (v) Charter Party Bill of Lading. ***(Q. 8, April 2008, CIBN)***

7.0 REFERENCES AND FURTHER READINGS

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UNIT 5 INTERNATIONAL LIQUIDITY AND INTERNATIONAL MONETARY COOPERATION

Table of Contents

1.0 INTRODUCTION

In the last unit, we defined the concept of market entry strategies, examined the concept within the control of a chose marketing mix, described the different forms of entry, enumerated the advantages of the methods of entry, listed the disadvantages of the methods of entry, defined and discussed the concept 'counter trade' and explained the special features of commodity trading.

This unit will introduce you to international liquidity and international monetary cooperation. International liquidity can be described as cash in form of other foreign currencies available to meet the importation of goods and services from other countries; and to increase earnings from the exportation of goods and services to other countries. At micro level, this concept can be understood as cash in individual or enterprise pocket for operation of business. If an individual has building, furniture, plant and equipment and stock but no cash in pocket, he/she cannot survive long term in his/her business. The same thing, any nation may have lots of natural resources in the form of land, mines and forest but to aid dealing with foreign country, that nation should have foreign currency in hand.

The unit would dwell extensively on the institutions that aid cooperation among countries of the world to enhance international trade and commerce as well as settlement of international obligations. They include international monetary fund, World Bank, international financial corporation, international development agency etc.

2.0 OBJECTIVES

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

- define the concept international liquidity;
- discuss the relationship between international liquidity and trade, exchange rates and economic efficiency;
- define international monetary cooperation;
- list and discuss the various institutions that assist international monetary cooperation.

3.0 MAIN CONTENT

3.1 International Liquidity – Definition

Economic Dictionary (2011) defined international liquidity as the ability of a given country to purchase goods and services from another country. According to this definition, it is a combination of a country's readily available supply of foreign currency, and the degree to which the assets may be used as a form of payment or converted to the currency of the country with which it is trading. Kumar (2011) sees international liquidity as that part of the concept of international finance. To him, international liquidity is foreign currency or gold in the reserve of any country. According to him, it is very useful to pay for the amount of imported goods and reduce balance of payment deficit.

International capital market is concerned primarily with the provision of international liquidity. International liquidity consists of international financial assets used in settling indebtedness between nations (Esezobor, 2009). Such indebtedness between nations could arise from both current accounts and capital accounts. International financial assets include gold, IMF Special Drawing Rights, reserve assets and convertible currencies. International liquidity is also required for the following purposes:

(1) to provide bulk production loans e.g. the US$1 billion Eurocurrency loan obtained by Nigerian National Petroleum Corporation in 1980;

(2) to finance banking, portfolio investments and re-insurance business e.g. the recent increase in the credit line extended to Intercontinental Bank Plc. from US$27 million to US$100 million to fund credit to small and medium sized enterprises under the bank's special scheme called I-CARE. Another loan of US$66 million were granted to the bank from European Investment Bank (EIB) during the 20 years anniversary of the bank in January, 2009;

(3) to convert into local currency in order to improve liquidity position and general domestic credit expansion;

(4) to promote international trade;

(5) to sponsor large-scale commercial purposes;

(6) to undertake profitable arbitrage operations. To finance infrastructural development e.g. the US$11 million loan granted to Nasarawa State for health improvement facilities.

International capital market consists of (Ezesobor, 2009):

- Euro-currency Market
- Euro-bond Market; and
- International Equity Market.

(a) Euro-currency Market

In this market, Euro-dollar accounts for about 80 percent of its operations. Euro-currency is the market in bank deposits in currencies other than the currency of the country where the account is located. Thus, in the United Kingdom that has in the main, pounds sterling as its legal tender, dollar deposits would be Euro-dollar, deposits in French Franc would be Euro-franc and deposits in German deutsche mark would be Euro-deutsche mark. These Euro currencies all have separate markets hence, the Euro-dollar market, Euro-Swiss market etc.

In reality, all these currencies are simply called Euro-currencies. The American dollar maintains its name as Euro-dollar because of the predominance in the Euro-currency market at the prevailing London Interbank Offer Rate (LIBOR).

Euro-currency should not be confused with Euro. Both currencies are convertible but differ in the following ways:

1. Euro-currency is an investment instrument denominated in a currency outside the shores of the country while Euro is the official single currency of members of the European Union.
2. Euro-currency could be denominated in several currencies like dollar, franc, deutsche mark, guilder etc. but Euro is just one currency.
3. Euro is a deposit while Euro is a medium of exchange.
4. Euro helps to break down the strictures of border demarcation thereby promoting economic integration. Euro-currency does not.
5. Euro promotes trade between members of the European Union and the rest of the world while Euro-currency does not.
6. Euro removes exchange rate risk between member countries. Euro-currency does not.

7. Euro performs all the functions of money. Euro-currency is not a store of value.
8. Euro can be spent in the streets of member countries. Euro-currency cannot easily be spent.
9. Euro is regulated by the European Central Bank. There is hardly any regulation for Euro-currency.
10. Euro established on 1st January, 1999 is already an international reserve. Euro-currency which has been on for some forty five years is not.

Since its first use in 1959 on commercial scale, the growth in the Euro-currency market has been phenomenal due to the following reasons:

1. The emergence of the oil producing states especially in the Arab world as the nouveau riche with mammoth resources to invest.
2. Euro-dollar commanded higher interest rate than domestic rates in the United States. That attracted investments of dollars outside the shores of the U.S.
3. The existence of syndicates of banks to process loan faster and with less difficulty but with a great deal of anonymity, boosted the market.
4. The lack of one single regulatory authority provided some freedom for operators.
5. General expansion in international trade and the preference of Central Banks to save dollar reserves outside the U.S.

The major participants in the market are central banks, multinational companies, oil exporting countries, and financial institutions. Individuals too, have access to the market because they can open, for example, a Swiss account in a bank in London by the following process:

1. Earn money in Swiss by exporting, for example, granulated ginger ordered, to Switzerland.
2. Subject to exchange control regulations, advise the buyers in Switzerland to credit a specified London account in Swiss to earn some interest.
3. The London Bank on receipt of the Swiss franc can use the fund to create a Euro-Swiss loan.

Advantages of Borrowing in the Euro-currency Market:

(i) It is the best way for multinational companies to raise substantial loans for development. This is facilitated through loan syndication.
(ii) Although interest rates are competitive, lower rates than conventional loans could be negotiated.
(iii) It is faster and possibly easier to arrange loans for blue chip companies and countries noted for previous loan repayments, without straw.
(iv) In times of credit squeeze in some countries, Euro-currency loans can be arranged because there is no strict regulation on the operation.

(v) Long-term repayment tenor of up to 10 years can be negotiated for the loans.

Disadvantages:

1. Possibility of adverse exchange rate movements during the time of liquidation.
2. There are hidden costs in project inspection and follow up and the management cost that goes with such exercises.

(b) Euro-bond Market

The bonds is simply a certificate denominated in any international convertible currency underwritten by an international syndicate and sold to willing investors in countries other than the country in whose currency the bond is denominated. It is sold in attractive varieties (Esezobor, 2009), such as:

- Fixed rate bond
- Floating rate bond
- Option bond with option to purchase issuing companies' shares
- Zero coupon bond
- Convertible bond, etc.

However, the predominant currency of issue again, is the American dollar. The tenor of the bonds range from 5 years to 20 years.

Being an international capital market instrument, it draws patronage from oil rich nations, multinational companies and the World Bank. Nations have used the facility to raise cheap hard currencies for development projects and also to balance payments. Cost of such fund is linked with LIBOR.

London still ranks as the world commercial centre for Euro-bonds.

Advantages of Investing in Euro-bonds:

1. The process of the loan syndication affords the borrower a great deal of anonymity through the issue of bearer bonds. The process too is fast and convenient for conveyance because no prospectus is needed.
2. Large volumes of loan can be arranged through the syndication.
3. The interest element is not liable to public withholding tax.
4. The loan normally has long-term repayment terms.
5. The option bond allows the investor the freedom to switch his portfolio into the shares of the company borrower. This is part of a process called securitization. The latter allows an investor in a company's debt instruments to convert them to the equity of the company within defined terms.

6. Euro-bond is denominated in convertible currencies.
7. Euro-bond is a negotiable instrument.
8. Euro-bond loan can be obtained in one convertible currency and swapped for another currency to meet the urgent needs of the borrower.

Disadvantages:

Just like Euro-currency, the following disadvantages existing (Esezobor, 2009):

1. Risk of exchange rate fluctuations at the time of liquidation.
2. Added cost in accommodating contingents of the syndicates on project inspection and necessary site follow-up.
3. The syndicate leader may apply additional management cost for these services.

(c) International Equity Market (IEM)

It works by means of global depository system managed by depository banks. If the shares will be under the agency of the Central Securities and Clearing System (CSCS) on behalf of the depositary bank abroad, CSCS will thereafter, inform the depository bank of the details of the shares. The latter in response, will raise depositary receipt, which would be sold to a willing investor in the international market.

The new method of sale of new shares by CSCS where only statements rather than share certificates, are issued suits this system. In the older system of share certificates, CSCS would retain the custody of the portfolio while the depositary receipts could freely be negotiated by the buyer.

The passing of Investments and Securities Act No. 45 in 1999 opened the Nigerian Stock Exchange to the international market. Thus, the shares of United Bank for Africa Plc are now a product of the Global Depositary System.

The company whose share is being traded under this international system, benefits from the following advantages:

1. International recognition and the prestige that goes with it especially, in local demand for the shares.
2. Access to hard currency for expansion.
3. International expansion of shareholder’s register.
4. Improved operation to measure up to the regulations of the International Equity Market.
5. Possibility of higher profits from enhanced development.

3.1.1 Liquidity

Liquidity is a term which can be used to mean the same as cash, as in liquid assets (International Economic Glossary, 2011). Liquidity generally refers to the ease with which assets may be converted into cash or the amount of cash available to an individual or an entity, such as a company or a government, at any given time.

3.1.2 Liquid Assets

Liquid assets describe resources of cash as well as securities which can be easily sold in order to obtain their cash-equivalent value. Cash resources include physical currency, checking accounts and certain types of savings accounts. Soluble securities include short-term money market items as well as bonds.

Self Assessment Exercise 3.1

1. Define concepts liquidity, liquid assets and international liquidity.

2. What are the differences between Euro-currency, Euro-bond and International Equity Markets?

3.1.3 International Liquidity and Trade

The wide effects of globalization (which itself is described as the worldwide expansion of trade and investment, aided by developments in communications, transport and technology [Gimba, 2003]) have impelled countries to engage in trade on an unprecedented scale. To this extent, global economic growth and consequent regional prosperity are heavily affected by countries' supplies of foreign currency and reserves of liquid assets, such as precious metals.

3.1.4 International Liquidity and Exchange Rates

In Unit 1, we discussed briefly about foreign exchange and exchange rates, so our discussion in this sub-head is to show the relationship between international liquidity and exchange rates.

For a given country participating in international trade, the relative value of its own currency will heavily impact its purchasing power against another country's currency. In other words, if a country has a stronger currency than a given trading partner, it will be able to leverage the liquidity of its own currency into greater buying power upon conversion.

By contrast, if a country's own currency is weaker than that of a given trading partner, its relative liquidity becomes diminished as conversion requires value of the home currency to be divided rather than multiplied.

3.1.5 International Liquidity and Economic Efficiency

The higher the level of liquidity in an economy, the more efficiently it functions and expands. In other words, the greater the availability of extent cash resources and easily soluble assets, the greater and the more quickly goods and services can be bought and sold. This principle also holds true in the international economy, since the size and scope of countries' currency reserves have a direct effect on how expediently import transactions can be executed.

Self Assessment Exercise 3.2

What is the relationship between international liquidity and trade, exchange rates and economic efficiency of a country?

3.2 International Monetary Cooperation

There are three key terms in this concept, namely, international, monetary and cooperation. Hornby (2006) defined international as something connected with two or more countries i.e. a relationship that goes beyond the shore of a country. It also defined monetary as something that has to do with money e.g. policy guiding money supply within a country. It further defined cooperation as doing something together or working together for a shared goal or objective. Glossary of Statistical Terms (2011) describes current international cooperation as consisting of current transfers in cash or in kind between the governments of different countries or between governments and international organisations.

From the above definitions, one could define international monetary cooperation as the relationship between countries including the roles of states, intergovernmental organisations, international non-governmental organisations (INGOs), non-governmental organisations (NGOs) and multinational corporations (MNCs) of the world to evolve policies that would aid global trade and financial transactions.

The following are the institutions that assist global trade and commerce and financial settlement:

- International Monetary Fund (IMF)
- International Bank for Reconstruction and Development (World Bank)
- International Finance Corporation (IFC)
- International Development Association (IDA)
- Multilateral Investment Guarantee Agency (MIGA)
- World Trade Organisation (WTO)

3.5.1 International Monetary Fund (IMF)

Investopedia (2011) defined the international monetary fund (IMF) as an international organization created for the purpose of:

(1) promoting global monetary and exchange stability;

1. facilitating the expansion and balanced growth of international trade; and

2. assisting in the establishment of a multilateral system of payments for current transactions.

It states that IMF plays three major roles in the global monetary system. The Fund surveys and monitors economic and financial developments, lends funds to countries with balance-of-payment difficulties, and provides technical assistance and training for countries requesting it.

The International Monetary Fund (IMF) is an organization of 187 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world (Harold, 1996). The organization's stated objectives are to promote international economic cooperation, international trade, employment, and exchange rate stability, including by making resources available to member countries to meet balance of payments needs (Articles of Agreement of IMF, 2009). Its headquarters are in Washington, D.C.

The IMF was conceived on July 22, 1944 originally with 45 members and came into existence on December 27, 1945 when 29 countries signed the agreement (IMF, 2009); with a goal to stabilize exchange rates and assist the reconstruction of the world's international payment system. Countries contributed to a pool which could be borrowed from, on a temporary basis, by countries with payment imbalances. The IMF was vital when it was first created because it helped the world stabilize the economic system. The IMF works to improve the economies of its member countries (Escobar, 1988). The IMF describes itself as "an organization of 187 countries (as of July 2010), working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty."

(b) Membership

The members of the IMF are the 187 members of the UN and Kosovo (IMF, 2009). Former members are Cuba (which left in 1964) and (Andrews and Davies, 2009) the Republic of China which was ejected from the UN after losing support of then U.S. President Jimmy Carter, and replaced by the People's Republic of China in 1980 (Andrews and Davies, 2009). The other non-members are North Korea, Andorra, Monaco, Liechtenstein, Nauru, Cook Islands, Niue, Vatican City, and the rest of the states with limited recognition. Some members have a very difficult relationship with the IMF and even when they are still members they do not allow to be monitored. Argentina for example refuses to participate in an Article IV Consultation with the IMF.

All member states participate directly in the IMF. Member states are represented on a 24-member executive board (five executive directors are appointed by the five members with the largest quotas, nineteen executive directors are elected by the remaining members), and all members appoint a governor to the IMF's board of governors. The powers of the other countries within the organization are represented on a proportional scale to their population and economic rank in the world. The Executive board are the general owners of the IMF and can control major decisions within the organization, but all other member countries are represented on the population, economic scale. For further in depth information and a guide to the proportions and numbers associated with deciding the voting rights of the other countries please reference "Power distribution analysis in the international monetary fund." (IMF Article, 2009).

(c) History

The International Monetary Fund was conceived on July 22, 1944 during the United Nations Monetary and Financial Conference. The representatives of 45 governments met in the Mount Washington Hotel in the area of Bretton Woods, New Hampshire, United States, with the delegates to the conference agreeing on a framework for international economic cooperation (IMF, 2008). The IMF was formally organized on December 27, 1945, when the first 29 countries signed its Articles of Agreement. The statutory purposes of the IMF today are the same as when they were formulated in 1943.

The IMF's influence in the global economy steadily increased as it accumulated more members. The number of IMF member countries has more than quadrupled from the 44 states involved in its establishment, reflecting in particular the attainment of political independence by many developing countries and more recently the dissolution in 1991 of the Soviet Union. The expansion of the IMF's membership, together with the changes in the world economy, has required the IMF to adapt in a variety of ways to continue serving its purposes effectively.

(d) Data Dissemination Systems

In 1995 the International Monetary Fund began work on data dissemination standards with the view of guiding IMF member countries to disseminate their economic and financial data to the public. The International Monetary and Financial Committee (IMFC) endorsed the guidelines for the dissemination standards and they were split into two tiers: The General Data Dissemination System (GDDS) and the Special Data Dissemination Standard (SDDS).

The International Monetary Fund executive board approved the SDDS and GDDS in 1996 and 1997 respectively, and subsequent amendments were published in a revised "Guide to the General Data Dissemination System." The system is aimed primarily at statisticians and aims to improve many aspects of statistical systems in a country. It is also part of the World Bank Millennium Development Goals and Poverty Reduction Strategic Papers. The IMF established a system and standard to guide members in the dissemination to the public of their economic and financial data. Currently there are two such systems: GDDS and its superset SDDS, for those member countries having or seeking access to international capital markets.

The primary objective of the GDDS is to encourage IMF member countries to build a framework to improve data quality and increase statistical capacity building. This will involve the preparation of meta data describing current statistical collection practices and setting improvement plans. Upon building a framework, a country can evaluate statistical needs, set priorities in improving the timeliness, transparency, reliability and accessibility of financial and economic data.

(e) Member states – Membership qualifications

The application will be considered first by the IMF's executive board. After its consideration, the board will submit a report to the board of governors of the IMF with recommendations in the form of a "membership resolution." These recommendations cover the amount of quota in the IMF, the form of payment of the subscription, and other customary terms and conditions of membership. After the board of governors has adopted the membership Resolution, the applicant state needs to take the legal steps required under its own law to enable it to sign the IMF's Articles of Agreement and to fulfill the obligations of IMF membership. Similarly, any member country can withdraw from the Fund, although that is rare. For example, in April 2007, the president of Ecuador, Rafael Correa, announced the expulsion of the World Bank representative in the country. A few days later, at the end of April, Venezuelan president Hugo Chavez announced that the country would withdraw from the IMF and the World Bank. Chavez dubbed both organizations as "the tools of the empire" that "serve the interests of the North" (Bretton Woods Project, 2010). As of June 2009, both countries remain as members of both organizations.

A member's quota in the IMF determines the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of Special Drawing Rights (SDRs). A member state cannot unilaterally increase its quota—increases must be approved by the Executive Board of IMF and are linked to formulas that include many variables such as the size of a country in the world economy. For example, in 2001, the People's Republic of China was prevented from increasing its quota as high as it wished, ensuring it remained at the level of the smallest G7 economy (Canada) (Barnett and Finnemore (2004).

(f) Members' Quotas and Voting Power, and Board of Governors

Major decisions require an 85 percent supermajority (Counter Punch, 2010). The United States has always been the only country able to block a supermajority on its own. The following table shows the top 20 member states in terms of voting power (2,220,817 votes in total). The 27 member states of the European Union have a combined vote of 710,786 (32.07 percent). On October 23, 2010, the ministers of finance of G-20, governing most of the IMF member quotas, agreed to reform IMF and shift about 6 percent of the voting shares to major developing nations and countries with emerging markets (BBC, 2010) (see on the page overleaf the members' quotas and voting power).

3.5.2 International Bank for Reconstruction and Development (World Bank)

The International Bank for Reconstruction and Development (IBRD) is one of five institutions that compose the World Bank Group. The IBRD is an international organization whose original mission was to finance the reconstruction of nations devastated by World War II. Now, its mission has expanded to fight poverty by means of financing states. Its operation is maintained through payments as regulated by member states. It came into existence on December 27, 1945 following international ratification of the agreements reached at the United Nations Monetary and Financial Conference of July 1 to July 22, 1944 in Bretton Woods, United States.

The IBRD provides loans to governments, and public enterprises, always with a government (or "sovereign") guarantee of repayment subject to general conditions.[1] The funds for this lending come primarily from the issuing of World Bank bonds on the global capital markets—typically $12–15 billion per year. These bonds are rated AAA (the highest possible) because they are backed by member states' share capital, as well as by borrowers' sovereign guarantees. (In addition, loans that are repaid are recycled, or relent.) Because of the IBRD's credit rating, it is able to borrow at relatively low interest rates. As most developing countries have considerably lower credit ratings, the IBRD can lend to countries at interest rates that are usually quite attractive to them, even after adding a small margin (about 1%) to cover administrative overheads.

Membership

International Bank for Reconstruction and Development member states – Members of the IBRD are 186 of the UN members and Kosovo. The latest member is Tuvalu, which joined in 2010.

Non-members are Andorra, Cook Islands, Cuba, Liechtenstein, Monaco, Nauru, Niue, North Korea and Vatican City. All other non-members are states with limited recognition. All members of the IBRD are also IMF members, and vice versa.

Functions

The IBRD was established mainly as a vehicle for reconstruction of Europe and Japan after World War II, with an additional mandate to foster economic growth in developing countries in Africa, Asia and Latin America. Originally the bank focused mainly on large-scale infrastructure projects, building highways, airports, and power plants. As Japan and its European client countries "graduated" (achieved certain levels of income per capita), the IBRD became focused entirely on developing countries. Since the early 1990s the IBRD has also provided financing to the post-Socialist states of Eastern Europe and the republics of the former Soviet Union.

The bank also operates the Economic Development Institute, which offers training in economic development for officials of member countries. Closely affiliated with the bank is the International Finance Corporation (est. 1956), which invests in private enterprises without government guarantee. The bank organized the International Development Association (1960) to extend credit on easier terms, mainly to developing countries. The group of institutions is known as the World Bank Group. Criticism that the IBRD-financed projects were environmentally destructive led the bank to establish an environmental fund (1990) providing low-interest loans for developing countries. Developing nations have complained that the IBRD imposes the free-market system on them, thereby discouraging planning, nationalization, and public investment.

History

International Bank for Reconstruction and Development (IBRD) specialized agency of the United Nations, with headquarters at Washington, D.C.; also called the World Bank. Plans were laid at the Bretton Woods Conference in 1944 for the formation of a world bank; it was formally organized in 1945, when 28 countries ratified the agreement; there are now 185 members. The bank not only makes loans to member nations, but, under government guarantee, to private investors, for the purpose of facilitating productive investment, encouraging foreign trade, and discharging burdens of international debt. All members of the bank must also belong to the International Monetary Fund. The bank is self-sustaining and has maintained a profit on its lending activities. It is controlled by a board of governors, one from each member state. Votes are allocated according to capital subscription. Ordinary affairs are conducted by 22 executive directors, five appointed by the five largest capital subscribers, France, Germany, Great Britain, Japan, and the United States, and 17 elected by the remaining members. Regional vice presidents oversee the bank's operations in five regions: Asia, Latin America and the Caribbean, East Africa, West Africa, and (in one grouping) Europe, the Middle East, and North Africa.

3.5.3 International Finance Corporation (IFC)

The International Finance Corporation (IFC) promotes sustainable private sector investment in developing countries. IFC is a member of the World Bank Group and is headquartered in Washington, D.C., United States. Established in 1956, IFC is the largest multilateral source of loan and equity financing for private sector projects in the developing world. It promotes sustainable private sector development primarily by (Wikipedia, 2011):

1. Financing private sector projects and companies located in the developing world.

2. Helping private companies in the developing world mobilize financing in international financial markets.

3. Providing advice and technical assistance to businesses and governments.

Ownership and Management

IFC has 182 member countries, which collectively determine its policies and approve investments. To join IFC, a country must first be a member of the International Bank for

Reconstruction and Development (IBRD). IFC's corporate powers are vested in its Board of Governors, to which member countries appoint representatives. IFC's share capital, which is paid in, is provided by its member countries, and voting is in proportion to the number of shares held.

As of June 30, 2010 and 2009, IFC’s authorized capital (the sums contributed by its members over the years) was $2.45 billion, of which $2.37 billion was subscribed and paid in.

The Board of Governors delegates many of its powers to the Board of Directors, which is composed of the Executive Directors of the IBRD, and which represents IFC's member countries. The Board of Directors reviews all projects.

The President of the World Bank Group, Robert Zoellick, also serves as IFC's president. IFC's CEO and Executive Vice President, Lars H. Thunell, is responsible for the overall management of day-to-day operations. He was appointed on January 15, 2006.

Although IFC coordinates its activities in many areas with the other institutions in the World Bank Group, IFC generally operates independently as it is legally and financially autonomous with its own Articles of Agreement, share capital, management and staff.

Membership

Members of the IFC are 181 of the UN members and Kosovo.

Non-members are: Andorra, Brunei, Cook Islands, Cuba, Liechtenstein, Monaco, Nauru, Niue, North Korea, Saint Vincent and the Grenadines, San Marino, Tuvalu and Vatican City. The remaining non-members are all states with limited recognition.

Funding

The IFC's equity and quasi-equity investments are funded out of its paid-in capital and retained earnings (which comprise its net worth). Strong shareholder support, triple-A ratings and a substantial capital base allow the IFC to raise funds on favorable terms in international capital markets.

Activities

Within the World Bank Group, the World Bank finances projects with sovereign guarantees, while the IFC finances projects without sovereign guarantees. This means that the IFC is primarily active in private sector projects, although some projects in the public sector (at the municipal or sub-national level) have recently been funded.

Private sector financing is IFC's main activity, and in this respect is a profit-oriented financial institution (and has never had an annual loss in its 50-year history). Like a bank, IFC lends or invests its own funds and borrowed funds to its customers and expects to make a sufficient risk-adjusted return on its global portfolio of projects.

IFC's activities, however, must meet a second test of contributing to a reduction in poverty in line with its mandate. In practice, this is broadly interpreted, but considerable time and effort is devoted to both (i) selecting projects with positive developmental outcomes, and (ii) improving the developmental outcome of projects by various means.

IFC provides both investment and advisory services. IFC also carries out technical cooperation projects in many countries to improve the investment climate. These activities may be linked to a specific investment project, or, increasingly, to broader goals such as improving the legislative environment for a specific industry. IFC's technical cooperation projects are generally funded by donor countries or from IFC's own budget.

IFC's Advisory Services focus on five core areas: Access to Finance, Business Enabling Environment, Environmental & Social Sustainability, Infrastructure Advisory, and Corporate Advice. Advisory services to expand access to finance (A2F) often accompanies IFC's financial investments, and includes assistance to banks and specialized financial institutions in improving their ability to provide financial services to micro, small, and medium enterprises.

After successful pilots in several countries, the WorldHotel-Link project was successfully spun off from the IFC on 31 March 2006 and is now a private company with global reach helping locally owned small scale travel service providers in developing-world destinations overcome market access barriers.

CommDev (The Oil, Gas and Mining Sustainable Community Development Fund) is a funding mechanism for practical capacity building, training, technical assistance, implementation support, awareness-raising, and tool development. Operating flexibly and efficiently, CommDev serves as an integral component of an extractive industry project, enhancing, accelerating, and extending the value-added support given to communities beyond the compliance requirements of IFC investment projects and World Bank loan.

3.5.4 International Development Association (IDA)

The International Development Association (IDA) is the part of the World Bank that helps the world’s poorest countries. It complements the World Bank's other lending arm — the International Bank for Reconstruction and Development (IBRD) — which serves middle-income countries with capital investment and advisory services (Wikipedia, 2011).

IDA was created on September 24, 1960 and is responsible for providing long-term, interest-free loans to the world's 80 poorest countries, 39 of which are in Africa. IDA provides grants and credits (subject to general conditions, with repayment periods of 35 to 40 years. Since its inception, IDA credits and grants have totaled $161 billion, averaging $7–$9 billion a year in recent years and directing the largest share, about 50%, to Africa. While the IBRD raises most of its funds on the world's financial markets, IDA is funded largely by contributions from the governments of the richer member countries. Additional funds come from IBRD income and repayment of IDA credits.

IDA loans address primary education, basic health services, clean water supply and sanitation, environmental safeguards, business-climate improvements, infrastructure and institutional reforms. These projects are intended to pave the way toward economic growth, job creation, higher incomes and better living conditions.

Mission statement

The International Development Association (IDA) is the part of the World Bank that helps the world's poorest countries reduce poverty by providing no- interest loans and grants for programs aimed at boosting economic growth and improving living conditions. IDA funds help these countries deal with the complex challenges they face in striving to meet the Millennium Development Goals. They must, for example, respond to the competitive pressures as well as the opportunities of globalization; arrest the spread of HIV/AIDS; and prevent conflict or deal with its aftermath.

IDA's long-term (stretched over 35 to 40 years), no-interest loans pay for programs that build the policies, institutions, infrastructure and human capital needed for equitable and environmentally sustainable development. IDA's goal is to reduce inequalities both across and within countries by allowing more people to participate in the mainstream economy, reducing poverty and promoting more equal access to the opportunities created by economic growth. IDA also provides grants to countries at risk of debt distress.

Membership

Members of the IDA are 170 of the UN members and Kosovo.

Non-members are: Andorra, Antigua and Barbuda, Bahrain, Belarus, Brunei, Bulgaria, Cook Islands, Cuba, Jamaica, Liechtenstein, Malta, Monaco, Namibia, Nauru, Niue, North Korea, Qatar, Romania, San Marino, Seychelles, Suriname, Turkmenistan, Uganda, Uruguay, Vatican City and Venezuela. The remaining non-members are states with limited recognition.

History

The International Bank for Reconstruction and Development (IBRD), better known as the World Bank, was established in 1944 to help Europe recover from the devastation of World War II. The success of that enterprise led the Bank, within a few years, to turn its attention to the developing countries. By the 1950s, it became clear that the poorest developing countries needed softer terms than those that could be offered by the Bank, so they could afford to borrow the capital they needed to grow. With the United States taking the initiative, a group of the Bank's member countries decided to set up an agency that could lend to the poorest countries on the most favourable terms possible. They called the agency the "International Development Association." Its founders saw IDA as a way for the "haves" of the world to help the "have-nots." But they also wanted IDA to be run with the discipline of a bank. For this reason, US President Dwight D. Eisenhower proposed, and other countries agreed, that IDA should be part of the World Bank (IBRD).

IDA's Articles of Agreement became effective in 1960. The first IDA loans, known as credits, were approved in 1961 to Chile, Honduras, India and Sudan.

IBRD and IDA are run on the same lines. They share the same staff and headquarters, report to the same president and evaluate projects with the same rigorous standards. But IDA and IBRD draw on different resources for their lending, and because IDA's loans are deeply concessional, IDA's resources must be periodically replenished. A country must be a member of IBRD before it can join IDA; 169 countries are IDA members.

3.5.5 Multilateral Investment Guarantee Agency (MIGA)

The Multilateral Investment Guarantee Agency (MIGA) is a member organization of the World Bank Group that offers political risk insurance. It was established to promote foreign direct investment into developing countries. MIGA was founded in 1988 with a capital base of $1 billion and is headquartered in Washington, DC. 175 member countries comprise MIGA's shareholders (Wikipedia, 2011).

MIGA promotes foreign direct investment into developing countries by insuring investors against political risk, advising governments on attracting investment, sharing information through on-line investment information services, and mediating disputes between investors and governments. MIGA's membership in the World Bank Group enables the organization to intervene with host governments to resolve claims before they are filed (MIGA, 2008).

Membership

Members of the MIGA include 174 members of the United Nations and the Republic of Kosovo. Non-members are: Brunei, Sao Tome and Principe, Niger, Somalia, Comoros, San Marino, Bhutan, Myanmar, Tuvalu, Kiribati, Marshall Islands, Samoa, Cuba, North Korea, Andorra, Monaco, Liechtenstein, Nauru, Cook Islands, Niue, Vatican City and the rest of states with limited recognition.

MIGA's Business

MIGA provides guarantees against noncommercial risks to protect cross-border investment in developing member countries. The organization's efforts protect investors against the risks of currency inconvertibility and transfer restriction; expropriation; war, civil disturbance, and terrorism; breach of contract; and non-honoring of sovereign financial obligations (Donovan, 2004). These coverages may be purchased individually or in combination.

MIGA can cover:

- new, greenfield investments;
- new investment contributions associated with the expansion, modernization, or financial restructuring of existing projects;
- acquisitions involving privatization of state enterprises;
- existing investments with high development impact when the investor demonstrates a long-term commitment to the project.

Over the years, the organization has provided more than $24 billion in political risk insurance for over 600 projects in more than 100 developing countries. Its outstanding guarantees portfolio stands at $9.1 billion. Among MIGA's accomplishments: it provides water, electricity and other basic infrastructure, in addition to generating tax revenues and creating training programs. MIGA also assists with the development of facilities to tap natural resources through sustainable policies and programs (Donovan, 2004).

3.5.6 World Trade Organisation (WTO)

The World Trade Organization (WTO) is an organization that intends to supervise and liberalize international trade. The organization officially commenced on January 1, 1995 under the Marrakech Agreement, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1948 (Malanczuk, 1999). The organization deals with regulation of trade between participating countries; it provides a framework for negotiating and formalizing trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements which are signed by representatives of member governments and ratified by their parliaments. History has it that (WTO, 2008) stated that most of the issues that the WTO focuses on derive from previous trade negotiations, especially from the Uruguay Round (1986–1994).

The organization is currently endeavoring to persist with a trade negotiation called the Doha Development Agenda (or Doha Round), which was launched in 2001 to enhance equitable participation of poorer countries which represent a majority of the world's population. However, the negotiation has been dogged by "disagreement between exporters of agricultural bulk commodities and countries with large numbers of subsistence farmers on the precise terms of a 'special safeguard measure' to protect farmers from surges in imports. At this time, the future of the Doha Round is uncertain."

The WTO has 153 members, representing more than 97% of the world's population (Hart, 2010), and 30 observers, most seeking membership. The WTO is governed by a ministerial conference, meeting every two years; a general council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a director-general, who is appointed by the ministerial conference. The WTO's headquarters is at the Centre William Rappard, Geneva, Switzerland.

Harry White (l) and John Maynard Keynes at the Bretton Woods Conference — Both economists had been strong advocates of a liberal international trade environment, and recommended the establishment of three institutions: the IMF (fiscal and monetary issues), the World Bank (financial and structural issues), and the ITO (international economic cooperation).

The WTO's predecessor, the General Agreement on Tariffs and Trade (GATT), was established after World War II in the wake of other new multilateral institutions dedicated to international economic cooperation — notably the Bretton Woods institutions known as the World Bank and the International Monetary Fund. A comparable international institution for trade, named the International Trade Organization was successfully negotiated. The ITO was to be a United Nations specialized agency and would address not only trade barriers but other issues indirectly related to trade, including employment, investment, restrictive business practices, and commodity agreements. But the ITO treaty was not approved by the U.S. and a few other signatories and never went into effect (Bossche, Mavroidis and Fergusson, 2007).

In the absence of an international organization for trade, the GATT would over the years "transform itself" into a *de facto* international organization.

GATT rounds of negotiations

The GATT was the only multilateral instrument governing international trade from 1945 until the WTO was established in 1995. Despite attempts in the mid 1950s and 1960s to create some form of institutional mechanism for international trade, the GATT continued to operate for almost half a century as a semi-institutionalized multilateral treaty regime on a provisional basis.

From Geneva to Tokyo

Seven rounds of negotiations occurred under GATT. The first real GATT trade rounds concentrated on further reducing tariffs. Then, the Kennedy Round in the mid-sixties brought about a GATT anti-dumping Agreement and a section on development. The Tokyo Round during the seventies was the first major attempt to tackle trade barriers that do not take the form of tariffs, and to improve the system, adopting a series of agreements on non-tariff barriers, which in some cases interpreted existing GATT rules, and in others broke entirely new ground. Because these plurilateral agreements were not accepted by the full GATT membership, they were often informally called "codes". Several of these codes were amended in the Uruguay Round, and turned into multilateral commitments accepted by all WTO members. Only four remained plurilateral (those on government procurement, bovine meat, civil aircraft and dairy products), but in 1997 WTO members agreed to terminate the bovine meat and dairy agreements, leaving only two.

Uruguay Round

During the Doha Round, the US government blamed Brazil and India for being inflexible, and the EU for impeding agricultural imports (Klapper, 2006). The Ex-President of Brazil, Luiz Inácio Lula da Silva, responded to the criticisms by arguing that progress would only be achieved if the richest countries (especially the US and countries in the EU) make deeper cuts in their agricultural subsidies, and further open their markets for agricultural goods (Lula, 2006).

Well before GATT's 40th anniversary, its members concluded that the GATT system was straining to adapt to a new globalizing world economy. In response to the problems identified in the 1982 Ministerial Declaration (structural deficiencies, spill-over impacts of certain countries' policies on world trade GATT could not manage etc.), the eighth GATT round — known as the Uruguay Round — was launched in September 1986, in Punta del Este, Uruguay.

It was the biggest negotiating mandate on trade ever agreed: the talks were going to extend the trading system into several new areas, notably trade in services and intellectual property, and to reform trade in the sensitive sectors of agriculture and textiles; all the original GATT articles were up for review. The Final Act concluding the Uruguay Round and officially establishing the WTO regime was signed April 15, 1994, during the ministerial meeting at Marrakesh, Morocco, and hence is known as the Marrakesh Agreement (WTO, 2010).

The GATT still exists as the WTO's umbrella treaty for trade in goods, updated as a result of the Uruguay Round negotiations (a distinction is made between *GATT 1994*, the updated parts of GATT, and *GATT 1947*, the original agreement which is still the heart of GATT 1994).[18] GATT 1994 is not however the only legally binding agreement included via the Final Act at Marrakesh; a long list of about 60 agreements, annexes, decisions and understandings was adopted. The agreements fall into a structure with six main parts:

- The Agreement Establishing the WTO
- Goods and investment — the Multilateral Agreements on Trade in Goods including the GATT 1994 and the Trade Related Investment Measures
- Services — the General Agreement on Trade in Services
- Intellectual property — the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)
- Dispute settlement (DSU)
- Reviews of governments' trade policies (TPRM)[21]

Ministerial conferences

The topmost decision-making body of the WTO is the Ministerial Conference, which usually meets every two years. It brings together all members of the WTO, all of which are countries or customs unions. The Ministerial Conference can take decisions on all matters under any of the multilateral trade agreements. The inaugural ministerial conference was held in Singapore in 1996. Disagreements between largely developed and developing economies emerged during this conference over four issues initiated by this conference, which led to them being collectively referred to as the "Singapore issues". The second ministerial conference was held in Geneva in Switzerland. The third conference in Seattle, Washington ended in failure, with massive demonstrations and police and National Guard crowd control efforts drawing worldwide attention. The fourth ministerial conference was held in Doha in the Persian Gulf nation of Qatar. The Doha Development Round was launched at the conference. The conference also approved the joining of China, which became the 143rd member to join. The fifth ministerial conference was held in Cancún, Mexico, aiming at forging agreement on the Doha round. An alliance of 22 southern states, the G20 developing nations (led by India, China, Brazil, ASEAN led by the Philippines), resisted demands from the North for agreements on the so-called "Singapore issues" and called for an end to agricultural subsidies within the EU and the US. The talks broke down without progress.

The sixth WTO ministerial conference was held in Hong Kong from 13–18 December 2005. It was considered vital if the four-year-old Doha Development Agenda negotiations were to move forward sufficiently to conclude the round in 2006. In this meeting, countries agreed to phase out all their agricultural export subsidies by the end of 2013, and terminate any cotton export subsidies by the end of 2006. Further concessions to developing countries included an agreement to introduce duty free, tariff free access for goods from the Least Developed Countries, following the Everything but Arms initiative of the European Union — but with up to 3% of tariff lines exempted. Other major issues were left for further negotiation to be completed by the end of 2010. The WTO General Council, on 26 May 2009, agreed to hold a seventh WTO ministerial conference session in Geneva from 30 November-3 December 2009. A statement by chairman Amb. Mario Matus acknowledged that the prime purpose was to remedy a breach of protocol requiring two-yearly "regular" meetings, which had lapsed with the Doha Round failure in 2005, and that the "scaled-down" meeting would not be a negotiating session, but "emphasis will be on transparency and open discussion rather than on small group processes and informal negotiating structures". The general theme for discussion was "The WTO, the Multilateral Trading System and the Current Global Economic Environment" (WTO, 2009).

Doha Round

The Doha Development Round started in 2001 and continues today. The WTO launched the current round of negotiations, the Doha Development Agenda (DDA) or Doha Round, at the fourth ministerial conference in Doha, Qatar in November 2001. The Doha round was to be an ambitious effort to make globalization more inclusive and help the world's poor, particularly by slashing barriers and subsidies in farming (The Economist, 2006). The initial agenda comprised both further trade liberalization and new rule-making, underpinned by commitments to strengthen substantial assistance to developing countries. The negotiations have been highly contentious and agreement has not been reached, despite the intense negotiations at several ministerial conferences and at other sessions. Disagreements still continue over several key areas including agriculture subsidies (Fergusson, 2008).

Functions

Among the various functions of the WTO, these are regarded by analysts as the most important:

- It oversees the implementation, administration and operation of the covered agreements.

- It provides a forum for negotiations and for settling disputes.

Additionally, it is the WTO's duty to review and propagate the national trade policies, and to ensure the coherence and transparency of trade policies through surveillance in global economic policy-making. Another priority of the WTO is the assistance of developing, least-developed and low-income countries in transition to adjust to WTO rules and disciplines through technical cooperation and training.

The WTO is also a center of economic research and analysis: regular assessments of the global trade picture in its annual publications and research reports on specific topics are produced by the organization. Finally, the WTO cooperates closely with the two other components of the Bretton Woods system, the IMF and the World Bank.

Principles of the trading system

The WTO establishes a framework for trade policies; it does not define or specify outcomes. That is, it is concerned with setting the rules of the trade policy games. Five principles are of particular importance in understanding both the pre-1994 GATT and the WTO:

1. **Non-Discrimination**. It has two major components: the most favoured nation (MFN) rule, and the national treatment policy. Both are embedded in the main WTO rules on goods, services, and intellectual property, but their precise scope and nature differ across these areas. The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO members, i.e. a WTO member has to grant the most favorable conditions under which it allows trade in a certain product type to all other WTO members. "Grant someone a special favour and you have to do the same for all other WTO members." National treatment means that imported goods should be treated no less favorably than domestically produced goods (at least after the foreign goods have entered the market) and was introduced to tackle non-tariff barriers to trade (e.g. technical standards, security standards et al. discriminating against imported goods).

2. **Reciprocity**. It reflects both a desire to limit the scope of free-riding that may arise because of the MFN rule, and a desire to obtain better access to foreign markets. A

related point is that for a nation to negotiate, it is necessary that the gain from doing so be greater than the gain available from unilateral liberalization; reciprocal concessions intend to ensure that such gains will materialise.

3. **Binding and enforceable commitments**. The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a schedule (list) of concessions. These schedules establish "ceiling bindings": a country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures.

4. **Transparency**. The WTO members are required to publish their trade regulations, to maintain institutions allowing for the review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO. These internal transparency requirements are supplemented and facilitated by periodic country-specific reports (trade policy reviews) through the Trade Policy Review Mechanism (TPRM). The WTO system tries also to improve predictability and stability, discouraging the use of quotas and other measures used to set limits on quantities of imports.

5. **Safety valves**. In specific circumstances, governments are able to restrict trade. There are three types of provisions in this direction: articles allowing for the use of trade measures to attain noneconomic objectives; articles aimed at ensuring "fair competition"; and provisions permitting intervention in trade for economic reasons.[37] Exceptions to the MFN principle also allow for preferential treatment of developed countries, regional free trade areas and customs unions.

Organizational structure

The General Council has multiple bodies which oversee committees in different areas, re the following:

Council for Trade in Goods

There are 11 committees under the jurisdiction of the Goods Council each with a specific task. All members of the WTO participate in the committees. The Textiles Monitoring Body is separate from the other committees but still under the jurisdiction of Goods Council. The body has its own chairman and only 10 members. The body also has several groups relating to textiles (WTO, 2008).

Council for Trade-Related Aspects of Intellectual Property Rights

Information on intellectual property in the WTO, news and official records of the activities of the TRIPS Council, and details of the WTO’s work with other international organizations in the field.

Council for Trade in Services

The Council for Trade in Services operates under the guidance of the General Council and is responsible for overseeing the functioning of the General Agreement on Trade in Services (GATS). It is open to all WTO members, and can create subsidiary bodies as required.

Trade Negotiations Committee

The Trade Negotiations Committee (TNC) is the committee that deals with the current trade talks round. The chair is WTO's director-general. The committee is currently tasked with the Doha Development Round (WTO, 2008).

The Service Council has three subsidiary bodies: financial services, domestic regulations, GATS rules and specific commitments. The General council has several different committees, working groups, and working parties. There are committees on the following: Trade and Environment; Trade and Development (Subcommittee on Least-Developed Countries); Regional Trade Agreements; Balance of Payments Restrictions; and Budget, Finance and Administration. There are working parties on the following: Accession. There are working groups on the following: Trade, debt and finance; and Trade and technology transfer.

Decision-making

The WTO describes itself as "a rules-based, member-driven organization — all decisions are made by the member governments, and the rules are the outcome of negotiations among members". The WTO Agreement foresees votes where consensus cannot be reached, but the practice of consensus dominates the process of decision-making.

Richard Harold Steinberg (2002) argues that although the WTO's consensus governance model provides law-based initial bargaining, trading rounds close through power-based bargaining favouring Europe and the U.S., and may not lead to Pareto improvement (Steinberg, 2002).

Dispute settlement

In 1994, the WTO members agreed on the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) annexed to the "Final Act" signed in Marrakesh in 1994. Dispute settlement is regarded by the WTO as the central pillar of the multilateral trading system, and as a "unique contribution to the stability of the global economy". WTO members have agreed that, if they believe fellow-members are violating trade rules, they will use the multilateral system of settling disputes instead of taking action unilaterally.

The operation of the WTO dispute settlement process involves the DSB panels, the Appellate Body, the WTO Secretariat, arbitrators, independent experts and several specialized institutions. Bodies involved in the dispute settlement process, World Trade Organization.

Accession and Membership

The process of becoming a WTO member is unique to each applicant country, and the terms of accession are dependent upon the country's stage of economic development and current trade regime. The process takes about five years, on average, but it can last more if the country is less than fully committed to the process or if political issues interfere. As is typical of WTO procedures, an offer of accession is only given once consensus is reached among interested parties.

Accession Process

A country wishing to accede to the WTO submits an application to the General Council, and has to describe all aspects of its trade and economic policies that have a bearing on WTO agreements. The application is submitted to the WTO in a memorandum which is examined by a working party open to all interested WTO Members.

After all necessary background information has been acquired; the working party focuses on issues of discrepancy between the WTO rules and the applicant's international and domestic trade policies and laws. The working party determines the terms and conditions of entry into the WTO for the applicant nation, and may consider transitional periods to allow countries some leeway in complying with the WTO rules.

The final phase of accession involves bilateral negotiations between the applicant nation and other working party members regarding the concessions and commitments on tariff levels and market access for goods and services. The new member's commitments are to apply equally to all WTO members under normal non-discrimination rules, even though they are negotiated bilaterally.

When the bilateral talks conclude, the working party sends to the general council or ministerial conference an accession package, which includes a summary of all the working party meetings, the Protocol of Accession (a draft membership treaty), and lists ("schedules") of the member-to-be's commitments. Once the general council or ministerial conference approves of the terms of accession, the applicant's parliament must ratify the Protocol of Accession before it can become a member.

Members and observers

The WTO has 153 members and 31 observers. In addition to states, the European Union is also a member. WTO members do not have to be full sovereign nation-members. Instead, they must be a customs territory with full autonomy in the conduct of their external commercial relations. Thus Hong Kong (as "Hong Kong, China" since 1997) became a GATT contracting party, and the Republic of China (Taiwan) acceded to the WTO in 2002 as "Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu"

(Chinese Taipei) despite its disputed status. The WTO Secretariat omits the official titles (such as Counselor, First Secretary, Second Secretary and Third Secretary) of the members of Chinese Taipei's Permanent Mission to the WTO, except for the titles of the Permanent Representative and the Deputy Permanent Representative.

Russia is the biggest economy outside WTO and after the completion of Russia's accession; Iran would be the biggest economy outside the WTO. With the exception of the Holy See, observers must start accession negotiations within five years of becoming observers. Some international intergovernmental organizations are also granted observer status to WTO bodies. 14 states and 2 territories so far have no official interaction with the WTO.

Agreements

The WTO oversees about 60 different agreements which have the status of international legal texts. Member countries must sign and ratify all WTO agreements on accession. A discussion of some of the most important agreements follows. The Agreement on Agriculture came into effect with the establishment of the WTO at the beginning of 1995. The AoA has three central concepts, or "pillars": domestic support, market access and export subsidies. The General Agreement on Trade in Services was created to extend the multilateral trading system to service sector, in the same way the General Agreement on Tariffs and Trade (GATT) provides such a system for merchandise trade. The Agreement entered into force in January 1995. The Agreement on Trade-Related Aspects of Intellectual Property Rights sets down minimum standards for many forms of intellectual property (IP) regulation. It was negotiated at the end of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in 1994.

The Agreement on the Application of Sanitary and Phytosanitary Measures — also known as the SPS Agreement was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the beginning of 1995. Under the SPS agreement, the WTO sets constraints on members' policies relating to food safety (bacterial contaminants, pesticides, inspection and labelling) as well as animal and plant health (imported pests and diseases). The Agreement on Technical Barriers to Trade is an international treaty of the World Trade Organization. It was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the end of 1994. The object ensures that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade".[61] The Agreement on Customs Valuation, formally known as the Agreement on Implementation of Article VII of GATT, prescribes methods of customs valuation that Members are to follow. Chiefly, it adopts the "transaction value" approach.

4.0 CONCLUSION

Whereas international liquidity as the ability of a given country to purchase goods and services from another country, international monetary cooperation refer to the relationship between countries of the world to set necessary machinery in motion for the success of trade, commerce and other financial transactions.

5.0 SUMMARY

In this unit, we defined international liquidity and international monetary cooperation. We also discussed extensively on the institutions which aid cooperation among countries of the world to enhance international trade and commerce as well as settlement of international obligations. These institutions included international monetary fund, World Bank, international financial corporation, international development agency, multilateral investment guarantee agency and world trade organisation.

6.0 TUTOR MARKED ASSIGNMENT

1. Write short notes on the following international monetary institutions:

   (a) IMF
   (b) World Bank
   (c) IFC
   (d) IDA
   (d) MIGA
   (e) WTO

2. What is the difference between International Liquidity and International Monetary Cooperation?

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MODEL 2: FOREIGN EXCHANGE AND FINANCE OF INTERNATIONAL TRADE

UNIT 1: METHOD OF PAYMENT I

CONTENTS

1.0 INTRODUCTION

You are welcome to Module 2 of this course. In the first unit of this module, we shall examine the various ways of placing orders for goods from abroad and at the same time, look at the different methods by which export products can be sold abroad in order to ensure that the proceeds of payment are received intact.

2.0 OBJECTIVES

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

- outline the methods of payment in international trade;
- provide detailed analysis of payment in advance and open account;
- enumerate the strengths and weaknesses of each of the two methods;
- define collections and differentiate between clean collection and documentary collection;
- understand the route process and the responsibilities of the players in the documentary collection;
- describe the place of Case of Need;

- discuss how to remit payments or handle accepted documents;
- advise on the merits and demerits of documentary collection.

3.0 MAIN CONTENT

3.1 An Outline of the Methods of Payment

To buy or sell products or services internationally, four methods are recognized as the means by which the business could be concluded. They are:

(i) Payment in Advance;
(ii) Open Account;
(iii) Documentary Collection; and
(iv) Documentary Letter of Credit.

The above four methods give various sense of security to both the exporter and importer.

In the order in which they are listed, the exporter is most secured in terms of ensuring that he would receive payment for goods shipped or services rendered first in number (i) followed by number (iv), number (iii), and lastly, number (ii).

The exporter could agree on his best payment methods as follows:

(i) Payment in Advance;
(ii) Documentary Collection; and
(iii) Documentary Letter of Credit.
(iv) Open Account;

The importer on the other hand, wants an iron-cast assurance that the exporter will not swindle him by failing in the first instance, to ship the ordered goods. From his point of view therefore, he is most secured with Open Account in the hyphenated list and in that order upwards.

We therefore derive the following risk ladder for both the exporter and importer:

Exporter		Payment Method	Importer
Most secured	(i)	Payment in advance	Least secured
	(ii)	Documentary letters of credit	
	(iii)	Documentary Collection	
	(iv)	Open Account	
Least secured			Most secured

While the payment in advance, open account and documentary collections would be taken in this unit, the fourth one, documentary letters of credit would be considered in the next unit. This has become necessary to show the importance and concern by the International Chamber of Commerce (ICC) in ensuring that their operational terms, applications and procedures are well known and uniformly too all over the world to facilitate international trade.

It is also important in international trade that both the buyer and seller know each other fairly well and where appropriate, trade references obtained to boost confidence in each other. It is necessary for merchants to understand each of the four methods and the responsibilities that pertain to them as a prelude to entering into international contract.

3.2 Payment in Advance

Payment in advance is defined as money paid for goods or services before they are actually delivered or money paid earlier than expected.

This is a seller's market whereby the seller dictates his terms of trade as above when dispatching his pro-forma invoice to the prospective buyer.

To the seller (the exporter), this is the best method of doing international business because he receives his money without difficulty. Having received his money, he may elect not to sell at all; rather bearing the odds of being unethical and being a man of straw.

Rightly, he could use the money to procure his raw materials and commence production – a long process that could give the importer a lot of cause for concern. A flimsy minded exporter, having received his money without batting an eye, could decide to cut corners by producing goods which are below standard to export to the buyer.

The importer, on the other hand, would not part with his money excepting he has a time-tested trade relationship with the exporter. Furthermore, he must ensure that the exchange control regulations of his country allow for payment in advance. For the avoidance of doubt, payment in advance as a method of doing international business is not allowed in Nigerian foreign exchange regulations if the merchant is buying from abroad.

3.3 Open Account

Under this method, there is absolute trust between the exporter and importer built up over many years of a trading relationship. As a result, the exporter is quite happy to honour fresh orders within a mutually agreed limit for which payment would be made by his importer at a future date acceptable to the exporter.

Open account trade is a generous credit facility extended by the exporter to the importer to enable him to find buyers for the products. The exporter could grant it to market centres where his products are new and for which, an aggressive international market strategy is being pursued through familiar trading partners who perhaps also sell to him the required primary products on suitable equivalent terms.

Open account terms for the importation of legitimate goods into Nigeria are hundred percent welcomed. However, this is not so with exports which must be by documentary letters of credit.

Self Assessment Exercise 1.1

1. Itemise the various methods of conducting international business.

2. How do you arrange these methods in terms of security of payment from the perspectives of the exporter and the importer?

3.4 Documentary Collection

Any regular buyer in international trade always looks forward to a time the seller can do business with him on the basis of documentary collections since open account trading facility becomes increasingly unattainable outside members of the same economic bloc. This is because documentary collections are faster to execute, cheaper in terms of bank charges and less cumbersome than documentary letters of credit.

3.4.1 Definition of Documentary Collection

The International Chamber of Commerce (ICC) in the Uniform Rules for Collection (URC), 1995 Revision, ICC Publication No. 522, Article 2 (Esezobor, 2009) define documentary collection as follows:

> *Collection means the handling by banks of documents as defined in sub-Article 2 (b), in accordance with instructions received, in order to obtain payment and/or acceptance or deliver documents against payment and/or against acceptance or deliver documents on other terms and conditions.*
>
> *'Documents' means financial documents and/or commercial documents.*
>
> *'Financial documents' means bills of exchange, promissory notes, cheques, or other similar instruments used for obtaining the payment of money.*
>
> *'Commercial documents' means invoices, transport documents, documents of title or other similar documents, or any other documents whatsoever, not being financial documents.*
>
> *'Clean collection' means collection of financial documents not accompanied by commercial documents.*
>
> *'Documentary collections' means collection of financial documents accompanied by commercial documents.*

URC was first published by ICC, an international organisation committed to removing the structures in international trade, in 1956 and subsequently revised in 1976 and 1978. The current version came into operation in 1995. The motivation for the rules stemmed from differences between countries in the following socio-cultural matters:

- Laws and legal systems
- Culture
- Personal and group preferences
- Economic system
- Religious beliefs

URC therefore states clearly the roles, duties and responsibilities of all parties in international trade. Thus, disputes that should have emerged from the above-stated differences don't even arise because at every stage, all parties understand their obligations except as stated in Article 1, parties elect to trade outside the rules.

There are 26 articles put into the following compartments:

- General Provisions and Definitions, Articles 1 to 3.
- Form and Structure of Collection, Article 4.
- Form of Presentation, Articles 5 to 8.
- Liabilities and Responsibilities, Articles 9 to 15.
- Payment, Articles 16 to 19.
- Interest, Charges and Exposures, Articles 20 and 21.
- Other provisions, Articles 22 to 26.

Defining the concept documentary credits in a layman's language, Esezobor (2009) says collection is a contract between an exporter and importer whereby the exporter sells his goods by shipping directly to the importer but sends the shipping documents with which the goods can be cleared through his bank to another bank in the importer's country with strict instructions that the shipping documents should be released either against payment (Document Against Payment) or against acceptance of the attached bill of exchange (Document Against Acceptance).

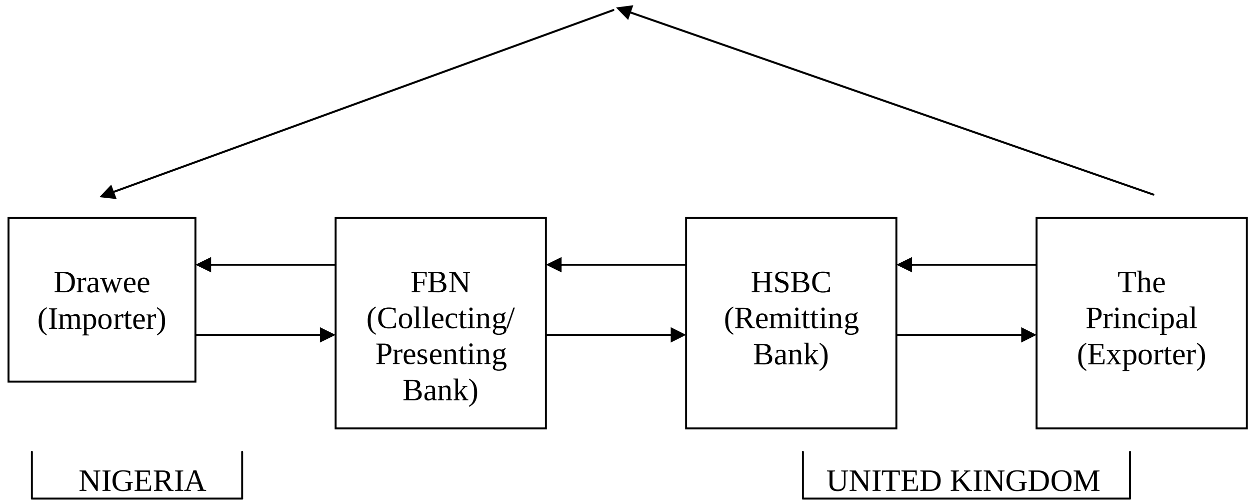
In effect, after the contract of importation must have been signed by the importer by completing the order form attached to the pro-forma invoice, the collection flows from the exporter.

Self Assessment Exercise 1.2

Define in your own way what is meant by documentary collection.

To explain the collection scenario better, the following figure will suffice.

Figure 1.1 **Goods Shipped Directly**



Key:

← Route for sending the shipping documents

→ Route for remitting the payment.

3.4.2 Parties to a Collection

Once again, we quote from Article 3 of the Uniform Rules for Collection, ICC Publication No. 522 which states that:

(a) For the purpose of this article, the 'parties thereto' are:

- (i) the principal who is the party entrusting the handling of a collection to a bank;
- (ii) the 'remitting bank' which is the bank to which the principal has entrusted the handling of a collection;

(iii) the 'collecting bank' which is any bank other than the remitting bank involved in processing the collection;

(iv) the 'presenting bank' which is the collecting bank making presentation to the drawee.

(b) The drawee is the one to whom presentation is to be made in accordance with the collection instruction.

3.4.3 Collection Order/Collection Instructions

The bank's collection instruction form is designed in such a way that all the exporter has to do is simply to fill in his collection order. The collection order is therefore the body of instructions passed by the exporter to the remitting bank to guide the collection of proceeds of the collection he is handing in.

The collection instruction is the covering letter by the remitting bank which details all aspects of the collection order from the customer, to the collecting bank. Until the review of the Uniform Rules for Collection, the collection instruction used to be called 'Remittance Letter'.

As contained in Article 4 of URC, the collection instructions should indicate the following (Esezobor, 2009):

- that the collection is subject to URC No. 522 and it should give complete and precise instructions;
- that banks will not examine documents in order to obtain collection instruction;
- that unless stated in the collection instruction, banks will disregard any instruction from any party/bank other than from the party/bank from which they received the instruction;
- details including contact address and SWIFT address of the remitting bank and presenting bank;
- details of the principal and drawee including their contact address, telephone and fax numbers;
- currency and amount of the collection;
- list and number of shipping documents;
- whether the collection is against payment or against acceptance;
- charges, whether to be waived or not;
- interest, whether to be waived or not including the rate, period and basis of collection;
- if the collection is honoured, the method of advice i.e. mail transfer, telegraphic transfer or SWIFT;
- if the collection is not honoured, action to take including protest as in Article 24 and the express powers of the case of need stated in Article 25.

In addition to the above, the remitting bank would like precise instructions on whether to store and insure the goods if the collection is dishonoured at the expense of the remitting bank. This instruction is pertinent to save the goods from deterioration or theft until an alternative buyer is found or in an extreme case, the goods are shipped back to the exporter.

Instruction would also be required as to whether to present the shipping documents on the drawee before the arrival of the goods. This dispute arises when the goods are freighted by sea while the shipping documents arrive by air.

Self Assessment Exercise 1.3

Define collection orders/instructions. Who are the parties to a documentary collection?

3.4.4 Types of Collection

Whether the collection is clean or documentary as defined above, there are two broad types of collections, namely:

- Documents against payment
- Documents against acceptance.

The collection order will be specific as to which of them the collecting/presenting bank must adopt to ensure safety of the dispatched goods in accordance with the contract signed between the exporter and importer.

The first order, Documents against Payment, means that the shipping documents which entitle the importer to clear the goods on presentation should only be delivered to him on payment either by cash or by cleared solar bill of exchange. In other words, the instruction is directed at the collecting/presenting bank who would necessarily deal with the importer. Any act short of payment on presentation of the shipping documents would amount to dishonour. Under Document against Payment, is a fairly new development called **Cash against Documents**. This facility quickens the encashment of any collection. While the goods are shipped by the exporter to the importer as usual and the shipping documents obtained, evidence of such shipment is sent by electronics e.g. e-mail, fax, telex to enable the exporter to get immediately a part-payment of up to 90 percent of the value of the collection. If the importer has a representative in the exporter's country, the process is facilitated as originally agreed to enable the exporter to obtain a part-payment. The balance is paid in due course after the shipment had been received and the quality/quantity confirmed in agreement with contract signed.

The second order, Documents against Acceptance, is also directed at the collecting/ presenting bank from the remitting bank and it means that the shipping documents could only be released to the importer on formally accepting the attached bill of exchange by signing his signature and preferably domiciling the payment when due in a bank. No doubt, this is clearly a risky thing to do from the exporter's point of view because the accepted bill could still bounce at maturity of the tenor. At any rate, if the importer has a good name or can convince his bankers to append their acceptance to the bill, the accepted bill can easily be discounted by the same collecting/presenting bank or any other bank to enable the exporter to receive his proceeds outright if allowed for in the collection order. Otherwise, the accepted bill would be secured and presented for payment at maturity.

Self Assessment Exercise 1.4

Define the terms documents against payment and documents against acceptance and clearly state the differences between the two.

3.4.5 Case of Need

In order to protect the goods in the event of dishonour of the collection (non-payment of the documents against payment or non-payment of matured documents against acceptance or non-acceptance of documents against acceptance), exporters of substance normally appoint obliging persons of integrity to act as their Case of Need. The powers of a case of need, according to Article 25 should be stated in the collection instruction otherwise, the presenting bank will not be obliged to take instructions from him.

Generally, the case of need arranges to protest a bill of exchange before a law court of Justice of the Peace (JP) if the bill is dishonoured. This is done by writing at the back of the bill the reason for the dishonour as evidence for subsequent legal action, if necessary. The case of need if empowered, can take over the dishonoured collection, warehouse and insure the goods and find alternative buyers. He earns a commission to be subtracted from the proceeds of sale of the goods.

In the absence of specific instructions, it should be noted that a bank concerned with the presentation of the collection has no obligation, according to Article 24, to protest any dishonour of a collection. The same article however states that should a bank incur expenses by undertaking the protesting of a dishonoured bill, it should be reimbursed by the bank from whom the collection instruction was received.

3.4.6 Notes on Sight and Tenor Bill of Exchange

A sight bill of exchange is the one the drawee must pay on presentation on him. This is the type that accompanies collection or documents against payment. Frankly, if the drawee is well-known as a man of integrity, there is usually no need for a bill of exchange to accompany a collection against payment. A bill would become important if the collection was dishonoured and had to be protested.

For example, '*Pay to me at sight, for value received, the sum of fifty thousand naira only*', is a sight instruction which must be honoured on presentation of the bill otherwise, the refusal would amount to dishonour.

A tenor or usuance bill of exchange on the other hand, has to be presented first on the drawee for a formal acceptance and possibly, domiciliation in a bank on the face of the bill before allowing the tenor (the number of days stated on the bill) to run out.

For example, '*Pay to me, 90 days after sight, for value received, the sum of fifty thousand naira only*'.

The tenor on the above stated bill of exchange is 90 days. Once the bill has been accepted, it could be returned to the drawer (exporter) to keep or discounted in the money market in order to raise cash. However, at the end of the 90 days, it is presented on the drawee otherwise called the acceptor for payment. It is used in most cases as a credit facility to the drawee who over a long trading association, has proved worthy of it. It is this type of bill that is given prominence in documents against acceptance. The drawee must accept it first by merely writing 'ACCEPTED' on the face of the bill and signing it. It could also be domiciled by making it payable at a named bank on a specified account or place.

For example:

ACCEPTED, payable at:
ABC Bank Plc
1, Arthur Square,
Lagos.
Account No. 00000000011234

Signature

Refusal to accept the bill amounts to dishonour. Similarly, inability to honour an accepted bill at maturity is a clear case of dishonour of the bill.

3.4.7 Responsibilities of Banks

The responsibilities of the banks in the transactions are as stated below:

(a) The Remitting Bank

It should ensure the collection order is clear, properly filled into the bank's standard collection form and signed by the exporter. The signature should be duly verified. Under Article 5(d), the principal can nominate the collecting bank but in the absence of that, the remitting bank can utilise the services of its correspondent bank in that country.

Article 9 requires banks to act in good faith and exercise reasonable care. Goods should not be consigned to or to the order of a bank except the bank had consented to the arrangement. Where necessary, the remitting bank should assist in taking up status inquiry on the buyers to determine their integrity. This is so because banks deal with documents and take no responsibility for the genuineness of signature or authority for the signature as contained in Articles 12 and 13.

Where the remitting bank was advised of extra action to protect the collection goods, it must absorb the cost of such expenses as stated in Article 10.

The remitting bank also has a duty to follow up on all collections, keep the exporter informed of developments and promptly credit the proceeds to his account, when received. Where charges were subtracted from the proceeds, the details should be explained to the exporter.

(b) Collecting / Presenting Bank

The Collecting/Presenting Bank who could be the same bank in most cases of collection has responsibilities in the handling of the following items:

- payment
- interest, charges and expenses
- advice of fate

The collecting bank is expected under Article 16 to remit to the remitting bank without delay, amounts collected less charges, disbursements or expenses where applicable. The rules relating to partial payment under clean collection and documentary collection must be carefully noted. Under clean collection as stated in Article 19(b), partial payment in document collection can only be accepted if the collection order permits but the release of the shipping documents would only be tenable on full payment of the collection.

Where interest is to be collected, the rate, tenor and basis of calculation must be stated in the collection order. Such interest instruction could be waived if the drawee refuses it but ht waiver is prohibited if the collection order specifically states that the interest should not be waived in accordance with Article 20. In the event of the latter, any refusal to pay the interest element would be treated as dishonour of the collection and the remitting bank advised by telecommunication or by any other expeditious means. Charges and expenses are also similarly treated in Article 21. However, where the charges and expenses are waived, they will be for the account of the drawer of the collection. Banks under the same article have a right to ask for their charges or anticipated expenses in advance.

The Collecting Bank must advice fate as in Article 26 in the following manner:

- the details of the collection including references must be stated.

- It shall be the responsibility of the remitting bank to state how the Collecting Bank should advise fate in the event of payment, acceptance or dishonour of the collection. In the absence of this specifying instruction, the Collecting Bank shall advice fate by the method of its choice to the debit of the remitting bank. Where the Collecting Bank advises dishonour and the remitting bank fails to give appropriate instruction within 60 days, the Collecting Bank could return the collection to its complete discharge.

3.4.8 Force Majeure

Article 15 describes Force Majeure as interruption of business arising from Acts of God, riots, civil commotions, insurrections, wars or any other causes, strikes or lockouts beyond the control of banks.

Force majeure should not be confused with delays, loss in transit and translation as stated in Article 14.

Both articles have on thing in common; banks assume no responsibility for the occurrence of either.

Self Assessment Exercise 1.5

Write short notes on the following:

(a) Force Majeure
(b) Notes on sight and tenor bill of exchange
(c) Case of need

3.4.9 Benefits and Problems of Collections

It is now necessary to assess the benefits and problems of collections from the perspectives of both the exporter and importer.

(a) Benefits to the Exporter

(1) Although not as secured as payment in advance or documentary letters of credit, the exporter feels comfortable to ship his goods and remit the shipping documents, through the banking system with specific handling instructions. The latter affords him some form of security.

(2) Collections provide better security than open account trading as long as the credit status of the importer is confirmed positive.

(3) By insisting on documents against payment, the exporter is sure to receive his money quickly provided he meets his part of the shipment contract.

(4) With time, the exporter can boost his turnover by extending documents against acceptance to well-known buyers. This facility can be boosted if the buyer has representatives in the seller's country who are ready to serve as del credere agent. Del credere agents not only introduce buyers to the sellers but also offer guarantee that the buyer is creditworthy for the credit line being offered.

Another method of boosting turnover is for the exporter to stipulate as his choice of collection, documents against acceptance **pour aval**. By this method, the importer's bank is required to add his guarantee to the importer's acceptance thereby making the accepted bill eligible for discount at a fine rate (low and competitive rate) in the money market because of the bank's acceptance.

(5) Collections, if properly documented, can be used to raise finance in any of the following ways:

- Export factoring
- Invoice discounting
- Overdraft or loan
- Produce advance
- Accommodation finance
- Nigeria Export Promotion Council's facilities, especially manufacture-in-bond scheme.

- Nigeria Export-Import Bank (NEXIM) facilitates like Rediscounting and Refinancing Facility, Foreign Input Facility, Stocking Facility, Treasury Operations and Price Guarantee Contracts.
- Central Bank of Nigeria sponsored facilities.

(6) By negotiating with the importer to absorb some of the attendant charges in handling the collection or by insisting on more faovurbale incoterms like Free on Board (FOB) or Cost and Freight (C&F), the exporter can brighten his chances of earning more profits.

(b) Disadvantages to the Exporter

(i) The first major setback to the exporter is that he parts with his goods and the shipping documents without receiving payment. He is therefore completely exposed to the whims of international payment. We read in newspapers, cases of collections of up to ten years that have still not been remitted to the drawer, the exporter.

(ii) The country risk of some third world countries could be high. Where export arrangement to any of such countries is Cost and Insurance Freight (CIF), the insurance component could be quite high.

(iii) In the event of dishonour of the collection, additional cost in the form of payment to the Case of Need, handling charges, warehousing, extended insurance, possible pilferage, the goods missing in the market and even consideration of repatriating the goods back to the exporter could spell disaster to the finances of the exporter.

(iv) Collections are not as secured as payment in advance or documentary letters of credit.

(c) Benefits to the Importer

(1) It is less stringent because goods and shipping documents arrive about the same time. Thus, the arrival of the goods can be verified before honouring the bill of exchange attached to the collection.

(2) If the collection is documents against acceptance, the importer is granted credit facility in accordance with the tenor. All he has to do, is to accept the bill of exchange, obtain the shipping documents to clear the goods and immediately find buyers to enable him to honour the accepted bill at maturity.

(3) Collections are generally cheaper in terms of bank charges than documentary letters of credit.

(4) In terms of safety, collections are better than payment in advance. The exporter could be paid in advance and simply refuse to ship the goods or in a better case, ship refurbished or sub-standard goods.

(5) Collections under documents against acceptance is a good chance for the importer to boost his turnover and profit if he honours all accepted bills at maturity.

(6) The importer can arrange finance in any of the following ways:

- Overdraft or loan
- Produce advance
- Documents against acceptance as already stated
- Accommodation finance

(d) Disadvantages to the Importer

(i) If the collection is against payment, the importer might not have the opportunity of physically inspecting the goods before making payment. This setback can be minimized if a status report was obtained to determine the business honesty of the exporter before entering into the contract.

(ii) If for any unfortunate reason, the bill is dishonoured and has to be protested, the exercise could impinge on the business status of the importer, and in fact, could be damaging in a well-ordered society where people assiduously protect their name and reputation.

4.0 CONCLUSION

In international trade, the overriding consideration is for both the buyer and seller to know each other fairly well and where appropriate, trade references obtained to boost confidence in each other.

5.0 SUMMARY

In this unit, we have

- outlined the methods of payment in international trade;
- provided detailed analysis of payment in advance and open account;
- enumerated the strengths and weaknesses of each of the two methods;
- defined collections and differentiate between clean collection and documentary collection;
- understood the route process and the responsibilities of the players in the documentary collection;
- described the place of Case of Need;
- discussed how to remit payments or handle accepted documents;
- advised on the merits and demerits of documentary collection.

6.0 TUTOR MARKED ASSIGNMENT

1. What are the responsibilities of banks in a documentary collection transaction?

2. State the advantages and disadvantages of documentary collection transaction to an importer and exporter.

3. As a presenting bank adhering to the ICC Uniform Rules for Collection, you are requested by the various drawees to release documents to them in the circumstances described below:

   Note: The collection order has no provision for any specific instruction to cover the following problems:

   (a) When immediate payment is offered to enable goods to be passed through the Customs. (This is essential before funds can be remitted abroad).

   (b) A bill of exchange (D/A) is returned to you which purports to bear the stamp of the company which should accept. As you do not hold the account of the company concerned, you do not know whether the person who has signed it is authorised to do so.

   (c) The collection order states that interest is to be collected at 15 percent per annum in respect of any delay in payment after first presentation – terms are Collection against Documents. Two weeks after the first presentation, the drawee offers the principal amount but refuses to pay any interest.

   (d) The collecting bank demanded for collection charges from the drawee who refused to pay, collection charges were to be for the account of the exporter; besides, prior transactions had borne no recourse to them in terms of collection charges and that if his condition was refused since the goods had arrived, he would hold the bank liable for demurrage charges.

   (e) Succinctly define / describe Bills for Collection.

(Q. 5 October, 2001 (old syllabus) CIBN Exams)

7.0 REFERENCES AND FURTHER READINGS

Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

UNIT 2: METHOD OF PAYMENT II

CONTENTS

1.0 INTRODUCTION

Most trading transactions between the developing countries and the developed world are conducted through this method of payment in international trade especially when the former is buying from the latter.

In the earlier unit, it was noted that documentary letters of credit stood second to payment in advance in terms of security to the exporter. In the alternative, this method is not very attractive to the importer because he has to put his money upfront in cost, charges and a small margin for exchange rates fluctuation before a letter of credit in the order of irrevocable letter of credit can be opened for him by any bank.

In this unit, we shall examine the role of International Chamber of Commerce in documentary credits, define and describe the route structure of documentary letters of credit; highlight the parties involved in the process, how documentary letters of credit work; forms of documentary letters of credit; how discrepancies in documentation are resolved, the attractions and setback of documentary letters of credit.

2.0 OBJECTIVES

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

- Define documentary letters of credit;
- Examine the role of International Chamber of Commerce (ICC);
- Enumerate the different forms documentary letters or credit;

- Describe the route structure of documentary letters of credit;
- Highlight and discuss the parties involved in the process;
- Describe how discrepancies in documentation are resolves;
- List and discuss the attractions and setbacks of documentary letters of credit.

3.0 MAIN CONTENT

3.1 Role of International Chamber of Commerce (ICC)

The International Chamber of Commerce (ICC) is an international organisation whose main duties are to articulate rules to guide commerce all over the world. They have a few publications, prominent amongst which are (Esozobor, 2009):

- Incoterms Publication No. 460.
- Uniform Customs and Practice for Documentary Credits (UCP) 2007 Revision Publication No. 600L.
- Uniform Rules for Collection Publication No. 522.
- Uniform Rules for Bank-to-Bank Reimbursement under Documentary Credit Publication No. 525.

UCP Publication No. 600L is to ensure that international merchants understand uniformly, basic definitions, procedures and roles from the exporter's and importer's points of view of methods of payment by way of documentary letters of credits.

The necessity for uniformity arose from differences in culture and preferences, laws and legal system, religious beliefs and economic systems between countries which could create disputes from time to time in the handling of credits. With UCP, there is no room for such disputes because all parties to a credit understand their roles and responsibilities at every stage of business unless as stated in Article 1, both parties expressly decide to trade without the customs.

UCP consists of 39 articles which shall be taken in some detail in this unit.

Self Assessment Exercise 2.1

Account for the role of International Chamber of Commerce (ICC) in documentary letters of credit.

3.2 Definitions of Documentary Letters of Credit

Article 2 of Uniform Customs and Practice for Documentary Credits, Publication No. 600L, 2007 Revision, issued by ICC to regulate business in this subject, defines only 'Credit' obviously in reference to the subject under study. It says "Credit means any arrangement however named or described that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation". Other relevant aspects of the definition such as "a credit is irrevocable even if there is no indication to that effect" and "branches of a bank in different countries are considered to be separate banks' were brought in under Article 3.

In the 1993 edition of UCP 500 issued by ICC, it comprehensively defined documentary credits and standby letters of credit as an "arrangement however named or described whereby a bank (issuing bank) acting at the request and on the instructions of a customer (the applicant) or on its own behalf,

(i) is to make a payment to or to the order of a third party (the beneficiary) or is to accept and pay bills of exchange (drafts) drawn by the beneficiary, or

(ii) authorizes another bank to effect such payment, or to accept and pay such bills of exchange (drafts), or

(iii) authorizes another bank to negotiate against stipulated document(s) provided that the terms and conditions of the Credit are complied with.

For the purpose of these articles, branches of a bank in different countries are considered another bank".

Expressed in a layman's language, a documentary letter of credit is a body of instructions passed from the issuing bank in the importer's country through another bank in the exporter's country to the exporter at the behest of the importer, assuring the exporter that if he ships the specified quantity and quality of named product and tenders the stated shipping documents as evidence, he would be paid or his bill of exchange accepted depending on the underlying agreement or contract entered into between the importer and exporter.

It is called a letter because the instructions are passed to the exporter in the form of a letter.

Self Assessment Exercise 2.2

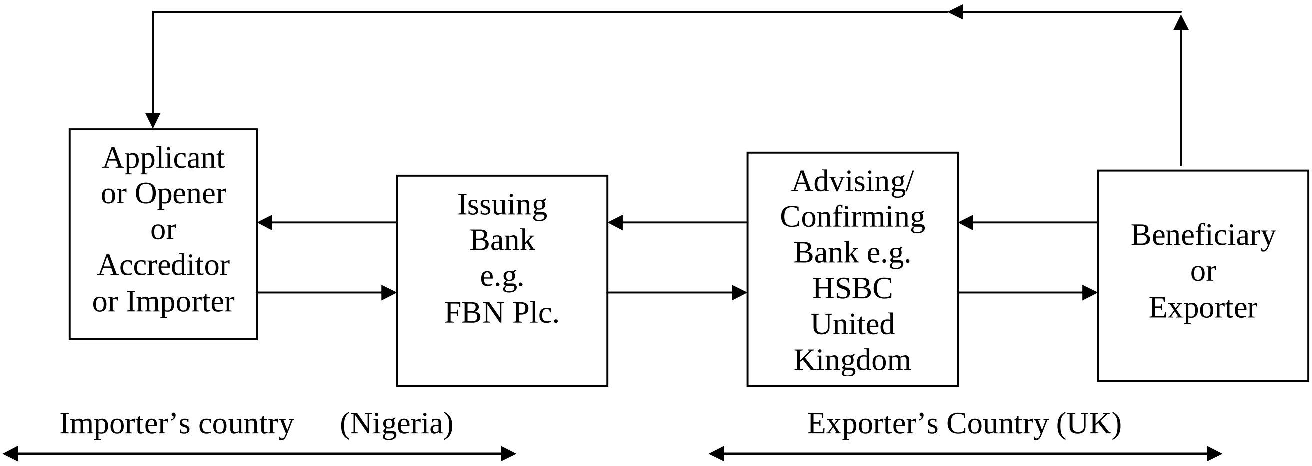
1. Define a documentary letter of credit.

2. Using a sketch, explain the parties to it.

3.3 Parties to a Documentary Letters of Credit

The following sketch would help in understanding who the parties are to a standard documentary letter of credit:

Figure 1.2 **Goods Shipped Directly**



Key:

← Route for sending the shipping documents
→ Route for remitting the payment.

(a) Accreditor

He has other names as shown in the model. He initiates the opening of the documentary letter of credit after he must have had discussion with the exporter who sent him a pro forma invoice. The latter is like a catalogue, which shows the different products from the exporter's stable and also includes an order form. In Nigeria, the accreditor must comply with the exchange control requirements (Form M et. al.) and provide the cash margin for his bank, the issuing bank, to bid for the foreign exchange for the credit to be opened.

(b) Issuing Bank

It opens the credit after obtaining the customer's instructions on its standard form. Often, the bank is given the liberty to use its correspondent bank in the exporter's country. If the exporter wants the credit transferred to his bank who is not the correspondent bank of the issuing bank, it is quite possible but the issue of added costs arising from the commissions chargeable by two banks in the exporter's country should be addressed from the onset to avoid misunderstanding when payment is to be made in due course.

(c) Advising/Confirming Bank

As noted above, the advising bank is more often than not, the correspondent bank of the issuing bank and perhaps the overseas branch of the same issuing bank. On receipt, the advising bank must verify the signatures on the credit and pass it through the security test. If satisfied, a formal advice to which is attached, a copy of the credit is sent to the exporter. Emphasis is made by way of assurance that payment would be made across the counter on compliance with the terms of the credit.

If the advising bank is also told to add its confirmation, that is, after receiving the 100 percent cash margin from the issuing bank, it plays both roles of advising and confirming banks and the exporter should also be duly informed because the guaranteed the credit portends is now further enhanced with the confirmation. In fact, the chances of payment after shipping the goods and tendering the required shipping documents become iron-cast.

Another bank could confirm the credit but once again, the exporter will look carefully at the added cost before conceding to the arrangement.

(d) Beneficiary

He is the seller of the goods but might not necessarily be the manufacturer. He will first and foremost, checks the credit to ensure that it is in agreement with the discussion he had with the importer. Furthermore, he will check that he can procure the shipping documents called for under the credit otherwise he would not be paid. He might also request his bank to crosscheck the authenticity of the credit before he commences the packaging of the goods. Definitely, before getting to this stage, the exporter must have obtained satisfactory credit references on the importer possibly through the help of his bankers or his country's embassy in the importer's country.

(e) Nominated Bank

This is a new development which cropped up in the 2007 Revision otherwise called UCP 600L. It is defined under Article 2 as 'the bank with which the credit is available or any bank in the case of a credit available with any bank'.

3.4 How Documentary Letters of Credit Work

- There is initial discussion between the importer and the exporter for the procurement of a specified product the exporter sells. The discussion could be by way of phone call or letter or e-mail.

- The exporter sends his pro forma invoice which includes an order form to the importer to enable him to place an effective order.

- The importer selects his choice from the pro forma invoice and completes the order form.

- If the importer is in Nigeria, he goes to his bank to complete the "Form M" in sextuplicate and meets the current foreign exchange regulations which include:

  - Pro-forma invoice (1 original plus 3 photocopies)

  - In the case of importation of pharmaceuticals, a current license issued in the name of the importer by the Pharmaceutical Board of Nigeria and certificate or registration of business premises.

  - Local insurance certificate

  - Letters of credit instrument (where applicable).

  He provides the cash margin and about 10 percent extra charges to enable the bank to bid for the foreign currency in the foreign exchange market.

- If the bank procures the foreign currency, it completes its standard documentary letter of credit form from the details the importer provides on the Form M.

- The Letter of Credit duly authenticated and secured, is forwarded by courier service to the advising bank who may be the bank's correspondent bank in the beneficiary's country. Meanwhile, the cash cover in foreign currency would have been remitted to the bank's nostro account with the correspondent bank selected. The credit can also be advised by SWIFT.

- The advising bank confirms the genuineness of the letter of credit and ascertains that the necessary cash cover has also been remitted to facilitate settlement on execution by the exporter. Usually, if the cash cover is remitted to the advising bank, the instruction is also passed on from the issuing bank to the advising bank that it should add its confirmation.

- The exporter may request that the letter of credit be advised through his bankers. This is acceptable only if he is prepared to bear the additional charges arising from the use of a further bank.

- In any case, the letter of credit is advised the way it was received to the exporter with emphasis on the documents he must tender as evidence of shipment before his draft would be paid, negotiated or accepted across the counter as stated on the original credit.

- On receipt of the advice, the exporter carefully checks to confirm that the content tallies with his discussion with the overseas buyer and that he can procure the documents asked for under the credit.

- If there is any aspect of the letter of credit he does not like, he could effect a change through a process of amendment which on contact with the overseas buyer, would be effected the way the letter of credit was advised i.e. from the issuing bank to the advising bank and to the exporter.

- The exporter ships the ordered goods in the right quantity and quality and obtains all the necessary documentation required to prove the shipment. He thereafter, writes his bill of exchange in accordance with the advice received and submits all the documents to the advising bank as directed, for settlement.

  Note: In the case of a deferred payment credit, no bill of exchange is written.

- The advising bank carefully crosschecks the documents if any, to ensure there is no discrepancy. If it is satisfied, the bill is paid, negotiated or accepted as relevant. Thus, the exporter gets his money less charges as agreed with the overseas buyer while the remitting bank's account is debited.

- The advising bank now secures the shipping documents and sends them by courier service. It was the practice in the past to split the shipping documents into two sets for security reasons while sending through the post office.

- Once receipt, the issuing bank also crosschecks with the original letter of credit and amendments if any, to ensure there is no discrepancy. It stamps them and contacts the importer by the quickest means to announce the arrival of the shipping documents.

- The importer collects the shipping documents and arranges to clear the goods at the port for his market. It is assumed that all charges including those on amendments must have been applied when due and not necessarily at this terminal stage.

- Within 90 days, the importer must submit to his bank, the following evidence of a concluded letter of credit to enable the bank to also conclude its exchange control documentation:

- Customs Bill of Entry duly franked and executed Form C 188.
- Tally Gate/Gate Pass Import Duty Payment Receipt for bill of landing or air transport documents, as the case may be.
- Import Duty Report (IDR), where necessary.
- Single Goods Declaration, where applicable.

- For the avoidance of doubt, an LC is quite different from the underlying contract that led to it. Article 4 of UCP 600L emphasises that banks are only concerned with the credit and not the contract even if any attempt was made to integrate it in the LC.

Self Assessment Exercise 2.3

1. Explain to a prospective exporter how documentary letter of credit operates.
2. Would you recommend it as a secured method of doing international business?

Give reasons for your answer.

3.5 Different Types and Forms of Documentary Credit

This will be discussed under the following sub-topics.

3.5.1 Types of Documentary Credit

They are sight, acceptance, negotiated and deferred payment credits:

(a) Sight Credit

It is a credit whose terms permit immediate payment on compliance with the credit. This is done by cashing for the exporter, his sight bill of exchange that accompanies the shipping documents evidencing the shipment of the ordered goods in the right quantity and quality.

It can be linked to documents against payment in documentary collections. This is the best for form of payment to the exporter because the assurance is that once he tenders the shipping documents at the counter of the advising/confirming bank, he would be paid promptly if there is no discrepancy between the L/C and amendments with the details of his submission.

(b) Acceptance Credit

The payment instruction under this credit is that the advising/confirming bank should accept the exporter's bill of exchange that accompanies the shipping documents if it is satisfied that the terms of the credit have been met. The advising/confirming bank does this by signing on the face of the bill, which of course would be drawn in accordance with the tenor agreed with the buyer. With this acceptance by a bank, the bill could easily be discounted at a fine (low) rate in the money market. Even the accepting bank would be quite happy to discount the bill and earn the small discount fee for a transaction it can attest to is above board.

(c) Negotiated Credit

If settlement is agreed on under this method, the issuing bank would request the advising/confirming bank to negotiate the LC by advancing money on presentation of the correct shipping documents called for. In doing so however, the bank must ensure that there is no discrepancy in the documents.

Negotiation of credit is usually "with recourse" to the exporter who would be required to pay up with interest, any money advanced which at the end of the tenor, is not forthcoming from the issuing bank.

UCP 600 L succinctly explained 'Negotiation' along the above lines under Article 2 – Definitions.

(d) Deferred Payment Credit

This method of payment bears the guarantee of the issuing bank over a stated period but differs in that the exporter has no need to write a bill of exchange in order to obtain payment. Depending on the status of the issuing bank, the advising bank can negotiate the LC if the correct documents called for, are submitted without any discrepancy.

One advantage of deferred payment credit is that it saves the exporter the stamp duty which bills of exchange must bear in most countries. While it could be low in some countries, it could be high in others. Stamp duty was abolished in the United Kingdom in 1971.

3.5.2 Forms of Credits

There are two broad forms of letters of credit, namely:

- Revocable Credit, and
- Irrevocable Credit

(i) Revocable Credit

It is advisable to indicate if a credit is revocable or irrevocable and where this is not done, the credit shall be deemed to be irrevocable.

A revocable credit therefore is one that could be revoked or amended at any moment without the prior notice of the beneficiary. However, a bank that has paid, negotiated or accepted such an LC or accepted commitment under a deferred payment credit before cancellation and where the documents appear on their face to be in compliance with the terms and conditions of the credit, must be reimbursed by the issuing bank.

(ii) Irrevocable Credit

It bears the guarantee of the issuing bank backed with 100 percent cash margin that the L/C would be paid, negotiated or accepted if the terms and conditions of the credit are met. Thus, such an LC can neither be revoked, amended nor cancelled without the consent of all the parties to it.

It is quite possible that an LC bearing the magnitude of such a guarantee is executed correctly and payment is not made. Due to strike action, political upheaval or in more serious cases, legal deferment of payment or moratorium that remittance of funds from the issuing bank's country is not forthcoming and no one could say precisely when further remittance would be made. Any bank that advised such an irrevocable credit on the basis of time-tested relationship with the issuing bank would be embarrassed. The way out of such possibilities and which experienced exporters would normally ask for especially from third world countries, is for the advising bank to add its **CONFIRMATION** to the credit, which thereafter becomes **CONFIRMED IRREVOCABLE CREDIT**. Logically, only an irrevocable letter of credit can be confirmed.

Responsibility for settlement after confirmation shifts from the issuing bank to the confirming bank. Technically though, the commitment on a confirmed credit is that of both the issuing and confirming bank. It stands to reason therefore that no bank would add its confirmation to a credit excepting it is satisfied with the credit standing of the issuing bank and more importantly, that the 100 percent cash margin to the LC is safely in its coffers.

By Article 9(e), if a bank is requested to add its confirmation to an L/C but it is not prepared to do so, it must inform the issuing bank without delay.

Once again, UCP 600L recognizes only irrevocable documentary credit as clearly stated in the definitions.

3.5.3 Special Types of Letters of Credit

There are different types of letters of credit meant for special maritime orders. They are:

- Transferrable Credit
- Revolving Credit
- Red Clause Credit
- Transit Credit
- Back to Back / Counter Credit

Of the lot, only transferrable credit is recognized under Article 38 of UCP 600L.

(a) Transferrable Credit

It is well treated in Article 38 of UCP 600L, which defines it in (b) as:

"a credit that specifically states it as "transferrable". A transferrable credit may be made available in whole or in part to another beneficiary ("second beneficiary") at the request of the beneficiary ("first beneficiary").

Transferring bank means a nominated bank that transfers the credit or, in a credit available with any bank, a bank that is specifically authorised by the issuing bank to transfer and that transfers the credit. An issuing bank may be a transferring bank. Transferrable credit means a credit that has been made available by the transferring bank to a second bank".

Transferrable credit is best in the hands of a middleman who understands the export market, knows the cheap sources of export products and enjoys a good image before overseas buyers. To achieve such status, the middleman frequently visits the overseas merchants to establish rapport and be recognized as a dependable foreign supplier of assorted goods. In transferrable credit, the buyer might not even know that the beneficiary is not the supplier of the ordered goods.

Once the beneficiary is advised of the credit, he approaches the advising bank to transfer the credit to a named supplier with strict adherence to the following provisions of Article 38:

The credit can be transferred only on the terms and conditions specified in the original credit, with the exception of:

- The amount of the credit
- Any unit price stated thereon
- The expiry date
- The last date for presentation of documents.
- The latest shipment date or given period for shipment, any or all of which may be reduced or curtailed.

The percentage for insurance cover may be increased to cover the amount of the original credit.

In a simpler language, transferrable credit consists of the following:

(i) The first arm of the credit is the usual standard credit, from the accreditor to the issuing bank in the buyer's country and thereafter, to the advising/confirming bank and the beneficiary in the exporter's country. In transferrable credit, this beneficiary is called the first beneficiary.

(ii) Thereafter, the second arm follows. The first beneficiary now requests the advising bank to transfer the credit to another beneficiary called the second beneficiary on identical terms apart from unit price, amount, expiry date, the last day for shipment and insurance which will all be reduced to enable the first beneficiary earn his profit. Article 43 provides that where no deadline for submission of documents was given, the bank can refuse acceptance of such documents after 21 days. The advising bank, who perhaps would not have opened a credit without the cash margin does so in reliance on the first credit as its security. In this second credit, the first beneficiary becomes the accreditor.

(iii) When the second beneficiary ships the goods, usually directly to the importer and tenders the required documents, he is paid according to terms. The first beneficiary thereupon now replaces the commercial invoice of the second beneficiary which of course would be less in amount with his own commercial invoice bearing the original contract amount and draws the difference as his profit.

(iv) The advising/confirming bank now sends the shipping documents duly checked, by the quickest means to the issuing bank after reimbursing itself from the cash margin provided when the credit was opened.

(v) By the time the issuing bank receives the shipping documents, the carrying vessel would either have berthed or be close to the wharf. If shipment is by air, there would hardly be any delay before the goods arrive the importer's country.

Of course, having received the shipping documents, which would be carefully checked first, the importer would be contacted immediately to come and collect the shipping documents and attend to the clearing of the goods.

(b) Revolving Credit

This credit makes execution of contracts of repetitive nature easy. If a revolving credit is opened for say US$20,000, it simply means that when the contract is executed, a fresh contract for another US$20,000 automatically comes into place until the credit is cancelled.

Another method is to open a bulk credit for US$100,000 and make the revolving aspect, US$20,000 over 5 months.

When a revolving credit is cumulative, it allows any shortfall in any shipment to be added to the next shipment. Credits can revolve not only in amount of money but time as well. A time revolving credit would state that every month or quarter of bi-annually as the case may be, a credit of which the amount could vary according to needs would be opened and executed.

Revolving credits are generally suitable in procuring on a regular non-stop basis, important raw materials without which a factory cannot operate. Procuring of animal feeds especially poultry feeds would best be obtained through this type of credit.

(c) Red Clause Credit

It is so called because the tradition is to print this special type of credit that allows some form of preparatory credit to the beneficiary, in red ink. Although common in the Australian wool trade, it can also be used by the accreditor to support the beneficiary if the product would require special handling in processing and packaging for exports. Thus, serious overseas buyers of a product like kolanut would adopt this special type of credit in order to afford the Nigerian producer at

Ilesha, a part-withdrawal of the credit by way of a loan to be granted by the advising bank to enable him the producer, to harvest the kolanuts, process, store and package the lot according to specifications; the completion of which may take up to three or more months.

On the complete execution of the credit, the loan is subtracted and the balance paid to the farmer. If the farmer defaults in paying back the loan, the advising bank can look up to the issuing bank for reimbursement. The issuing bank will in turn debit the account of the accreditor.

With the increasing use of kolanuts in pharmaceutical companies and cassava in animal feeds for the treatment of foot and mouth disease in cows, the Nigerian farmers, the best producer of both crops all over the world, should expect to see more of red clause credits, if effective overseas marketing and prompt execution of orders are sustained.

(d) Transit Credit

For many reasons, some of which are political or ethical, credits opened directly or advised from a third world with or without upfront cash cover may not be acceptable to a beneficiary or his bank in a developed country for lack of confidence in the country of the accreditor.

The way round such a setback is for the beneficiary to request the credit to be advised through a world financial centre like London or Paris.

Example:

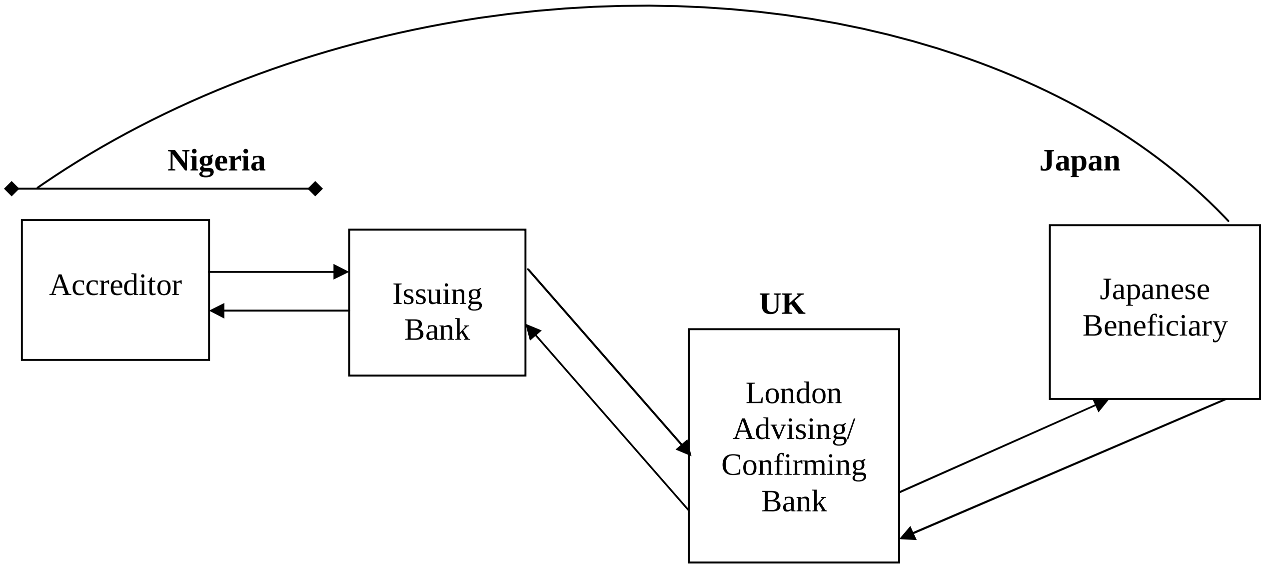
A Nigerian merchant wants to order for the spare parts of an uncommon machine from Tokyo, Japan. The Japanese seller is prepared to sell on the condition that a confirmed irrevocable LC is opened in his favour through a London bank.

The London bank in this example will be used as a transit by lending its name for a commission, on the credit.

The issuing bank in Nigeria will open the credit after the usual financial strengthening and exchange control compliance in the name of the Japanese seller but advise it through its correspondent bank in London who would be instructed to add its confirmation.

The scenario will look as follows:

Figure 1.2 **Goods Shipped Directly**



Key:

← Opening of the LC
→ Movement of shipping documents

As seen above, the goods are shipped directly from the beneficiary to the accreditor without berthing in the transit country. The major financial centres of London, New York, Frankfurt and Paris earn a lot of income by merely lending their name to credits opened from the developing countries to the developed economies.

(e) Back to Back / Counter Credit

The process of this special credit is similar to a transferable credit but differs in many aspects.

The focus of back-to-back / counter credit is the middleman who wants to earn a profit by sourcing the required export goods cheaply preferably from the manufacturer without disclosing to the overseas buyer his middleman's role.

In fact, the credit is opened on the insistence of the middleman's bank that an inward credit is required to serve as collateral for the outward credit provided the bank is satisfied with the credit standing of the middleman.

Back-to-back / counter credits consist of two distinct credits; the inward one from the buyer (accreditor), provides the backing for the outward one to the supplier. In the first credit, the middleman is the first beneficiary while in the second, he is the accreditor. The difference between the two separate credits will be in the unit price, amount and expiry date of the second credit which will be less than the first to enable the middleman earn his profit and also provide enough time for the checking of the shipping documents when received from the supplier, the second beneficiary.

If the outward credit is correctly executed and the documents found adequate, the middleman is debited by the issuing bank who invariably, will be the advising bank of the inward credit from the overseas buyer. Meanwhile, the goods had already been shipped by the supplier direct to the overseas buyer. The middleman replaces the supplier's invoice with his own invoice bearing the agreed unit price and amount with the overseas buyer.

If the necessary cash cover had been received from the issuing bank for the buyer, the concluding entries that will credit the middleman's account to cancel the earlier debit and leave him with the profit can be effected immediately before dispatching the shipping documents to the issuing bank of the first credit.

Differences between Transferrable Credit and Back-to-Back / Counter Credit

(i) Transferable credit is specifically recognized under Article 38 of UCP. Back-to-back / counter credit although an aged-long practice, is not so recognized.

(ii) Transferable credit is specifically marked as such; so the overseas buyer is aware of it. In back-to-back / counter credit, he may not be aware.

(iii) To the middleman and his bank, there is no serious risk in transferable credit as long as the inward credit received is appropriately backed up with cash margin by way of an irrevocable credit to which the advising bank had added its confirmation. In back-to-back / counter credit, the major risk is that there are two separate credits. The second credit, being the private business of the middleman (the importer might not know the existence) might be botched up and therefore create problems for the actualization of the first credit.

(iv) In the advising bank of the first credit, the only entry passed will be the profit of the middleman in a transferrable credit. In back-to-back / counter credit, the obliging advising bank will pass two sets of entries; the first, to open the outward credit and the second, to reverse the entries and account for the middleman's profit.

Self Assessment Exercise 2.4

1. In what ways would a sight credit be different from an acceptance credit?
2. Distinguish between 'transferable credit' and 'back-to-back credit'.

3.6 How Discrepancies in Documentation are Resolved

Any evidence in the shipping documents submitted by the beneficiary that negates the terms of the credit under which he, the beneficiary took action, amounts to a discrepancy.

Suffice it to say that the shipping documents that show evidence that the goods ordered had been shipped in the right quantity and quality must tally with the contents of the original credit opened and subsequent amendments. Recall that in accordance with Article 5 of UCP 600L, banks deal with documents and not goods.

Prior to submission of the shipping documents, the beneficiary can request the issuing bank through the advising bank to amend the terms of the credit to enable him to execute it. If however, without requesting for an amendment, he goes ahead to ship the goods, it is expected that the documents that will evidence such shipment should agree with the documents and the details the original credit called for. In irrevocable or confirmed irrevocable credit, any amendment must be endorsed by all the parties to the credit. An amendment can either wholly be accepted or declined.

If submitted documents are to be returned for being discrepant, Article 14(b) of UCP 600L states that "the return should be done within 5 days of receipt of the documents". The 5 days deadline would not be changed even if the issuing bank in its sole judgement elects to approach the applicant for a waiver of the discrepancies – Article 16(b). In all cases, it is important that current credits are frequently studied and requests for amendment entered in the bank's standard form for endorsement by all the parties to the credit.

Examples of Discrepancies

1. Commercial Invoice
   - Not signed where the credit called for signed invoices.
   - Incoterms, not stated.
   - Goods not described.
   - Issued for a wrong amount.
   - Shipping marks different from bill of lading.
   - Unit cost different from credit.

2. Transport Document e.g. Bill of Lading
   - Not signed as required by Articles 23(a) of UCP.
   - Goods shipped on deck rather than on board.
   - Carrier not indicated.
   - Claused or dirty rather than clean.
   - Not endorsed by the exporter.

3. Bill of Exchange
   - Not sent.
   - Drawn on the wrong person.
   - Drawn for a wrong amount.
   - Drawn sight rather than tenor or vice versa, as agreed.

4. Clean Report of Finding
   - Not sent.

- Copy not signed by the Inspection Agent.
- Dirty Report of Finding.

Action to Take to Amend a Credit

When necessary, amendment will in most cases, flow from the exporter's end. In the circumstance, advising / confirming bank can take any of the following courses of action:

(a) Draw the beneficiary's attention to any unsigned document or unsigned alteration and generally, help him to procure clean and signed documents within the timeframe of the credit.

(b) Where the discrepancies are minor, contact the issuing bank by electronics for permission to pay. It will also be helpful to contact the buyer directly, if necessary. This could be faster.

(c) Where the discrepancies are many and serious, accept the documents on collection basis. That is, the documents are sent to the issuing bank to examine and by Article 43, must take necessary action to pay or reject, within 7 days.

(d) Unless forbidden under the credit, obtain the indemnity of the exporter against the discrepancies and pay accordingly. In the event of difficulty from the issuing bank, indemnity can be invoked upon. This option is definitely not the best because it can create unnecessary friction with the advising bank and even the buyer.

(e) When a nominated bank acting on its nomination, a confirming bank, if any, or the issuing bank decided to refuse to honour or negotiate, it must give a single notice to that effect to the presenter.

    The notice must state:

    (i) That the bank is refusing to honour or negotiate; and
    (ii) Each discrepancy in respect of which the bank refuses to honour or negotiate;
    (iii) and
        (a) That the bank is holding the documents pending further instructions from the presenter; or
            That the issuing bank is holding the documents until it receives a waiver from the applicant and agrees to accept it, or receives further instructions from the presenter prior to agreeing to accept a waiver; or
        (b) That the bank is returning the documents; or
        (c) That the bank is acting in accordance with instructions previously received from the presenter.

(f) The notice required in (e) above must be given by telecommunication or, if that is not possible, by other expeditious means not later than the close of the fifth banking day following the day of presentation.

Self Assessment Exercise 2.5

1. What discrepancies would you expect to see in a bill of lading and commercial invoice?

2. How would you attempt to amend such discrepancies?

3.7 Attractions and Setbacks of Documentary Letters of Credit

(a) Advantages to the Exporter

The main fear of the exporter is that he could ship his wares and possibly part with his shipping documents (if a tenor credit) and at the end, he is not paid fully as and when due.

Documentary letters of credit provide a safe method of doing international business because it has the guarantee of two banks to any credit: the first, the issuing bank in the importer's country and the second, the advising bank in the exporter's country. The assurance is simple: ship the stated product in the right quantity and quality and tender the stated evidence in shipping documents to obtain payment. In addition to this principal advantage, there are a number of other advantages, such as:

1. Country risk can be avoided if the irrevocable credit is confirmed by a local bank. In effect, that means the local bank has been provided the cash backing to honour the credit on compliance.
2. An irrevocable documentary credit cannot unilaterally be amended except the exporter gives his consent to it.

3. The buyer risk is completely eliminated as long as the credit is not revocable. The issuing bank would normally not lend its name to accredit except it has adequate cash backing or a credit facility had been granted for it.

4. The exporter does not have to fear that complications could arise at a stage for non-compliance with the prevailing exchange control in the buyer's country. That an LC had been opened pre-supposes that all exchange control regulations in the accreditor's country had been met.

5. Where the documentary credit is sight, the exporter is assured that on presentation of his shipping documents, the covering bill of exchange

would be paid on the spot. He can therefore plan well, knowing precisely when he would be paid.

6. Documentary credits as we have seen earlier, provide a better means of settlement than collections which infers a decision to pay or not in the buyer's country and the further rigmarole of obtaining exchange control approval and release of the foreign exchange by the importing country's Central Bank especially in a developing country.

7. A smart middleman who manufactures nothing can easily travel abroad (once again to the developing countries) to procure orders ultimately through letters of credit by exuding confidence and giving generous discounts and credit concessions from his envisaged mammoth profits. He relies firmly on the facilities of transferable credit or back-to-back credit to procure the goods from the manufacturers without putting his money upfront on the security afforded by the inward LC received.

8. A hard-up exporter can look to the financial system and export financing agencies like the Export Credit Guarantee Department in the United Kingdom and in Nigeria, Nigeria Export Promotion Council, Nigeria Export / Import Bank, the banks and other export financing agencies, for assistance.

(b) Disadvantages to the Exporter

1. The letter of credit could be fake or unauthorized from the issuing bank. The genuineness of a credit can easily be ascertained by requesting the bankers on receipt, to initiate necessary enquiries on the source possibly through their correspondent bank in the buyer's country.

2. The exuberant exporter eager to secure business might overlook initially, the possibility of procuring the itemized shipping documents to evidence shipment. Anxiety sets in when the shipping documents are being gathered only to find that one or two of the documents cannot be obtained that easily or locally. At this point, when he should have been tendering the shipping documents for payment, he will be requesting for an amendment to the credit.

   The way out for the exporter is to carefully study the advising bank's letter of conveyance of the credit and be satisfied that he can procure all the documents called for.

3. Documentary credit comes second to payment in advance as a means of settling international trade. The former should only be accepted if the latter cannot be obtained.

4. If the credit is against acceptance of the bill of exchange (acceptance credit), the exporter should appreciate that he is funding the buyer throughout the period of the tenor. Exporters naturally reflect such credit extension in their prices.

5. In the process of assembling the ordered goods and putting them in to the right shape and packaging as well as sourcing all the documents called for under the credit, hitches could arise to warrant unnecessary amendment to the credit. Amendments attract additional bank charges and unprogrammed deferment of when payment would be received. If the exporter is being financed by a bank, a delay in settlement through the credit amendment will also spell additional interest charges.

6. If the exporter accepts to do business under a revocable letter of credit, he should be mindful of the fact that the credit can be cancelled or amended at any time without his say-so.

(c) Advantages to the Importer

1. Although he may have parted with his money to open an irrevocable credit, he is rest assured that the exporter will not lay hands on it until he has satisfied his part of the contract. The security is effected through the use of banks, the issuing and advising banks as a minimum.

2. If the credit is revocable, he can amend or cancel it at will without the consent of the exporter.

3. He can use the medium of amendment to increase the stock or to make modifications to the product under manufacture to meet special local orders. This will of course attract extra costs.
4. A well-packaged proposal for importation under documentary credit can be submitted to a bank and other finance institutions for necessary finance. Retired knowledgeable bankers who left positive track record while in the banks' employment can use this method effectively to break into the import business.

(d) Disadvantages to the Importer

1. For an irrevocable credit which could be confirmed, he puts his money upfront for the issuing bank to open it. He must therefore reckon with the cost of fund in the duration of the importation especially if he had obtained a bank credit for it.

2. If he opened a confirmed or an irrevocable revolving credit and found the first shipment to be substandard, he cannot cancel or amend the credit

without the consent of the exporter. He might be stressed making contacts with the exporter to amicably resolve the disappointment.

3. If the credit is revocable, the exporter could amend or cancel the credit without his permission, possibly after he had accepted local orders in reliance on the importation.

4. The exporter, through series of amendments, can delay the goods thereby causing the importer to miss the market. For example, Christmas decorations and crackers can only be reasonably used for Christmas. If delay causes the goods to arrive in January, the importer must consider the huge loss of tying down the goods till the next Christmas or consider offloading them at a cut down price to a speculator. The way out is to state the latest shipment date.

5. With large orders, any disappointment on shipment or quality of the ordered product can ruin a whole project. For example, iron rods for construction works are in different specifications and sizes. An attempt to cut corners by an exporter by shipping an inferior product can throw the contractor into disarray. The way out is for the importer to request for a bank's performance bond from the exporter.

3.8 Uniform Rules for Bank-to-Bank Reimbursements under Documentary Letters of Credit

This is a new ICC publication No. 525 which became operative in July, 1996 (Esezobor, 2009).

A reimbursement authorization was defined under Article 2(c) as "an instruction and/or authorization, independent of the Credit, issued by an Issuing Bank to a Reimbursing Bank to reimburse a Clearing Bank, or, if so requested by the Issuing Bank, to accept and pay a time draft(s) drawn on the Reimbursing Bank".

From the above definition, bank-to-bank reimbursement can be issued on its own or to support a documentary credit while still retaining its independence. Article 3 states that "a reimbursement authorization is separate from the Credit to which it refers and a Reimbursing Bank is not concerned with or bound by the terms and conditions of the Credit, even if any reference whatsoever to the terms and conditions of the Credit is included in the Reimbursement Authorization".

A bank could elect to open a bank-to-bank reimbursement (the instruction is called reimbursement authorization) either for self or for a customer through their correspondent. Three banks are involved in it, namely:

1. Issuing Bank.

2. Reimbursing Bank, who executes the instruction of reimbursement. It could be the correspondent bank of the issuing bank.

3. Claiming Bank means a bank that honours a Credit and presents a reimbursement claim to the Reimbursing Bank.

The reimbursing authorization from the Issuing Bank to the Reimbursing Bank should be in "form of an authenticated tele-transmission" or a signed letter and should include:

(i) Credit number.
(ii) Currency and amount.
(iii) Clearing Bank or in the case of freely negotiable credits, that claims can be made by any bank.
(iv) Parties responsible for charges.

The title "Uniform Rules …." Should not be confused with Uniform Rules for Collection, ICC Publication No. 522 because while the former is Documentary Credit, the latter is for Documentary Collections.

If a credit according to Article 13(b) and (c), does not state that reimbursement is subject to the ICC rules for bank-to-bank reimbursements, the following apply:

(i) An issuing bank must provide a reimbursing bank with a reimbursement authorization that conforms with the availability stated in the credit. The reimbursement authorization should not be subject to an expiry date.

(ii) A claiming bank shall not be required to supply a reimbursing bank with a certificate of compliance with the terms and conditions of the credit.

(iii) An issuing bank will be responsible for any loss of interest, together with any expenses incurred, if reimbursement is not provided on first demand by a reimbursing bank in accordance with the terms and conditions of the credit.

(iv) A reimbursement bank's charges are for the account of the issuing bank. However, if the charges are for the account of the beneficiary, it is the responsibility of an issuing bank to so indicate in the credit and in the reimbursement authorization.

    If a reimbursing bank's charges are for the account of the beneficiary, they shall be deducted from the amount due to a claiming bank when reimbursement is made. If no reimbursement is made, the reimbursing bank's charges remain the obligation of the issuing bank.

(v) An issuing bank is not relieved of any of its obligations to provide reimbursement if reimbursement is not made by a reimbursing bank on first demand.

4.0 CONCLUSION

You will note from the discussion that documentary letters of credit stood second to payment in advance in terms of security to the exporter. We also noted that this method is however not very attractive to the importer because he has to put his money upfront in cost, charges and a small margin for exchange rates fluctuation before a letter of credit in the order of irrevocable letter of credit can be opened for him by any bank.

5.0 SUMMARY

In this unit, we have examined the role of International Chamber of Commerce in documentary credits, defined and described the route structure of documentary letters of credit; highlighted the parties involved in the process, how documentary letters of credit work; listed the types and forms of documentary letters of credit; how discrepancies in documentation are resolved, the attractions and setback of documentary letters of credit.

6.0 TUTOR-MARKED ASSIGNMENT

Bayelsa Cement Company Plc, buys limestone from different parts of West Africa for the raw material of its manufacturing process for onward selling of cement in Western Europe. Inward and outward payments have normally been made by cable transfer upon shipment but occasionally by letters of credit.

The company has just concluded a strategy reorganization which brought on board Dr. Idoh Ukpome as the Financial Director. He calls to see you on a new general strategy for the company and one particular transaction which he is trying to arrange involving a Ghanaian supplier and a German buyer. Payment will be by sight letters of credit and the terms of shipment, CIF Hamburg. The German buyer has no objection to arranging an irrevocable documentary letters of credit in favour of the company who has ascertained that the Ghanaian required payment to be made by the same method.

The letter of credit is to be issued by a German bank and will be advised through you. Dr. Ukpome says that when the company issued irrevocable letters of credit in the past, there had been difficulties with CIF contracts because it had never been able to get is documentation right. With the provision in the Uniform Customs, however, he is going to arrange an irrevocable letter of credit in the company's favour which will cater for the needs of Bayelsa Cement Company Plc as well as those of the Ghanaian supplier.

Required:

(a) A description of the basic instrument which will satisfy the needs of all parties and an indication of why it will be satisfactory.

(b) Name the parties to the instrument in (a) above.

(c) To what provision is Dr. Idoh Ukpome referring in the Uniform Customs and Practice and will this provision help in these particular transactions? Make reference and summarise please (Esezobor, 2009).

7.0 REFERENCES AND FURTHER READINGS

Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

UNIT 3 SETTLEMENT OF INTERNATIONAL TRANSFERS AND METHODS OF REMITTANCE OF FUNDS

Table of Contents

1.0 INTRODUCTION

Madu (2011) opined that in any trade transaction, one of the overriding considerations for both the importer and the exporter is security of settlement. The banks ensure that payments are made for the settlement of international trade.

Every working day, banks all over the world remit funds abroad on behalf of customers (and self too) for a variety of reasons such as:

- Importation of wares and services
- Payment of school fees
- Home remittance
- Maintenance of foreign offices and missions
- Donations etc.

These are, in a nutshell, the routine foreign banking transactions engaged in by the banks to aid international trade and settlement.

In this unit, we shall examine the accounting methods of settlement between banks as well as the methods through which transfers are effected.

2.0 OBJECTIVES

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

- mention the importance of agency arrangement;
- describe how nostro and vostro accounts work;
- the methods by which funds are remitted internationally;

- the strong points of each method as well as the limitations.

3.0 MAIN CONTENT

3.1 Agency Accounts: Nostro/Vostro Accounts

Ezesobor (2009) states that banks between themselves internationally, maintain nostro/vostro accounts for the purpose of effecting funds transfer and reconciling their accounts from time to time. Thus, a bank in Nigeria would open accounts in major financial centres in the world to facilitate the transfer of funds.

According to him, a Nigerian bank's account in Chase Manhattan Bank in New York would be called NOSTRO ACCOUNT, that is, OUR ACCOUNT. That account would be denominated in United States of American dollar.

A foreign bank may also open an account in theory with a Nigerian bank here in Nigeria in naira for the same purpose. Such an account is called VOSTRO ACCOUNT, that is, THEIR ACCOUNT. The arrangement is not necessarily done on reciprocal basis between banks but essentially to meet the exigencies of international transfers of funds. For example, First Bank of Nigeria Plc. may be in account with Chase Manhattan Bank, New York. To First Bank, that account is a NOSTRO account. In order to ensure that the NOSTRO account is reconciled regularly, First Bank will keep a mirror account, that is, an account that serves as a mirror of transactions on the NOSTRO account.

Furthermore, to make sure that the transactions on both the NOSTRO and mirror accounts bear the same date as much as possible, funds transfers are value-added by stating in the transfer instructions, the precise date, the transfer should be effected.

A VOSTRO account is used to effect the transfer of funds in the currency of the recipient country. For example, HSBC, formerly Midland Bank could have an account with Bank of America in New York in dollar. To the latter, Bank of America, the account will be a VOSTRO account. Expectedly, the VOSTRO account would be used to effect transfers in United States dollar by Bank of America while HSBC would be duly credited and advised to execute the transfer as directed by the customer. HSBC on their part, would credit the customer in dollars or convert to sterling as instructed by the beneficiary. Meanwhile, both banks would use their respective mirror accounts for reconciliation purpose.

Self Assessment Exercise 5.1

What is the difference between vostro and nostro accounts?

3.2 The Concept of Vostro Account in Nigeria

Ezesobor (2009) observed that while many foreign banks maintain accounts with some Nigerian banks, the concept of VOSTRO account does not work here in Nigeria because the currency, Naira, is neither convertible nor an international currency like the U.S.

dollar. Besides, funds transfer from Nigeria can only be effected in U.S. dollar through the prevailing system of foreign exchange allocation. If the concept of VOSTRO account was practicable in Nigeria, it would have been possible to transfer Naira abroad by crediting the VOSTRO account of a correspondent in Lagos who in turn would credit the beneficiary abroad in Naira or whatever currency desired. The exchange control regime in Nigeria and the limitation of Naira in terms of convertibility suffice it to say, do not make the use of VOSTRO account possible.

Self Assessment Exercise 5.2

Why does Vostro account not work in Nigeria?

3.3 How Vostro Account Works

National Westminster Bank (NATWEST) may have an account with French Bank in Paris. On behalf of a customer, they are transferring French Franc (FRF) 300,000 to a beneficiary in Paris. NATWEST's account in French Bank in French Franc is a nostro account to NATWEST. To the French Bank, NATWEST's account is a vostro (their) account. In this example, the following entries would be passed:

- Debit the customer, the principal sum plus charges (commission and exchange receivable).
- Credit the Mirror Account of the French Bank Nostro account. A mirror account is simply a control account that reflects precisely, what an overseas account contains.
- Credit the appropriate income accounts with the charges. Thereafter, relay the funds transfer message by electronics or any other means.

The French Bank on receipt of the instruction will take the following actions:

- Debit the VOSTRO account of NATWEST with the principal sum.
- Credit the beneficiary under advice.

Self Assessment Exercise 5.3

How does vostro account works?

3.4 How Nostro Account Works

Still between NATWEST and French Bank, a customer of French Bank has requested the bank to transfer FFr25,000 (a home currency) to a named beneficiary in London.

The French Bank will raise the following entries:

- Debit the customer with the principal cost and charges.
- Credit the VOSTRO account of NATWEST with the principal sum.

- Credit the appropriate income accounts with the charges.

Then relay the details of the transfer message to NATWEST, London by the means duly agreed on with the customer.

At NATWEST, London, the following vouchers will emerge:

- Debit the Nostro mirror account in French Bank with the principal sum.
- Credit the beneficiary with the principal sum under advice.

If the beneficiary has no bank account, credit Account payable in Suspense – Sundry Creditors and advice the beneficiary. If he turns up and suitably identifies himself, debit the same account and mark the voucher CASH to enable obtain cash across the counter.

In this hypothetical case as with nostro account, it is assumed that NATWEST, the receiving bank will not also apply charges to the funds transferred.

Self Assessment Exercise 5.4

How does nostro account works?

3.5 Methods of Funds Transfer

Having examined the accounting methods of nostro and vostro accounts, we may now look at the various methods of remittance of funds which are:

- Buyer's cheque
- Travellers' cheque
- Bank draft
- Mail transfer
- Telegraphic transfer
- Society for Worldwide Interbank Financial Telecommunication (SWIFT)
- Other methods of transfer

3.5.1 Buyer's Cheque

Most payments of small amounts are effected through this method. By it, the buyer simply draws out his private cheque in the currency agreed with the seller and sends it to him.

It however suffers from the following defects:

- The exchange control regulations of a country might not allow it. It is not allowed in Nigeria;
- The cheque could be lost, stolen or destroyed in transit;

- It takes upward of 30 days to clear cheques between countries. If the paying bank sends a bank draft in settlement, a minimum of 3 clearing days would also be required to clear the bank draft locally;
- The collecting bank might levy extra charges to cover the cost of postage, tracking and documentation;
- After all the trouble the cheque might even bounce on presentation on the paying bank.

Between member states of an economic community, private cheques denominated in the common currency e.g. Euro for European Union, is quite common.

3.5.2 Travellers' Cheques

They are international payment instruments issued by first class international banks for a commission and distributed worldwide through banks. They are issued in various currencies but the popular ones are the United States of America Dollar, the British Pound Sterling, and the German Deutsche Mark.

By printing them in various denominations, they come handy to travellers who must sign at the point of purchase and sign them again at the point of encashment abroad after due identification with the holder's international passport.

In Nigeria, Travellers' Cheques are sold as part of basic travel allowance, pilgrim's allowance and personal home remittance. In the recently released CBN guidelines for 'Sale of Travellers' Cheques', the following details were stated (Ezesobor, 2009):

(i) Travellex shall supply the travellers' cheques (apart from ECOWAS travellers' cheques).

(ii) All Travellers' Cheques shall be denominated in American dollar.

(iii) Corporate entities shall be entitled to Business Travel Allowance (BTA) in the amount of US$2,500 per quarter while bona fide Nigerian residents aged 12 years and above, shall be entitled to Personal Travel Allowance (PTA) of US$2,000 every six months subject to the following documentation requirements:

  - Duly completed travel form;
  - Valid passport with relevant visa(s);
  - International return ticket;
  - Certificate of business registration/incorporation (for BTA)

(iv) As regards foreign nationals who choose to enjoy PTA under this arrangement, the CBN stress that 'the amount procured shall be endorsed in their passports and should be deducted from their Personal Home Remittance (PHR) for the year'. Naturalized Nigerians who are entitled to only 50 percent of their PHR, the CBN explained, shall be entitled to PTA as Nigerian citizens.

(v) In addition to the above-stated conditions, the apex bank emphasised that the ticket and passport of the beneficiary should be duly endorsed with the amount of foreign exchange sold, while beneficiary shall be required to sign the Travellers' Cheques at the point of purchase/collection, in line with international requirement and practice.

(vi) The monetary watchdog however pointed out that the sale of Thomas Cook Travellers' Cheques for BTA/PTA shall not be applicable to travel to countries in the ECOWAS sub-region.

(vii) The CBN recognized that 'some of the perennial problems associated with foreign exchange procurement by travellers and other end-users in the country have encouraged:

- The use of spurious documentation;
- Multiple uses of air tickets;
- Round tripping of foreign exchange bought for travel purpose;
- Use of Travellers' Cheques to pay for commercial imports;
- Presentation of large quantity of blank Travellers' Cheques by Nigerians overseas for encashment contrary to internationally accepted practice'.

'All these malpractices', according to the report, 'prompted the monetary authorities to re-examine the process of the sales of foreign exchange for travel-related transactions for which we are now implementing one of the options'.

Travellex is an affiliate of Thomas Cooke and sells its Travellers' Cheques in Nigeria.

3.5.3 Bank Draft

A bank draft is a special bill of exchange because it is drawn by a bank on another bank by prior arrangement for the purpose of making payment on behalf of customers or self. A customer requesting for an international bank draft must first of all, satisfy the exchange control requirements. Thereafter, he will complete the bank's requisition form, which of course, will contain the details of the beneficiary and attach his payment cheque or instrument which the bank will verify and approve.

Once issued, the security marks, well known to the correspondent bank the draft is written on, are entered and delivered to the customer to dispatch himself or cash abroad, as the case may be. Quite naturally, the issuing bank ensures there is adequate cover for the bank draft to prevent it from bouncing.

A bank draft is convenient to handle because the buyer can travel with it or mail by courier service. It however has the following set-banks:

- it could be lost, stolen or destroyed in transit;

- although rarely, it could be returned unpaid if the drawing bank's account is not sufficiently funded;
- if stolen, banks are not often eager to stop their drafts because it could be damaging to the image of the bank if an innocent party takes it in good faith and for value. It is possible anyway for a bank to stop its own draft if the beneficiary provides a cash-backed indemnity;
- payment of drafts could be delayed if the remitting bank had changed the list of their authorised signatories without swiftly informing their correspondent banks.

3.5.4 Mail Transfer

By this method, as in bank draft and all other methods of transfer apart from buyer's cheque, the customer must satisfy the exchange control requirement where this is in place. Once this is done, he completes the bank's standard requisition form which will indicate the details of the beneficiary and his bank account, if it is known. The customer receives the counterfoil of the bank's requisition as his receipt after his payment cheque or savings withdrawal form or any other debit instrument must have been verified and approved as funded. The necessary entries to pass to complete the double entry principle in any bank would flow from the details of the requisition form.

The bank thereafter selects its appropriate correspondent agent in the beneficiary's country and relays the transfer by mail. Banks send mails through courier service; the cost of which is built into charges. The remitting bank at the same time will ensure that there is adequate cover to absorb the value of the transfer in their nostro account with the correspondent bank. Mail transfers are safe and comparatively cheaper but the inherent set-backs should be noted thus:

- It could be slower than other means because the beneficiary abroad has to be advised of the receipt of the transfer by the correspondent bank when the account is credited (if in account)or special identification (e.g. international passport) required to be paid cash. The remitter would also have notified the beneficiary of the transfer.

- It is not impossible for the advice and telephone contact to be intercepted by a crook who could fake a convincing identification and get paid by an innocent correspondent bank.

- There could be some delay in the courier service and advice to the beneficiary through circumstances beyond the control of the courier company e.g. national strike action.

- The handling charge by the correspondent bank could mean the beneficiary getting less than expected.

3.5.5 Telegraphic Transfer

Of all the methods discussed so far, this is the fastest because the message is relayed by electronic means. This is done within seconds and the beneficiary who by prior contact, may be standing by, is paid within a few minutes on proper identification if not in account with the correspondent bank.

At any rate, the exchange control regulation must be met by the remitter where this is in place and the remitting bank's requisition form completed. The remitting bank too should ensure that at all times; the account with the correspondent bank is adequately funded for any remittance to avoid the humiliation of delayed payment to the beneficiary.

As with other transfers, there must be some form of coding or security mark agreed to between the remitting and correspondent banks. Expectedly, the method is expensive to the remitter but could be quite convenient to take advantage of urgent orders or to rescue a stranded loved one.

3.5.6 Society for Worldwide Interbank Financial Telecommunication (SWIFT)

It is an arrangement between contributing banks all over the world including Nigeria whereby transfers that would normally have been sent by telegraphic transfer are further reinforced with the inscription "URGENT SWIFT MESSAGE".

This method is unarguably the fastest method of funds transfer because it is systems-based and directly linked with thousands of member banks the world over.

It is expensive to the remitter but quite swift and safe.

3.5.7 Other Methods of Transfer

There are some other methods of transfer including Western Union Transfer, Internet Funds Transfer, Credit Cards issued bank for their customers who intend to travel etc.

(a) Western Union Transfer (Et A1)

In international money transfer, the role of Western Union, MoneyNet, Vigo, RIA Express etc. cannot be ignored.

Although comparatively new, this method of transfer of funds is targeted at prosperous immigrants to enable them to remit money to their home countries. So far, the process seems to be one-way; from the developed economies without stringent exchange control regulations to the less developed countries.

For Nigerians, this method appears to be effective and popular but the snag is that the conversion rates are not always competitive. The procedure for the remittance is straightforward. The sender fills a form in an obliging outlet, which includes street corner shops abroad and pays in hard currency, the money to be remitted plus charges. He is given a code and a password to relay to the beneficiary in Nigeria who on receipt, goes to the nominated bank in the syndicate with a convincing means of identification (preferably the international passport) to cash the remittance.

The beneficiary may elect to collect his money in the foreign currency especially the American dollar. The remitting bank elects to use either telegraphic transfer or SWIFT in effecting the transfer.

(b) Internet Fund Transfer

The best example of internet funds transfer facility in Nigeria is the ‘e-Tranzact’.

It is the first integrated and electronic payment system in Nigeria that facilitates transactions by using the:

- Internet
- Mobile phone (SMS and WAP)
- Voice XML
- Bank outlet

The attraction is that it is efficient and fraud-free. It enables users to shop securely, effect money transfer online, pay utility bills, make purchases and buy air time via mobile phone POS devices, bank outlet and internet online real time.

(c) Credit Cards

Of recent, banks such as Ecobank Nigeria Plc. issue credit cards to their customers who are desirous in travelling out of the country. These travellers could therefore travel out without the burden of having to undergo the exchange control processes of getting BTA and others. With the card, it is possible to make payment for goods and services in the foreign country.

Self Assessment Exercise 5.4

Write short notes on the following:

- Buyer’s cheque
- Travellers’ cheque
- Bank draft
- Mail transfer
- Telegraphic transfer
- Society for Worldwide Interbank Financial Telecommunication (SWIFT)

4.0 CONCLUSION

We note that the overriding considerations for both the importer and the exporter are security of settlement and that the banks ensure that payments are made for the settlement of international trade.

5.0 SUMMARY

In this unit, we shall examine the accounting methods of settlement between banks as well as the methods through which transfers are effected.

In the next unit, you will be introduced to another topic titled Management of Foreign Currency exposure. It promises to be another interesting topic in your course.

6.0 TUTOR MARKED ASSIGNMENT

1. Itemise the various methods for remitting funds. Pick any two of the methods and explain the attractions and demerits.

2. Why would you recommend SWIFT to a merchant to move his funds?

3. Describe the best ways in which funds can be provided to a company in the following situations:

   (a) Series of briefs abroad from time to time by its managing director to a variety of countries;
   (b) Longer visits, sometimes of uncertain duration by its marketing and sales directors.
   (c) Monthly expenses of up to a total of US$100 by its expatriate on-site Engineers.
   (d) Working capital for a small overseas subsidiary over a period of about two years during which time it is likely to become self-financing (the parent company does not itself wish to provide the funds).
   (e) In New York, the Indian Rupee is quoted R7.54 for $1 and London $1.3950 for £1, What is the cross rate for sterling per R100?

7.0 REFERENCES AND FURTHER READINGS

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UNIT 4: FOREIGN EXCHANGE SYSTEM IN NIGERIA

CONTENTS

1.0 INTRODUCTION

In this last unit, we examined the role of International Chamber of Commerce in documentary credits, defined and described the route structure of documentary letters of credit; highlighted the parties involved in the process, how documentary letters of credit work; listed the types and forms of documentary letters of credit; how discrepancies in documentation are resolved, the attractions and setback of documentary letters of credit.

In this unit, we shall look at Nigeria's foreign exchange system, its history, importance of exchange control, the forms used, participants in the foreign exchange market, documentation for foreign exchange applications, domiciliary accounts, methods of determining foreign exchange rates, types of floating exchange rates and details of foreign exchange bidding auctions

2.0 OBJECTIVES

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

- Trace the history of foreign exchange management in Nigeria;
- Highlight the importance of foreign exchange control regulations;
- Enumerate and discuss the role participants in the foreign exchange market;
- Define and explain the concept domiciliary accounts;
- List and discuss the various types of floating exchange rates;
- Examine the details of foreign exchange bidding auctions.

3.0 MAIN CONTENT

3.1 Short History of Foreign Exchange Management in Nigeria

Esezobor (2009) observed that the first attempt at regulating the foreign exchange system in Nigeria after independence was the passing of the Exchange Control Act in 1962. This Act vested in the Central Bank of Nigeria, the authority to approve all applications for visible imports and certain invisible items apart from repatriation of capital, profits and dividend which were hitherto the exclusive functions of the Federal Ministry of Finance.

3.1.1 Regulation to De-regulation

The period 1962 to 1986 was seen generally as the period of regulation to deregulation or more aptly, the pre-Second Tier Foreign Exchange Market era (Esezobor, 2009). The Nigerian currency at the time, pound, was tied to the British Pound Sterling in parity up to 1967 when the latter was devalued. The attempt to place the value of the Nigerian Pound on the gold content was short-lived as the currency got pegged against a basket of foreign currencies made up of Deutsche Mark, Swiss Francs, French Francs, Dutch Guilder, Japanese Yen and Canadian Dollar between 1971 and 1978. In line with global decimalization of currencies, the pound gave way to Naira and kobo in 1973. In 1984, the Buhari-led military government changed the colours of the naira and gave a short deadline for the exchange of the old notes to the new notes. This action was in response to the high volume of the naira floating outside the country at the time. Same year, the value of the currency was matched against the Pound Sterling and United States Dollar as intervention points. From 1985, the U.S. dollar became the sole currency of intervention in order to manage the damage of arbitrage (trading on a currency at different markets usually on short-term with a view to earning a profit) on the naira.

The Comprehensive Import Supervision Scheme (CISS) came into being through the Pre-Shipment Inspection of Imports Decree No. 36 on 1st January, 1979 with Societe Generale Du Surveillance (SGS) as the sole inspection agent. This development was an attempt by Lt. General Olusegun Obasanjo’s government then at the saddle, to stem all sorts of fraudulent practices to siphon foreign exchange from Nigeria through bogus importation. SGS ran into troubled waters and was ditched in 1984. In 1990, they were reinstated and three other inspectors namely: Intertek Services, Cotecna International Limited and Bureau Veritas, appointed. The whole world was carved out for these inspectors to physically inspect and value all exports to Nigeria for which a Clean Report of Finding was issued for successful inspection. It would be recalled that Nigeria then from about 1970 to 1985, was basking in the euphoria of oil boom which made the country a floodgate of importation of all sorts of things including bricks and sand.

3.1.2 Exchange Control Memoranda

According Esezobor (2009), 1984 was particularly special because it was that year that CBN in a circular dated 9th January created Exchange Control Memoranda, 22 in all, which specified what purposes ranging from basic travel allowance, business travel allowance, medical travels, payments for imports, personal home remittance and education amongst others, that foreign exchange could be approved for. This reform also cleared the way for authorized dealers (banks) to handle the pre-import processing and registration for the private sector.

3.1.3 Reconciliation of Trade Bills

The year 1984 will also be remembered as the year Nigeria attempted for the first time to reconcile its trade debts through CBN. Through a circular referenced ECD/AD/10/84 dated 19th January by CBN, all exporters with outstanding trade debts in Nigeria were informed to submit their trade claims to Chase Manhattan Bank. The latter also gave publicity to this development. Here in Nigeria, all importers and authorised dealers were required to submit to CBN, all their outstanding claims in respect of imports under the open account trading transactions, bills for collection, unconfirmed letters of credits and unpaid management and technical service fees.

The claim by both the exporter and importer were subsequently matched and refinanced by promissory notes issued to the exporters by International Creditor Institutions on behalf of the Federal Government. The exporters of the matched claims were notified to appoint a local agent for the purpose of collecting the naira cover deposited by the importers with various authorised dealers. The understanding was that such naira deposits which were not to attract interest would be used by the appointed agents to source foreign exchange in the unofficial market for remittance to the exporters. It was expected that such documents for the foreign exchange transactions including pre-SFEM transactions were not to be kept for more than 10 years.

3.1.4 Second-tier Foreign Exchange Market (SFEM)

SFEM came on the scene as the arrowhead of the Structural Adjustment Program through Decree No. 23 in September, 1986. It was primarily meant to remove the distortions in resource allocations with a view to finding a realistic value for the naira. It was also calculated to encourage domestic inventiveness especially in the export sector. Import and export licensing were abolished. Banks were authorised to sell foreign exchange in respect of eligible private sector transactions. To afford some protection to domestic enterprises, a great deal of rationalization of Customs and Excise Duties was undertaken. Meanwhile, the value of the naira had fluctuated and steadily depreciated in the following order up to this point:

1973	₦0.64 / $1.00
1980	₦0.55 / $1.00
1985	₦0.89 / $1.00
1986 (March)	₦1.00 / $1.00
1987 (September)	₦4.64 / $1.00

The Babangida Administration at the time of the inception of SFEM said that the sharp fall in the value of the naira was to create the cash to boost the export of non-petroleum products in line with SAP.

3.1.5 Period of Deregulation, 1986 to 1994

The highlights of this period were frantic attempts by the government to hands off many of its enterprises. The longstanding 6 commodity boards were abolished in December, 1986. The existing 18 River Basin and Rural Development Authorities were reduced to 11 and mandated to concentrate on the development of water resources. The Directorate of Food, Road and Rural Infrastructures (DFRRI) was set up to support amongst other things, the construction of feeder roads.

In the meantime, the banks were brimming with excess liquidity which made difficult, the management of monetary policies. Stabilization securities and regular review of interest rates were introduced to stem the tide. The Paris and London Clubs debts were re-scheduled. Expatriate Home Remittance was increased from 50 percent to 75 percent salary net of tax with effect from January, 1987. Advanced payment for import duty was reduced to 25 percent while the 75 percent became payable on arrival of the goods and submission of correct documentation.

Inter-bank Foreign Exchange Market (IFEM) was brought in as the instrument of foreign exchange allocation between 1988 and 1989.

3.1.6 Domiciliary Account/Crawling Peg

An innovation to encourage exporters was the setting up of an account called Foreign Exchange Domiciliary Account into which could be paid in foreign currencies, export proceeds. During the period, 1985 to 1986, the currency management approach was the Crawling Peg where two major currencies, the U.S. Dollar and the Pound Sterling were used as intervention points. Between 1986 and 1989 inclusive, CBN tried as instruments of foreign exchange allocation many systems including the following:

- Marginal Rate
- Dutch Auction System
- Merging of the first and second tier markets
- Inter-bank Foreign Exchange Market

3.1.7 Bureau De Change (BDC)

BDC was introduced in 1989 to reduce the pressure on the foreign exchange market. The operators were licensed to buy and sell foreign monies and encash travellers' cheques from private sources on cash and carry basis. No documentation was required apart from stamping the passport of a buyer for Customs purposes.

The swing from deregulation to regulation continued in 1994. the date, 11th January, 1994 is special because it was this day that CBN's hammer descended on open account and bills for collection as means of export payment with exemption for manufacturing companies. Thereafter, all export business in Nigeria apart from manufacturing companies, had to be by documentary letters of credit especially of the order of confirmed irrevocable or simply, the irrevocable type provided proceeds were repatriated within 90 days. In the policy statement on the issue, the concession previously granted exporters to retain the proceeds of exports was withdrawn to allow CBN pool all export proceeds.

3.1.8 Guided De-regulation, 1995 to 1999

In 1995, the Exchange Control Act was abolished. To replace it, was the Foreign Exchange (Monitoring and Miscellaneous Provisions) Decree, 1995.

Government in 1996 handed over the management and disbursement of export incentives to Nigerian Export Promotion Council (NEPC). All uncontainerised imports valued $1,000 and below were exempted from pre-shipment inspection although all such goods had to be accompanied with Import Duty Report.

The maximum amount repatriated by expatriates working in Nigeria was pegged at 75 percent of salary, net of tax. 1997 would be remembered for policy reversals. The use of open account trading and bills for collection banned in 1994, was restored. The term 'Basic Travel Allowance' was changed to 'Personal Travel Allowance' and the long standing limit of $500 per person was completely removed. Also removed was the Business Trip Allowance of $5,000. The 75 percent of net salary restriction for expatriate home remittance was similarly removed. Textile, which had previously been banned as an import item, was restored.

The highlights of the foreign exchange measures in 1999 were as follows:

(i) The dual exchange rate where the official rate was pegged at N22.00 to dollar was cancelled.

(ii) Inter-bank Foreign Exchange Market (IFEM) replaced Autonomous Foreign Exchange Market (AFEM).

(iii) The pre-shipment policy for imports and exports was abolished to make way for destination inspection to be introduced in due course.

(iv) The various export incentives were modified under a system called Manufacture-in-bond Scheme whereby cash incentives hitherto given to exporters, were replaced with Negotiable Duty Credit Certificate to be used in paying for Customs Duties.

The banking system was kept busy in the year 2001 with the introduction of Universal Banking and wide fluctuations in the naira exchange rate with foreign currencies. IFEM eventually gave way for the return of the Dutch Auction System on 15th July, 2002. The widespread round tripping and other malpractices amongst banks saw the CBN banning 21 banks and about 50 others were put on surveillance.

3.2 Importance of Foreign Exchange Control Regulations

Foreign exchange in whatever currency is a scarce commodity; hence like an individual private savings, has to be conserved strictly for the procurement of essential commodities. The following reasons stand out for restricting public access to foreign exchange reserves in a country:

(i) To attract and conserve earned foreign exchange for balance of payment purposes.

(ii) To make possible, efficient allocation of available foreign exchange reserves in accordance with the need areas of the economy.

(iii) To discourage the warehouse syndrome whereby virtually everything including tooth pick is imported.

(iv) To encourage inventiveness so that Nigerian entrepreneurs can produce and be protected in the Nigerian market which frankly, is enormous.

(v) To enable the CBN to keep record of aggregate inflows and outflows and the justification for the latter.

(vi) To stimulate economic growth by producing what we need and even selling such abroad to earn foreign exchange. This will support and strengthen local industries.

(vii) To support the naira by restricting its conversion to foreign currencies. When the naira is frequently on the parting end in large quantities, the value will fall while foreign currencies will appreciate.

(viii) It is a good thing to control the usage of foreign exchange because the fast developing countries of the Far East including Malaysia, Singapore and India started by clamping down on imports while experimenting with local manufactures which their own people had to live with until perfection naturally followed.

3.3 Basic Exchange Control Forms

Central Bank of Nigeria (CBN) by the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act No. 17 of 1994 is the main authority for exchange control regulations in

Nigeria. The basic exchange control forms in use as spelt out in the CBN Foreign Exchange Instructions Manual are as follows:

- Form A
- Form M
- Form NXP
- Form NCX
- Form TE
- Form TM

Form A
This form is completed by applicants for foreign exchange when paying for service transactions such as:

(i) Personal travel and pilgrimage
(ii) Medical travel
(iii) Business travel
(iv) Expatriate home remittances
(v) School fees
(vi) Cash gifts
(vii) Overseas conference
(viii) Subscriptions and examination fees, etc.

The above items constitute invisible trade.

Form M
Strictly used for the import of physical goods. The form is always completed in sextuplicate for documentary purposes.

Form NXP
Also called the Exporter's Form, it is completed for all commercial exports including oil exports. Particular note must be taken of Form EU1 and PSG in export trade documentation. While Form EUI must be completed for exports to Europe apart from Portugal, Form PSG must be completed for exports to Portugal. Importers in Europe including Portugal would demand these forms to enable them to claim the trade incentives applicable to their respective countries.

Form NCX
It is used to record non-commercial exports. Such items include:

- gifts and personal effects
- trade samples
- machinery and equipment being returned after execution of a specific contract
- machinery and equipment for replacement
- empty containers
- items being re-exported.

Form TE
This form must be completed, if the traveller from Nigeria has in his possession, precious stones, jewelry, work of arts including antiquities and cash above US$5,000 or its equivalent as specified from time to time by CBN.

Form TM
This form is meant for importers of precious stones, jewelry, work of arts including antiquity and cash above US$5,000 or its equivalent or as currently specified by CBN.

3.4 Participants in the Foreign Exchange Market

The foreign exchange market is an open one; open to all individuals, corporate bodies and the various tiers of government for genuine international businesses. The authorised foreign exchange dealers are however as follows:

(i) Federal Ministry of Finance
(ii) Central Bank of Nigeria
(iii) Authorised Dealers
(iv) Authorised Buyers
(v) Bureau De Change (BDC)

(i) Federal Ministry of Finance

It handles the foreign exchange applications of the public sector described as the federal, state and parastatals for the following businesses:

(1) Official tours.
(2) Ministry of Defence expenses.
(3) Remittances to Nigerian Embassies and High Commissions.
(4) Public sector imports e.g. to build an airport.
(5) School fees and maintenance fees for government scholars.
(6) NNPC Joint Ventures expenses.
(7) Official contributions.
(8) External debt servicing and payment.

(ii) Central Bank of Nigeria

It takes responsibilities for the following:

(1) Design and distribution of foreign exchange forms.
(2) Maintenance of overseas accounts of public sector institutions.
(3) Non-commercial exports.
(4) Pilgrims services.
(5) Miscellaneous transactions.
(6) Determination of the appropriate method of foreign exchange disbursement e.g. Dutch Auction System, Marginal Rate System, etc.

(iii) Authorised Dealers

They are banks authorised by CBN and Federal Ministry of Finance to approve applications for a long list of transactions such as:

(1) Imports, for which Form M is completed.
(2) Invisible transactions for which Form A is completed.

(iv) Authorised Buyers

They are five star hotels duly accredited to receive payment of hotel bills in foreign currencies into naira for visitors. Such hotels are expected to operate Foreign Currency Domiciliary Account which can be used to pay for eligible transactions. They can also exchange unused naira balance to foreign currencies for visitors subject to a maximum of US$2,500 or its equivalent.

They are required to render monthly returns to CBN.

(v) Bureau De Change (BDC)

They are also authorised buyers charged with the responsibilities of buying foreign currencies and travellers' cheques without any limit and also to sell foreign bank notes and coins up to a maximum of US$2,500 or its equivalent.

However, the reforms on the operations of BDC initiated in 2002 came to fruition on Friday, 27 February, 2004 with the approval of 7 BDC by CBN to sell travellers' cheques from Travellex Worldwide owned by Thomas Cooke of the United Kingdom. It is expected that the innovation will deepen the foreign exchange market with a view to compelling a downward movement in the parallel exchange rate. Although 16 BDC met the minimum capital of N10 million, the process of verification thinned down the number to only 7. It is also expected that the Association of Bureau de Change Operators of Nigeria (ABCON) will help to enforce transparency amongst the operators in order to facilitate the entry of more members into the enhanced business.

From year 2006, BDC were allowed to participate in the official Wholesale Dutch Auction System (WDAS). The maximum bid is however pegged at $200,000 per session at two sessions weekly and like banks, must back their purchases with the naira equivalent.

BDC source their funds from advances from the money and capital markets in addition to their share capital and retained profits. BDC add efficiency and competition to the foreign exchange market and thus enable CBN to determine a more accurate rate for the naira. They render faster personal service because of their limited size and are less formal to deal with.

3.5 Documentation for Foreign Exchange Applications

The popular exchange control documents that must be attached to each application for foreign exchange for invisible items are:

Form A

(a) Personal Travel Allowance
- completed Form A
- valid passport to which must be recorded the foreign exchange sold
- evidence of travel.

(b) Pilgrimage Travel Allowance
- completed Form A
- valid passport to show details of sale of foreign exchange (rate of exchange for the purpose is fixed by the government)
- evidence of travel.

(c) Business Travel Allowance
- completed Form A
- Letter of invitation from the overseas partner stating the purpose and duration of the business trip.
- Letter of acceptance by the applicant's company including the itinerary and proposed date of travel.
- Valid passport to which must be recorded the foreign exchange sold.
- Return air ticket.

(d) Medical Travel Allowance
- completed Form A
- a letter of reference from a specialist doctor or a specialist hospital e.g. University Teaching Hospital.
- letter of acceptance of the patient from the overseas hospital including the medical bill.
- valid passport, into which, will be entered the details of the foreign exchange sold.
- air ticket.

(e) Overseas Training, Conferences or Seminar
- completed Form A.
- Letter of acceptance by the overseas organisation running the program which will also state the cost of the program and estimated cost of personal maintenance including hotel charges.
- Letter from the attendee's organisation nominating him or her for the course.
- Passport of the beneficiary.
- Return air-ticket.

(f) Management Services Fees

- completed Form A.
- Cost estimate for services rendered.
- Copy of the management agreement fee.
- Certificate of satisfactory execution of the job issued by the principal.
- Evidence of tax paid on the service rendered.

(g) Royalties

- completed Form A.
- Executed agreement on the royalties.
- Evidence of tax paid on the royalties.
- Audited accounts for the period.

Form M

This must be completed for all imports whether valid for foreign exchange or not. The following particulars must be attached to the completed Form M:

- pro-forma invoice (the original and 3 copies).
- current license issued by the Pharmaceutical Board of Nigeria if the items to be imported are pharmaceuticals.
- current license of NAFDAC, if import item is food or food related items with effect from 1st April, 1999.
- local insurance certificate
- application to open a letter of credit.

It should be noted that quite a lot of goods are prohibited in the import eligible transactions such as live or dead poultry, maize, beer and stout, domestic articles and wares made of plastic materials excluding babies' feeding bottles, used re-treaded tyres, gaming machines etc.

Form NXP

To export goods (excluding petroleum oil), the following documentation must be completed:

- completed Form NXP
- a signed pro forma invoice
- sale contract agreement with buyers
- Nigerian Export Promotion Council registration certificate
- Clean Report of Inspection
- Shipping documents e.g. bill of lading

- Foreign EUR 1 for exports to the European Common Market apart from Portugal which requires rather, Form PS1.

Goods Exempted from the Payment of Import Duties

The following goods are exempted from the payment of import duties:

(i) Aircraft materials and equipment
(ii) Films
(iii) Fuel and lubricants
(iv) Goods imported for the Head of State/Commander-in-Chief.
(v) Goods imported for Consular Offices.
(vi) Diplomatic privileges importation.
(vii) Donation on technical assistance.
(viii) Passengers' baggage
(ix) Life-securing appliances.
(x) Military hardware and uniforms.
(xi) Arms and ammunitions imported by the Nigeria Police.

3.6 Domiciliary Accounts

They are accounts held in foreign currencies in any bank by Nigerians, companies, embassies and foreign nationals either as current account, term deposit account or simply, savings account.

Domiciliary accounts can be operated with foreign currencies from the following sources:

(i) Cash in foreign currencies
(ii) Promissory notes in foreign currency.
(iii) Bills of Exchange in foreign currency.
(iv) Travellers' cheques
(v) Foreign drafts
(vi) Mail / Telegraphic transfers
(vii) SWIFT transfers
(viii) Transfers from other domiciliary accounts in Nigeria
(ix) Foreign currency allocated by CBN for transfer from Nigeria e.g. personal home remittance approved for foreign nationals working in Nigeria.

There are two types of domiciliary account, namely:

- Ordinary Foreign Currency Domiciliary Account
- Foreign Currency Domiciliary Account

While the latter is strictly for the repatriation of export proceeds including exports of petroleum products (not crude oil), the former is opened to absorb receipts of foreign currencies apart from exports.

The advantages of domiciliary accounts are as follows:

(i) the source of the foreign currency is not required before opening the account or during the currency of the account;

(ii) the proceeds can be withdrawn in foreign bank notes, travellers' cheques, mail transfer, telegraphic transfer, or bank draft in the usual manner;

(iii) if the domiciliary account was opened in cash in excess of $10,000 or equivalent, withdrawal must be in cash;

(iv) withdrawals can be used to finance Forms A and M in the usual way;

(v) interest is payable on such deposits in foreign currency at a rate advised by CBN;

(vi) domiciliary account is exempt from tax except the lodgement was a refund of air fare collected in foreign currency;

(vii) bank charges are in foreign currency at rates determined by CBN except the account holder converted the foreign currency to naira where the charges shall be in naira;

(viii) authorised dealers are free to invest the foreign currencies in overseas bank. They are also allowed to lend the foreign currencies;

(ix) authorised dealers must render returns monthly not later than 15th of the month to CBN. In doing so, only aggregate details are required; names of account holders are not required.

3.7 Methods of Determining Foreign Exchange Rates

As earlier stated, until 1967 when the Nigerian currency was tied to the British Pound Sterling, a currency noted as the best example for fixed exchange rate regime, the exchange rate in Nigeria was fixed and managed accordingly by CBN.

The watershed in exchange rate management was in 1985 with the promulgation of SFEM. The naira has floated ever since in a bid to find its appropriate market value. The CBN had managed the naira value by adopting the following instruments of intervention:

(a) Average Pricing Method at inception of SFEM in September, 1986. A month later, Marginal Rate was adopted. Bidding was fortnightly.
(b) Autonomous Foreign Exchange Market (AFEM) came up in March, 1987 and the bidding period became daily.
(c) The Dutch Auction System (DAS) made its first entry on 2nd April, 1987 and the bidding sessions were fortnightly. This development facilitated the merging of the first and second tiers foreign exchange markets.
(d) Inter-bank Foreign Exchange Market (IFEM) was introduced along with Bureau de Change in January, 1989. The bidding session was daily.

(e) Foreign Exchange Market (FEM) replaced IFEM a year later in January, 1990 with weekly bidding sessions.
(f) DAS re-emerged in December, 1990 on a weekly bidding system.
(g) DAS was tinkered with and given a new name of Modified Dutch Auction System in August, 1991.
(h) AFEM was returned in 1995 as a daily session.
(i) AFEM gave way to IFEM in 1999 as a daily session. Amount for auction was determined by the bids received.
(j) DAS returned with fanfare on 15th July, 2002. CBN determines in the session held a week, what amount of currency it wants to sell.
(k) Wholesale Dutch Auction System (WDAS) was introduced on 20th February, 2006. Banks were free to bid on their own account and trade in the interbank market. In the spirit of liberalization of the foreign exchange market, BDC were for the first time allowed to bid directly but subject to a maximum of $200,000 at any session.
(l) Following an all-time record drop of the value of naira at N150 to the US$, CBN re-introduced the Dutch Auction System now christened Real Dutch Auction System (RDAS) on Monday 12 January, 2009.

3.8 Types of Floating Exchange Rates

Nigeria maintains a floating exchange rate regime which allows it to quote the naira at pence rate. A country could allow its floating rate to be free or managed.

3.8.1 Free Floating Exchange Rate

If the currency is a free float, the implication is that the monetary authorities sit back and allow the currency to find its competitive rate through the interactive forces of demand and supply in the international market. Unfortunately, it is not only market forces that affect the rate of exchange. Politics, speculation, counterfeiting and hot money amongst other things, all affect the level of exchange rate. No monetary authority can therefore afford its currency a free float without some form support when desirable.

3.8.2 Managed Float

It is also called ‘Dirty Float’ because by merely putting the currency on a floating roller, the understanding is that the monetary authorities want it to achieve its true market rate. Any attempt therefore to hedge the floating currency is negative to the spirit of the decision to float it hence it is called dirty.

A floating currency can be managed by its monetary authorities by intervening in the foreign exchange market in any of the following ways:

- Unofficial Peg
- Smoothening Out
- Leaning against the Wind

(a) Unofficial Peg

By this intervention, the currency is allowed to float between defined limits; one the upper limit and the other, the lower limit.

Such a decision will entail the monetary authorities in times of unacceptable movements in exchange rate, to actively buy its currency with foreign currencies with a view to mopping up the excess quantity in circulation, thereby making it scarce and therefore, expensive. To lower the peg will involve the opposite action.

(b) Smoothening Out

The action taken here is akin to unofficial peg except that it is a daily event to nip in the bud, actions of speculators that put pressure on the exchange rate of the currency. The volume of intervention is usually small but the key word is that it must be **daily**.

(c) Leaning against the Wind

This arises from the uncertainty that an event capable of changing the fortunes of the exchange rate of a currency could happen or may not happen. The sum effect is that speculators have a field day to manipulate the exchange rate of the currency in their favour and to the detriment of the fortunes of that country's economy. The monetary authorities of the country are put on the alert with appropriate foreign exchange tools of management to contain the event or non-event.

An example is the fear of imminent price changes in the pump price of petrol which may in turn; affect every aspect of economic endeavour.

3.9 Details of Foreign Exchange Bidding Auctions

Nigeria maintains the bidding auction system through which, authorised dealers bid for foreign exchange on behalf of customers and selves at the bidding sessions organised by CBN. The currency of auction is the American dollar. The success of any session depends on the interaction of demand and supply of the currency amongst other things.

In any of the auction systems earlier listed, the four key issues are:

(a) The effective rate
(b) The buying rate
(c) The selling rate
(d) The marginal rate.

Esezobor (2009) examined each of the systems and attempted simple calculations of the key issues using the following standard but hypothetical table:

Table 2.1 Hypothetical Table of Demands for Foreign Exchange at Bidding Sessions

S/N	BANKS	RATE (₦)	DEMAND $'m	CUM DEMAND $'m	WEIGHT ₦'000M
1.	FBN PLC.	130.00	600	600	78,000
2.	UBN PLC.	129.75	590	1,190	76,552
3.	UBA PLC.	129.50	585	1,775	75,757
4.	AN PLC.	129.45	570	2,345	73,786
5.	BON LTD.	129.30	550	2,895	71,115
6.	TB PLC.	129.15	510	3,405	65,866
7.	WB PLC.	129.10	450	3,855	58,095
8.	GTB PLC.	129.05	405	4,260	52,265
9.	CB LTD.	129.00	350	4,610	45,150
10.	CDB PLC.	129.90	320	4,930	41,568
	TOTAL	**1,294.20**	**4,930**		**638,154**

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

1. Average Pricing Method

Introduced at the inception of SFEM in September, 1986, it lasted for only one month. The key issues from the above table could be calculated thus:

(a) The Effective Rate

It is the exchange rate at which CBN debits the banks for winnings in the bidding session. In the table, there are 10 banks whose total bidding rates amount to ₦1,294.20.

The effective rate is therefore ₦1,294.20 divided by 10 which is equal to ₦1,29.42.

(b) The Buying Rate

It is the rate at which banks would buy foreign exchange e.g. from visitors to the country. The CBN allows a spread of 1 percent in determining the buying and selling rates by banks. This is done in the case of buying by subtracting the 1 percent from the effective rate, thus:

Effective Rate, 129.42 less 1 percent i.e. 1.2942 = <u>₦128.13</u>

(c) ***The Selling Rate***

It is the rate at which banks sell foreign exchange. The spread in this activity is an addition in accordance with the maxim of buy low, sell high for pence rate system.

Effective Rate, 129.42 + 1 percent i.e. 1.292	=	₦130.71

Note: You will observe that in the buying rate, the spread was a minus while in the selling rate, it was an addition. Furthermore, you may also have observed that the selling rate is higher than the buying rate. The reason for this is that Nigeria operates the PENCE RATE FOREIGN EXCHANGE SYSTEM where the operating maxim is buy low, sell high. That means, adopt the lower of the two rates as the buying rate and the higher, as the selling rate.

(d) ***The Marginal Rate***

It is the average of both buying and selling rates used by banks to value the stock of foreign exchange in their vaults at month-end for balance sheet purposes.

Buying rate	**₦128.13**
Selling rate	130.71
	₦258.84

The average, Marginal Rate, is therefore	=	₦129.42.

2. Marginal Rate System

The system was introduced in October, 1986 to replace the Average Pricing Method but was ditched for AFEM on 30th March, 1987. It is straightforward in operation. CBN comes to the bidding session with a stock of US dollars and starts allocating to the banks starting from the highest bidder. The rate at which the stock is completely sold out then becomes the Marginal Rate same as the Effective Rate.

Looking at our hypothetical table, assuming CBN came into the bidding session with US$3 billion, the marginal rate would be calculated as follows:

Look at the column of Cumulative Demand and rest your glance at the sixth row bearing TB Plc. CBN will start allocating dollars from the highest bidder, FBN Plc. All the banks up to BON Ltd. will get their full demands of dollar. TB Plc. that bid for $510 million will only get $105 million ($3,000 million brought by CBN minus $2,895 million cumulative demands up to BON Ltd.)

The bidding rate by TB Plc. i.e. N129.15 will now be the marginal (effective) rate. Banks 7 to 10 would leave the session empty handed. In the Foreign Exchange Allocation Schedule that would be drawn up at the end of the session, TB Plc's demand would be stated as $106 million while banks 7 to 10 would be NIL. The Cumulative Demand and Weight columns would also be adjusted accordingly.

Now let us return to the key issues as previously.

(a) Marginal and Effective Rate is ₦129.15.

(b) Buying Rate will be ₦129.15 – 1 percent i.e. 1.2915 = ₦127.86

(c) Selling Rate is now ₦129.15 + 1 percent i.e. 1.2915 = ₦130.44

Expectedly, the system encouraged banks to bid high in order not to lose in the session. A few bank executives were sanctioned by their banks for bidding too low and returning to the office empty-handed. Bidding very high was indirectly depreciating the value of the naira. It would appear some banks deliberately bid high with a view to doing business with the banks that lost out.

Autonomous Foreign Exchange Market (AFEM)

It made its debut in March, 1987 but was stopped for DAS a month later. It returned in 1995 for four years until Inter-bank Foreign Exchange Market (IFEM) took over in 1999.

Under this method, banks were free to source for foreign exchange which they could sell at mutually agreed exchange rates with fellow banks. CBN on its part, stood as a watchdog, intervening where appropriate on the naira value vis-à-vis the dollar in the market.

Esezobor (2009) regards AFEM like an official license for round tripping without bounds. The buying and selling rates were calculated the usual way as the effective rate. The effective rate this time would be the rate at which the foreign exchange was procured.

Dutch Auction System (DAS)

Viewed from the number of times it had been adopted by CBN, DAS appeared to be the most successful of all the systems tried in the past. The first entry was on 2nd April, 1987 and was on till 2nd January, 1989. It re-emerged in December, 1990 and was laid to rest nine months later. It was returned 15th July, 2002 and as at press time, was still the system for foreign exchange allocation.

The system is unique because it merges the benefits of the marginal rate system with its own method of allocating dollars to banks at the rate they bid for. The rate at which the

CBN's stock is exhausted serves as the operating rate for the period as in the marginal rate system. The other unique aspect of DAS is that each bank will have its own effective rate from which the buying and selling rates can be computed in the usual way.

In DAS, inter bank foreign exchange transaction is not allowed. All banks must back up their bids with the naira equivalent and submit to CBN on Mondays and Wednesdays before noon in readiness for the bidding session the next day. One other attraction of this system is that the customer determines his own rate by which CBN will allocate foreign exchange.

Using our earlier table as above for a US$3 billion, CBN market stock, we have already seen that the marginal rate would be TB Plc's bid rate of N129.15 at which, the stock was completely allocated.

For the first three banks, FBN Plc, UBN Plc and UBA Plc, the scenario of their respective rates would be as follows:

ITEM	FBN PLC	UBN PLC	UBA PLC
Effective Rate	130.00	129.75	129.50
Marginal Rate	129.15	129.15	129.15
Buying Rate	130 – 1.30 = 128.70	129.75 – 1.2975 = 128.45	129.5 – 1.295 = 128.20
Selling Rate	130 + 1.30 = 131.30	129.75 + 1.2975 = 131.05	129.5 + 1.295 = 130.80

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

Note: Under WDAS and RDAS, the results would be the same.

Modified Dutch Auction System (MDAS)

MDAS came on stream in August, 1991 and was used for 4 years as the system for foreign exchange allocation until the return of AFEM in 1995. With MDAS, the first and second tier foreign exchange markets were merged and thereafter, called FEM.

Two methods were open to CBN to compute the banks' winnings in FEM, namely:

- the weighted average method;
- the average of the successful bids rates system.

The first method, the weighted average method, could be used if CBN had the dollars demanded by banks and was ready to accommodate them.

Back to the hypothetical table above, the weighted average method will be summed up as:

$$\frac{\Sigma \text{ Bidding Weights}}{\text{Demand}} = \underline{638{,}154} = \text{₦}129.44$$

If on the other hand, CBN entered the market with a part of the cumulative demands of banks, it will adopt the Marginal Rate System (MRS) to eliminate the banks with low bidding rates. In the MRS, we saw that with $3 billion market stock, CBN allocated in our hypothetical table, funds to the first five banks and in the case of the sixth bank, TB Plc, only $105 million of the market bid of $510 million, to close the session. Furthermore, TB Plc's bidding rate of ₦129.15 became the marginal as well as the effective rates.

This time around, under the average of the successful bids rates system, CBN would take the average of the bidding rates of the successful banks in the session.

Thus, we have for the six successful banks, the following simple average calculation to arrive at the effective rate for that session:

$$\frac{130 + 129.75 + 129.50 + 129.45 + 129.30 + 129.15}{6}$$

$$= \quad \underline{₦129.53}$$

From the effective rate, the buying and selling rates could be calculated in the usual way thus:

Buying rate	=	N129.53 – 1.2953	=	₦128.28
Selling rate	=	N129.53 + 1.2953	=	₦130.83

The marginal rate at this point will be the average of both the buying and selling rates i.e.

$$\frac{128.23 + 130.83}{2}$$

$$= \quad \underline{₦129.53}$$

4.0 CONCLUSION

We noted from our discussion so far that until 1967 when the Nigerian currency was tied to the British Pound Sterling, a currency noted as the best example for fixed exchange rate regime. The exchange rate in Nigeria was therefore fixed and managed accordingly by CBN. We also noted that the watershed in exchange rate management came about in 1985 with the promulgation of SFEM. The naira has floated ever since in a bid to find its appropriate market value.

5.0 SUMMARY

In this unit, we looked at Nigeria's foreign exchange system, its history, importance of exchange control, the forms used, participants in the foreign exchange market, documentation for foreign exchange applications, domiciliary accounts, methods of determining foreign exchange rates, types of floating exchange rates and details of foreign exchange bidding auctions.

6.0 TUTOR MARKED ASSIGNMENT

1. What do you consider the reasons for foreign exchange control in Nigeria? State the basic foreign exchange forms and their uses.

2. Distinguish between Ordinary and Foreign Currency Domiciliary Accounts.

3. What are the advantages of domiciliary accounts? List the various methods of foreign allocations in Nigeria.

4. State the main attractions of the Dutch Auction System and why it seems to have been successful as a foreign exchange tool in Nigeria?

5. The Foreign Exchange (Monitoring and Miscellaneous Provisions) Act No. 17 of 1995 stipulates what can be termed as offences and unethical practices by authorised buyers and authorised dealers in the foreign exchange market.

   Required:
   (i) Who are the ‘authorised buyers’?
   (ii) Who are the ‘authorised dealers’?
   (iii) Briefly mention the impacts that can be attributed to effective Bureau de Change operations in a developing economy like Nigeria.
   (iv) List and explain the offences and unethical practices as stipulated in the above-mentioned Act. ***(CIBN, Q. 2, October, 2003)***

7.0 REFERENCES AND FURTHER READINGS

Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

UNIT 5: EXCHANGE RATES CALCULATION: FORWARD EXCHANGE CONTRACTS (SPOT AND FORWARD RATES)

CONTENTS

1.0 INTRODUCTION

In this last unit, we examined at Nigeria's foreign exchange system, its history, importance of exchange control, the forms used, participants in the foreign exchange market, documentation for foreign exchange applications, domiciliary accounts, methods of determining foreign exchange rates, types of floating exchange rates and details of foreign exchange bidding auctions.

In this unit, we shall discuss extensively the various methods of calculating exchange rates in a foreign exchange market.

2.0 OBJECTIVES

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

- Define and understand the expression 'exchange rates;
- Enumerate and explain the broad systems of exchange rates quotations;
- List the various types of exchange rates;
- Appreciate the use of forward exchange control including close-out and extension;
- Determine the percentage cost of forward exchange contract and its application;
- List the benefits of forward exchange contract.

3.0 MAIN CONTENT

3.1 Definition of Exchange Rate

In the final analysis, what is important in any international business relation is that goods and services rendered are paid for.
In making payment from one country into another, there must be a basis of conversion which both the seller and buyer are agreeable to (not necessarily happily) and that is the exchange rate for the currency desired.

Esezobor (2009) therefore defined an exchange rate as the medium by which one currency is converted to another. He explained further that the exchange rate of any country mirrors the strength of that country's economy amongst other things factors which affect exchange rates.

Slaving (2002) states that the basis for international finance is the exchange of well over 100 national currencies. He defined exchange rate as the price of a country's currency in terms of another currency. According to him, if you received 100 Japanese yen for $1, then you could say that a yen is worth about one cent, and if British pound were exchanged for $2, then one could say that a dollar is worth about half a pound.

3.2 Exchange Rates Systems

There are two main systems of exchange rate quotations (Esezobor, 2009), namely:

(a) Currency Exchange Rate System, and
(b) Pence Rate Exchange System

3.2.1 Currency Exchange Rate System, and

Currency rates are quoted by economies that maintain fixed exchange rate system. In any of such countries, the exchange rate is fixed but managed effectively by the country's monetary authorities within fixed bands authorised by the International Monetary Fund (IMF). The United Kingdom is one of such countries.

Generally, exchange rates are quoted in a double-barelled form whereby one of the rates is used to buy and the other to sell.

For example, stg£ / US$ 1.6301 – 1.6386

In currency rates, the home currency (stg£) is normally fixed in relation to variable units of the foreign currency as above. Under currency rates, the operating maxim is "BUY HIGH, SELL LOW. That means, use as a bank, the higher of the two rates to buy i.e. 1.6386 and the lower 1.6301 to sell. This maxim clearly negates the common market experience of buying low and selling high so as to make good profit. However, it is only through the operating maxim of BUY HIGH, SELL LOW that authorised dealers can earn sustainable profits and remain in business under this system.

Example:

Convert U.S. $10,000 to Stg£ by 1.6301.

(a) the selling rate;

(b) the buying rate and determine the profit from such conversions without the exchange rate charges.

Solution:

(a) Divide $10,000 by 1.6301

Why do we divide and not multiply? The reason is that if stg£1 will fetch $1.6301 when selling; $10,000 will produce something far less in sterling.

Therefore, $10,000 divided by 1.6301 is equal to stg£6,134.59. In the bank, when you sell you debit the customer's funded account.

(b) Using the buying rate, $10,000 divide by 1.6386. This equal to stg£6,102.77. This is the amount for which the customer would be credited.

Still on the maxim of BUY HIGH, SELL LOW, you can see that on the same amount of $10,000, when the bank sells, the customers pays stg£6,134.59 whereas if the bank were to buy, they would pay the customer only stg£6,102.77; showing a profit of stg£31.82 from the transaction.

3.2.2 Pence Rate Exchange System

Countries that maintain floating exchange rate system quote pence rate as their exchange rate. In floating exchange rate system, the exchange rate is left almost entirely to the market forces of demand and supply (Esezobor, 2009). There is minimal interference by the monetary authority of the country concerned although it still operates as a residual buyer and seller because no country can entirely leave its currency exchange rate to market forces.

Nigeria operates the floating exchange rate mechanism and as such, the naira is quoted in pence rate. In pence rate, the home currency is quoted in variable units in relation to a fixed unit of the foreign currency.

For example,	Stg£1 / ₦	164.10 – 163.75
	US$ / ₦	102.32 – 101.05

You can now see that in the above quotations that the naira is the subordinate; fluctuating against the fixed units of the pounds sterling and the dollar.

The operating maxim in pence rate is BUY LOW, SELL HIGH, which is in consonance with common commercial language.

The meaning is that, the bank should use the lower of the double-barelled rates to buy (163.75 in sterling and 101.05 for dollar as above) and the higher, to sell which in the example above, are 164.10 for sterling and 102.32 for dollar. Once again, it is only through the adoption of this maxim that banks can make sustainable profits.

Example:

Convert stg£5,000 to Naira at:

(a) selling rate;
(b) buying rate and state the profit or loss between both transactions.

Answer:

(a) Multiply stg£5,000 by 164.10 (buy low, sell high – 164.10 is the higher of the two rates).

Why do we, this time around, multiply and not divide as we did under the currency rates?

The rationale for this is that if stg£1 will fetch ₦164.20, one will need a big bag to stack in stg£5,000 which will amount to ₦820,500.

(b) Stg£5,000 multiplied by 163.75 will amount to ₦818,750.

In selling as in (a) above, we debit the customer	₦820,500
While in buying, we pay or credit the customer	818,750
Profit	₦1,750

3.3 Types of Rates of Exchange

The following constitutes the various types of exchange rates of exchange:

(a) Spot Rate
(b) Middle or Marginal Rate
(c) Cross Rate
(d) Tel Quel Rate
(e) Forward Exchange Rate

This will be discussed below:

(a) Spot Rate

It is the rate quoted by a dealer for counter transactions or transactions that must be executed in a period not exceeding two (2) days e.g. sale of travelers' cheques.

(b) Middle or Marginal Rate

It is the average of both selling and buying rates. When a single rate is quoted for any foreign currency as we see in the newspapers, it is the marginal rate that had been quoted. The other names for marginal rate are central rate or effective rate. In the bank, the marginal rate is applied when foreign currencies are being revalued at month-ends to get a more realistic value for the general ledger balance.

(c) Cross Rate

Although initially limited to the currencies of the developing countries arising from the dominance of the U.S. dollar after the Second World War to which such countries had to denominate their international trade, it is now freely used for most currencies of the world.

In Nigeria, in order to convert to any other currency apart from the pound sterling, the first action is to convert to the U.S. dollar and from that point to the foreign currency required. This is the roundabout or extensive method of conversion which wastes a great deal of time in a busy branch of a bank. The alternative is to use a direct rate between the naira and the foreign currency without first berthing at the U.S. dollar. The direct rate is called cross rate. It is easier and faster to use.

Given the following hypothetical rates, the cross rate scenario will be better understood.

US$ / N	100.32 – 101.05	-	(pence rate)
US$ / DM	2.52 – 2.56	-	(currency rate)

That is, the Euro-dollar is fixed in relation to variable quantities of the Deustche mark).

Question:

Sell DM 30,000 to a Nigerian business using the above quoted rates.

Answer:

Your first reaction will be to convert the DM 30,000 to US$ and then to naira in the following long process:

Step 1: Convert DM 30,000 to US$ at spot selling rate i.e. 2.52

This will amount to $\frac{30,000}{2.52}$ = US$11,904.76

To reason why we divide, if one US$ will fetch DM 2.52 at selling rate, how much in US$ will DM 30,000 fetch?

Step II: Now convert $11,904.76 to naira for the customer to pay thus:

US$11,904.76 x 101.05 = ₦1,202,975.99

Once again, we have multiplied because if one US$ will exchange for ₦101.05, it is easy to see that $11,904.76 will exchange for $11,904.76 x 101.05, which is ₦1,202,975.99.

Note:
In a busy schedule of work, it will be difficult to sustain this roundabout method of conversion especially when there are simpler methods separately for pence rates and currency rates.

(i) Cross Rate for Pence Rates System

Simply divide the naira rate by the dollar rate for the action being taken, that is, selling and multiply by the quantum of the foreign currency (DM 30,000) being converted, to arrive at the naira equivalent. Recall that the roundabout method above was to first convert the DM 30,000 to dollar and then the result to naira.

Now pick the naira selling rate in the example above which is 101.05. Divide this rate, 101.05 by the dollar selling rate i.e. 2.52. This will give us:

$$\frac{101.05}{2.52} = 40.0992$$

The interpretation of this answer is that ₦40.0992 will exchange for DM1 at the bank's selling rate.

How much therefore will DM 30,000 convert to at ₦40.0992 to DM1?

This will be DM 30,000 x ₦40.0992 which is equal to ₦1,202, 976.00.

This answer gives the same approximate answer as in the conversion process in the above example.

(ii) Cross Rate for Currency Rates System

Under this system, we multiply the rates of the two currencies involved rather than divide as we did under pence rate.

Example:

In London, the following rates were quoted:

Stg£ / US$	1.5450 – 1.5600
US$ / DM	2.52 – 2.56

Quote the bank's buying cross rate for a DM50,000 deal and convert to pounds sterling accordingly.

Answer:

The rates are currency rates because in London, one pound sterling fetches variables units of the US dollar. Similarly, the Euro-dollar is fixed in relation to pieces of the German Deutsche mark. Therefore we buy high, sell low.

The buying rate for sterling is 1.5600 while for the U.S. dollar, it is 2.56.

Simply multiply 1.5600 by 2.56 to obtain 3.9936. The interpretation is that DM 3.9936 exchanges for £1 at buying rate. DM 50,000 therefore will fetch only £12,520.03 i.e. 50,000 ÷ 3.9936.

If on the other hand, we adopt the extensive method of first converting DM 50,000 to dollars at 2.56 and then to sterling at 1.5600, we definitely will arrive at the same figure £12,520.03.

Formulae for Cross Rates

In determining cross rates therefore, we can adopt the following formulae:

Pence Rate – divide the rate for home currency by the rate for the foreign currency.

Currency Rate – multiply the rate for home currency by the rate for the foreign currency.

(d) Tel Quel Rate

It is a special exchange rate duly agreed to by both the bank and the customer for a specific purpose that is long term in value.

This type of rate is unlikely to be accepted in Nigeria because prevailing rates of exchange must be obtained through the process of CBN organised bidding session for foreign exchange allocation.

One of the surest ways out of protection against foreign exchange fluctuation on long term, is forward exchange contract for which the next type of exchange rate, forward exchange rate is used.

(e) Forward Exchange Rate

It is the rate quoted for transactions meant for execution in the future appropriately defined as two working days upwards. Being the rate quoted for forward exchange contract, let us now proceed to it.

3.4 Forward Exchange Contract

The Chartered Institute of Bankers, London defines forward exchange contract in one of the series of their Economic Report as "an immediately firm and binding contract between a customer and banker for the purchase or sale of a specified quantity of a stated foreign currency, at a rate of exchange fixed at the time making the contract and for performance by delivery and payment at a future time agreed upon when making the contract" (Esezobor, 2009).

Forward exchange contracts are usually subject to the spot rate ruling on the day the contract is entered into and forward margins or pieces of the foreign of the currency for the contract period. Such forward margins are quoted either as premium or discount or par.

Perhaps the following table and the examples that will follow after our discussion on fixed and option forward exchange contracts will elucidate their definitions and action to take on each of them in the circumstances of pence rate and currency rate systems.

Forward Margin	**Definition**	**Action to Take**	
		Pence Rates	**Currency Rates**
Premium	The foreign currency is expensive	Add to spot rate to increase the burden of parting with more of the home currency for the foreign currency	Subtract from the spot rate to produce less of the foreign currency (expensive).
Discount	Cheap – the foreign currency	Subtract from the spot rate to happily pay less of the home currency for the foreign currency	Add to the spot rate to arrive at more of the foreign currency (cheap).
Par	Same as the spot rate, neither cheap nor expensive	None	None

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

Note: We are not ready to use this table yet until after our discussion on types of forward exchange contract which will now follow.

There are two types of forward exchange contracts, namely:

- Fixed forward exchange contract, and
- Option forward exchange contract

(a) Fixed Forward Exchange Contract

When the future date of delivery of the foreign currency is known and specified, the forward exchange contract is said to be fixed.

For instance, if the bank is to sell £10,000 one month fixed

or

Customer to buy DM 25,000 three months fixed.

In both examples, the date of performance is definite from the day of the contract. Neither the bank nor the customer is on guesswork as to when to deliver the foreign currency. To enable us to use the table above on forward margin and get more conscious of the procedures in both the pence and currency rate systems, let us now look at simple examples of fixed forward exchange contract using exchange rates extracted from the past question papers of CIBN and CIB London (Esezobor, 2009).

Examples:

Pence Rates	**Currency Rates**
Spot US$ / N88.5250 – 89.9676 1 month 1.5492 – 1.5744 premium 2 months 3.0984 – 3.1488 premium 3 months 4.8500 – 4.9048 premium Quote the appropriate rates and calculate for the following: (i) Customer is buying US$10,000 3 months fixed; (ii) Bank is selling US$25,000 1 month fixed; (iii) Customer is selling US$3,000 2 months fixed. **Answer:** (i) Customer is buying, so the bank's	Spot Stg£ / US$ 1.7765 – 1.7875 1 month 0.38 – 9.44c discount 2 months 1.20 – 1.25c discount 3 months 2.42 – 2.48c discount Quote the appropriate rates and calculate for the following: (i) Bank is buying US$30,000 2 months fixed; (ii) Customer is selling US$12,000 3 months fixed; (iii) Bank is selling US$5,000 1 month fixed. **Answer:** Recall the maxim: BUY HIGH, SELL LOW. Pay attention too to the placing of the decimal

position is selling. (Exchange rates are quoted from bank's position, Remember the maxim: BUY LOW, SELL HIGH).

Spot Selling Rate		89.9676
Add 3 months premium		4.9048
Forward Rate	=	94.8724

US$10,000 at 94.8724
Debit the customer with **₦948,724.00**

a. Bank is selling:

Spot Selling Rate		89.9676
Add 1 month premium		1.5244
Forward Rate	=	91.5420

US$25,000 at 91.5420
Debit the customer with **₦2,288,550**

b. Customer is selling, so the bank buys.

Spot Buying Rate		88.5250
Add 2 months premium		3.0984
Forward Rate	=	91.6234

US$3,000 at 91.6234 = **₦274,870.20**
should be credited to the customer's account

point in the forward margin.

(i)	Spot buying rate	1.7875
	Add 2 months discount	0.0125
		1.8000

$30,000 at 1.800 = **£16,666.67**
(If US$1.8 will fetch only £1, then $30,000 will convert at $\frac{30,000}{1.8}$

How did a forward margin of 1.25 cent discount translate to 0.0125 in the arithmetic?

Answer: 100 cents make one dollar. The forward margin is a mere 1.25 cents. The spot rate value is $1 and 78.75 cents. Therefore, the correct position of 1.25 cents under the spot rate is 1.7875
.0125
That is, 1 cent under 8 cents and the other fractions properly linked.

If the customer is selling, it means the bank is buying. (Exchange rats are quoted from the bank's point of view)

Spot buying rate	1.7875
Add 3 months discount	0.0248
	1.8123

US$12,000 at 1.8123 = **£6,621.42**

Use the explanation in (i) above to rationalise why: $\frac{12,000}{1.8123}$ and

Why 2.48 cents margin surfaced as 0.0248 in the arithmetic.

(iii)	Spot selling rate	1.7765
	Add 1 month discount	0.0038
		1.7803

US$25,000 at 1.7803 = **£14,042.58**

Can you now explain why 0.38 cent (less than 1 cent) became 0.0038 in the arithmetic?

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

(b) Option Forward Exchange Contract

This time around, the date of performance is not known but only the period can be ascertained from the terms of contract.

For example, if customer is to deliver the foreign currency in 3 months, option over the third month.

The implication of this example is that the contract is fixed for two months with option only on the third month.

The bank has to be very careful when computing the rate over the option period especially in the area of whether to take the option at the beginning or at the end with due care for the forward margins provided.

As in our previous table and example, the calculations under pence rate system will be quite different from currency rate system because they are two opposite ends in the foreign exchange pendulum.

Again, a careful look at the following matrix and the accompanying notes from a determined point of view will be quite helpful:

Forward Exchange Rates Matrix

PENCE RATES			**CURRENCY RATES**		
Bank	**Margin**	**Action to Take**	**Bank**	**Margin**	**Action to Take**
Sells	Premium	Charge the margin to the beginning of the option period.	Sells	Premium	Charge the margin to the end of the option period.
Buys	Premium	Charge the margin to the end of the option period.	Buys	Premium	Charge the margin to the beginning of the option period.
Sells	Discount	Charge the margin to the end of the option period.	Sells	Discount	Charge the margin to the beginning of the option period.
Buys	Discount	Charge the margin to the beginning of the option period.	Buys	Discount	Charge the margin to the end of the option period.
NOTES: 1. The maxim is BUY LOW, SELL HIGH. That is, use the lower of the two rates quoted to buy and the higher to sell. 2. In all option cases, always compare the forward rate with the spot rate and adopt the lower of			**NOTE:** 1. ALWAYS remember the maxim, BUY HIGH, SELL LOW, that is, use the higher of the double-barelled quotation to buy and the lower to sell. 2. Further implication of the maxim in option is that after arriving at the forward rate, always compare with		

the two when buying and the higher when selling. 3. Add the premium margin to the spot rate so that more of the home currency is exchanged for less of the foreign currency because it is expensive. 4. Deduct the discount margin from the spot rate so that less of the home currency is exchanged for the foreign currency because the latter is cheap.	the spot rate. Use the higher of the two to buy and the lower to sell. 3. Deduct premium margin from the spot rate to obtain less of the foreign currency because premium means expensive. 4. Add the discount margin to the spot rate to obtain more of the foreign currency because is cheap.

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

The beginning of the option period is when the fixed period ends and in the absence of that, the beginning of the contract i.e. spot rate. The end of the option period is the maximum margin applicable from the contract.

Examples:

Pence Rates	**Currency Rates**
Spot US$ / N88.5250 – 89.9676 1 month 1.5492 – 1.5744 premium 2 months 3.0984 – 3.1488 premium 3 months 4.8500 – 4.9048 premium Quote the appropriate rates and calculate for the following: (i) Bank sells US$5,000 2 months option; (ii) Customer sells US$8,000 3 months; option over the third month. (iii) Customer buys US$10,000 2 months; option over the 2months. **Answer:** (1) Bank sells US$5,000 at: Spot Selling Rate 89.9676 Add 2 months premium 3.1488 Forward Rate = 93.1164 Now compare the post rate with forward rate and in keeping with the maxim of buy low, sell high	Spot Stg£ / US$ 1.7765 – 1.7875 1 month 0.38 – 9.44c discount 2 months 1.20 – 1.25c discount 3 months 2.42 – 2.48c discount Quote the appropriate rates and calculate for the following: (1) Customer buys US$10,000 1 month but option over the one month; (2) Customer sells US$15,000 2 months but option over the second month; (3) Bank sells US$20,000 3 months but option over the 3 months. **Answer:** (1) Customer buys, so the bank is selling. Spot buying rate 1.7765 Our matrix above says that if the bank is selling and the margin is quoted at a discount, charge to the beginning of the option period. The beginning of the option period is the spot

adopt the higher of the two rates i.e. 93.1164. This supersedes the need to change the margin to the beginning i.e. spot rate as in the matrix.

US$5,000 at 93.1164 = **₦465,582.00**

(2) Customer sells, so the bank will be buying. First, apply the maximum margin as in the matrix thus:

Bank buys US$8,000 at:

Spot Selling Rate		88.5250
Add 3 months premium		4.8500
Forward Rate	=	93.3750

Second, find out the position of the forward rate at the beginning of the option, that is, end of second month.

Spot Selling Rate		88.5250
Add 2 months premium		3.0984
Forward Rate	=	91.6234

In the spirit of buy low, sell high, the bank must adopt the lower of the two forward rates so as not to lose money.

Thus, US$8,000 at 91.6234 = **N732,987.20** credit to the customer. If the bank had used 93.3750 and credited the customer N747,000, a loss of N14,012.80 (N747,000 – 732,987.20) would have been incurred.

rate.

Therefore,
US$10,000 at 1.7765 = **£5,629.05**

To proof that the spot rate is the answer:

Spot selling rate	1,7765
Add 1 month discount	0.0038
Forward Rate	1.7803

The maxim is BUY HIGH, SELL LOW.

Between the spot rate of 1.7765 and the forward rate of 1.7803 which is lower? Definitely, the spot rate. Refer once again to Notes 1 and 2 under the matrix.

(2) Customer sells, so the bank is buying. Apply the margin to the end of the period, that is, the maximum margin.

Spot selling rate	1,7875
Add 2 months discount	0.0125
Forward Rate	1.8000

Do you still have any difficulty with the decimal point on the margin? If yes, please flick back to the exercises in fixed forward exchange contract.

$15,000 at 1.8000 = **£8,333.33**

On why we applied the 2 months discount, please refer to the matrix again.

If you compare the spot rate of 1.7875 with our forward rate of 1.8000, it tallies with the maxim of buy high, sell low.

(3) Spot selling rate 1.7765

The matrix says charge the forward margin to the beginning of the option period i.e. over the 3 months.

(3) Customer buys, so the bank will sell. You are supposed to charge the spot rate, that is, the option to the beginning. However, to enable you to compare the spot rate with the forward rate, calculate the latter. Bank sells US$10,000 at: Spot Buying Rate 89.9676 Add 2 months premium 3.1488 Forward Rate = 93.1164 The appropriate rate to use is 93.1164. Can you explain why at this point? It is because the bank is selling high. (remember the maxim: by low, sell high). US$10,000 at 93.1164 = **₦931,164** Debit the customer. **Note:** To have used the spot rate, the customer would have been debited N899,676; a loss of N31,488 to the bank.	The correct rate is the spot rate, that is, the beginning of the option period. US$20,000 at 1.7765 = **£11,258.09** Proof on the correctness of the use of the spot rate: Spot selling rate 1.7765 Add 3 months discount 0.0242 Forward Rate 1.8007 Between the spot rate of 1.7765 and the forward rate of 1.8007, the spot rate is lower and it is in consonance with the operating maxim. Assuming you had used the forward rate of 1.8007 let us now see the loss you would have caused your bank. US$20,000 at 1.7765 £11,258.09 US$20,000 at 1.8007 £11,106.79 LOSS TO THE BANK **£151.30** You should have debited the customer £11,106.79 instead of £11,258.09. If huge sums of money are involved, you probably will throw the bank into distress in using the wrong rate.

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

3.5 Close-Out

It transpires in the course of business that the customer and possibly the bank (rarely anyway), cannot perform its part of the contract by delivering the foreign currency as duly agreed on. in the event, there is the need to cancel the contract which you will recall from the definition of forward exchange contract is "immediately firm and binding contract". The cancellation is done by a process called CLOSE-OUT or CUT-OUT. The procedure to adopt is as follows:

(i) If the contract was for the bank to sell foreign currency, calculate how much in home currency the customer was to pay using the appropriate exchange rage.

(ii) Close-out the deal by buying same currency and same amount at the spot buying rate on the close-out date. Notionally, the result is what is due to the customer from the close-out.

(iii) Find the difference between what the customer should pay as in (i) above and what is due to the customer as in (ii) above too and pass it to the customer's account.

NOTE:

(i) The reverse applies if the bank initially contracted to buy foreign currency.

(ii) The close-out process is also applicable should part of the contract become impossible to complete.

(iii) The process can also be applied when the customer wants an extension to the contract already signed.

Examples:

Using the same rates as in the previous examples for the pence rates and currency rate systems, attempt the questions that follow:

Pence Rates	**Currency Rates**
Spot US$ / N88.5250 – 89.9676 1 month 1.5492 – 1.5744 premium 2 months 3.0984 – 3.1488 premium 3 months 4.8500 – 4.9048 premium Customer contracts to sell US$10,000 at 3 months option over the third month. He has now called to request cancellation today when the rates are: Spot $/₦ 92.5150 – 94.0000. Close-out the contract and state the necessary entries. **Answer:** **Step I:** Execute the initial transaction. Bank buys US$10,000 at: Spot Selling Rate 88.5250 Add 2 months premium 4.8500 Forward Rate = 93.3750 Between the spot rate and forward rate, the spot rate is lower and it should be adopted to keep in line with the maxim in pence rate system.	Spot Stg£ / US$ 1.7765 – 1.7875 1 month 0.38 – 9.44c discount 2 months 1.20 – 1.25c discount 3 months 2.42 – 2.48c discount Bank contracts to sell US$25,000 to a customer at 2 months option over the two months. Customer wants immediate cancellation when the spot rates are: Stg£ US$1.7802 – 1.7935 Close out the contract and state the necessary entries. **Answer:** **Step I:** Let the customer buy as originally agreed upon albeit notionally. Spot selling rate 1.7765 Add 2 months discount 0.0120 Forward Rate 1.7885 Buy high, sell low – the maxim. Therefore, adopt the spot rate in order to sell low.

Therefore, US$10,000 x 88.5250 = **₦885,250** (credit the customer). **Step II:** Close-out the deal by doing the reverse of the original contract. Bank sells US$10,000 at spot selling rate on the date of close-out i.e. 94.000 = **₦940,000**. **Step III:** Find the difference between both actions and state the necessary entries. Debit to customer ₦940,000 Credit to customer ₦885,250 Loss to customer **₦54,750** Bank charges of exchange and commission have not been considered in this transaction.	US$25,000 at 1.7765 = **£14,072.61** (debit to customer) **Step II:** Close-out the frustrated contract by doing the reverse of the original contract at close-out date. Bank buys US$25,000 at spot buying rate i.e. 1.7935 = **£13,939.22** Notional credit to customer. **Step III:** Find the difference between the two and state the necessary entries. Debit to customer £14,072.61 Credit to customer £13,939.22 Loss to the customer **£133.39**

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

3.6 Extension

It is not in all cases that absolute close-out is necessary. The customer can make his complaint and ask for an extension of the delivery date.

In this case, adopt the following procedure:

(i) Determine the forward exchange rate and deal as originally agreed upon.

(ii) Using the spot rate applicable on the close-out date, close out the transaction.

(iii) Raise necessary entries for the difference.

(iv) Extend the contract for the period agreed upon by taking the close-out rate and applying the appropriate extension margin to arrive at the extension rate of exchange.

Examples:

Still using the rates and margins we have used so far, we may now see how forward contract extension works in the two systems of pence rate and currency rate.

Pence Rates

Spot US$ / N88.5250 – 89.9676

1 month	1.5492 – 1.5744 premium
2 months	3.0984 – 3.1488 premium
3 months	4.8500 – 4.9048 premium

Customer contracts to sell US$10,000 at 3 months option over the third month.

Today, he called to ask for an extension of the delivery date of the dollars by two months when the rates and margins stood as:

Spot $/₦	92.5150 – 94.0000.
1 month	6.2400 – 6.9513 premium
2 months	7.5910 – 8.1000 premium

Extend the contract accordingly.

Answer:

Step I: Deal as originally agreed upon.

Bank buys US$10,000 at:

Spot Selling Rate		88.5250
Add 2 months premium		4.8500
Forward Rate	=	93.3750

Adopt the spot rate (Recall the operating maxim).

Therefore, US$10,000 x 88.5250 = **₦885,250** (credit the customer).

Step II: Close-out the deal by doing the reverse of the original contract.

Bank sells US$10,000 at spot selling rate on the date of close-out i.e. 94.000 = **₦940,000**.

Step III: Find the difference between both actions and state the necessary entries.

Currency Rates

Spot Stg£ / US$ 1.7765 – 1.7875

1 month	0.38 – 9.44c discount
2 months	1.20 – 1.25c discount
3 months	2.42 – 2.48c discount

Bank contracts to sell US$25,000 to a customer at 2 months option over the two months. Customer now wants an extension by one month today when bank's rates are as follows:

Stg£	US$1.7802 – 1.7935
1 month	6.2400 – 6.9513 premium
2 months	7.5910 – 8.1000 premium

Extend the contract accordingly.

Answer:

Step I: Deal as originally agreed upon.

Spot selling rate	1.7765
Add 2 months discount	0.0120
Forward Rate	1.7885

Buy high, sell low – the maxim. Therefore, adopt the spot rate in order to sell low.

US$25,000 at 1.7765 = **£14,072.61** (debit to customer)

Step II: Close-out the transaction at the ruling spot rate on close-out date.

Bank buys US$25,000 at spot buying rate i.e. 1.7935 = **£13,939.22** Notional credit to customer.

Step III: Find the difference between the two and state the necessary entries.

Debit to customer	£14,072.61
Credit to customer	£13,939.22
Loss to the customer	**£133.39**

Debit to customer ₦940,000 Credit to customer ₦885,250 Loss to customer **₦54,750** **Step IV:** Extend the contract by applying the appropriate extension margin to the close-out rate: Close-out rate 94.0000 Credit to customer 7.5910 premium Extension rate **101.5910** **Note:** The bank is still buying hence the buying margin for the extension period was selected. At any rate, in the spirit of buy low, sell high, we use for the extension, the close-out rate which is lower than the extension rate. Hence, US$10,000 x 94.000 = **₦940,000** (credit to customer) Again, note that the difference between close-out and extension in Step IV.	**Step IV:** Extend the contract by applying the appropriate extension margin to the close-out rate. Close-out rate 1.7935 Add 1 month discount 0.0254 Extension rate 1.8189 We adopt the spot rate for the extension. Can you explain why? (The lower of both the close-out and extension rates under the maxim of buy high, sell low). The extension margin is the selling margin because the bank is still selling. Hence US$25,000 at 1.7935 = **£13,939.22** Debit to customer. The difference between close-out and extension is simply the Step IV.

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

3.7 Benefits of Forward Exchange Contracts

To both the seller and buyer, forward exchange contracts provide immense insurance and eliminate risks associated with exchange rate fluctuation especially in an unstable economy.

Furthermore, since the facility enables both parties to know outright, the future amounts equivalent in their respective home currencies to either pay or receive, they can indulge in serious marketing for their products, fix their selling prices and prune their profits accordingly.

In a loose sense, the facility also enables the traders to know whether a business opportunity that looks rosy now might be worth it in a few months ahead in view of the unstable exchange rates.

Frankly, in a serious foreign exchange relationship spanning over a couple of months, not to cover one's position by way of forward exchange contract amounts to gambling or high risk speculation (Esezobor, 2009).

3.8 Alternative Way of Quoting Foreign Exchange Rates

In some publications, you may see exchange spot rates and the margins quoted in the following order:

£ / US$ 1.7765 / 85 3/4 5/4 4/3 6/7 for 4 consecutive months.

All the necessary information for spot rates and the accompanying margins are included in these quotes. However, some further work needs to be done to determine the following:

- The spot selling and buying rates in the currency rate quotation as above.
- Whether the margins are premium or discount.
- The forward rates for the four months after applying the margins.

To put these rates in their traditional format, a table would have to be charted as follows:

£ / US$	$1.7765	1.7785	
1 month	0.0003	0.0004	premium
	1.7762	1.7781	
£ / US$	$1.7765	1.7785	
2 months	0.0005	0.0004	discount
	1.7770	1.7789	
£ / US$	$1.7765	1.7785	
3 months	0.0004	0.0003	discount
	1.7769	1.7788	
£ / US$	$1.7765	1.7785	
4 months	0.0006	0.0007	premium
	1.7759	1.7778	

How do you determine that the margin is premium or discount?

The rule is (Esezorbor, 2009): if the margins are left bare without specification as to whether they are premium, discount or par and the buying margin is bigger than the selling margin, the margins given are premium. In the maxim of buy high, sell low for currency rates, the buying rate above is 1.7785 while the selling rate is 1.7765.

In the first and fourth months, the margins show that the buying margins are bigger than the selling margins. The margins are therefore premium which must be subtracted from the spot rate to produce less currency because the US$ is expensive (premium).

Par margins mean spot rate; neither premium nor discount.

Note:
The picture painted above is for currency rates. With pence rate, as you must have deduced from our progress so far, all workings including the operating maxim, are all in the opposite direction to what we have just done.

3.9 Cost of Forward Exchange Cover

Some fortunate businessmen who have the privilege of credit terms from their overseas suppliers usually pay interest for the terms of their credit as part of the conditions. Such businessmen, in order to save cost, also want to know whether it is cheaper to borrow at home at the prevailing lending rate and pay for the foreign currency at spot rate or to accept the foreign credit terms and pay the interest in foreign currency as well as bearing the cost of forward exchange cover.

The standard formula for computing the cost of forward exchange cover expressed in percentage is as follows:

$$\frac{\text{Forward margin}}{\text{Forward rate}} \times \frac{12}{\text{Forward tenor}} \times \frac{100}{1}$$

The procedure for calculation consists of two stages or steps. The first is to determine the forward exchange rate and the second is to put all the relevant figures in the formula and derive the percentage.

Example:

Bank sells US$50,000 to a local merchant at N125.5000 spot on fixed 3 months margin of N6.7500 premium. Calculate the percentage cost of covering forward.

Answer:

Step I: Find the outright forward exchange rate thus:

Spot selling rate	125.5000
Add 3 months premium	6.7500
	132.2500

Step II: Now determine the percentage cost:

$$\frac{\text{Forward margin}}{\text{Forward rate}} \times \frac{12}{\text{Forward tenor}} \times \frac{100}{1}$$

$$= \frac{6.75}{132.25} \times \frac{12}{3} \times \frac{100}{1}$$

= **20.4%**

Generally, the percentage cost of covering forward presents to the merchant, the option of either to borrow at the prevailing interest rate and buy foreign exchange at the prevailing Dutch Auction System (DAS) while covering the transaction forward or obtaining the goods on credit from the generous overseas supplier on the firm condition of paying the cost of credit the overseas supplier will quote.

In the former, the Nigerian merchant, having converted the credit to foreign exchange, remitted it through the banking system, he is placed in a position to ask for cash discount and possible, trade discount as well from the overseas supplier.

Let us assume that the cost of fund in procuring US$50,000 worth of orders from a U.S. supplier is 18%.

Will it be better for the local merchant to borrow naira at 25% and buy dollars at the ruling spot rate of 125.5000 in Lagos or accept the foreign credit?

Answer:

Cost of funds in the U.S.	18.0%
Cost of forward exchange cover	20.4%
	38.4%
Cost of funds in Lagos	25.0%
	13.4%

The U.S. credit supply will be more expensive by 13.4%. In the circumstance, it will be cheaper for the local merchant to borrow naira in Lagos and buy U.S. dollars through DAS.

3.10 Factors Affecting Exchange Rates

The factors affecting exchange rates (Esezobor, 2009) are:

(i) Balance of Payments
(ii) Interest Rate
(iii) Confidence in the Economy
(iv) Inflation Rate
(v) Central Bank Intervention
(vi) Hot Money
(vii) Speculation

The above points are discussed below:

(i) Balance of Payments

When a country realises a surplus in the balance of payments, the implication is that it has received more foreign currencies on both visible and invisible trade than it paid out. Such positive net flow signifies that the economy is strong and of course, that the currency has strength. The spot rate will have more value while in the forward exchange market; the currency will trade at a premium. In fact, businessmen will prefer to buy it forward.

In the event of a deficit, the reverse is the case; because of the diminishing exchange rate, businessmen will hold little of it at spot rate and will sell it forward in the forward exchange market. Countries like Japan and Germany that regularly have surplus in their balance of payments have very firm exchange rates that are quoted at premium in virtually all cases of forward exchange contract.

a. Interest Rate

The level of interest rate in any country also reflects on the currency's strength in the forward exchange market. A rise in interest rate will invariably attract foreign investments and speculation, other things being equal. On the negative side, such a rise is a signal that all is not well with the economy. The first casualty in this event is the exchange rate which falls on the spot market and slides gradually to a discount in the forward exchange market. Businessmen will hold little of it and sell it forward for future transactions.

Conversely, when the interest rate is low or falls, it implies a stronger exchange rate and the currency will trade at a premium in the forward exchange market.

b. Confidence in the Economy

The discipline shown in the annual budget and its implementation, money supply, oil prices including the rate and degree of public accountability, public utterances by key government officials on the economy, civil disturbances, frequent labour strike actions, war, delay in servicing foreign debts and the awkward case of arbitrary suspension of payment of international debts – all add up to international confidence on the nation's economy.

Taking all the above to the current setting in Nigeria, it will be quite clear why the market exchange rate of the naira vis-à-vis other currencies of repute seems to be on the slide on the spot market and discount in the forward exchange market.

c. Inflation Rate

A high inflation rate means poor management of resources. In exchange rates, it translates to poor rates for the home currency at spot and discount margin in the forward exchange market. Businessmen will hold little of it forward at the least opportunity.

Compare with a serious economy like Switzerland where the inflation rate is barely 5 percent or Russia of old with 1.25 percent inflation rate for many years;

spot rates get increasingly stronger while forward exchange business is on premium and buying basis.

d. Central Bank Intervention

No country allows the value of its currency to rise astronomically or fall hopelessly without some form of support from its Central Bank.

The Central Bank does this through direct intervention in the foreign exchange market and well articulated foreign exchange regulations. The more effective of the two in an emergency is the former especially for the international currencies.

The Central Bank does this by buying up the home currency in the international market when the exchange rate is sliding precariously. The intervention makes the home currency scarce thereby forcing up the exchange rate.

Should the problem be a case of too strong an exchange rate, the Central Bank sells its currency which buyers pay for in foreign currencies thereby helping to increase the stock of such currencies. Since the home currency is now plentiful in the exchange market, the rate falls thereby helping to encourage foreign buyers of the home products and services.

e. Hot Money

Hot money is a vast sum of foreign currency available on short-term basis for investment or speculation in any profitable international commercial centre of the world.

The net inflow of such money forces down the exchange rate of the country and reduces the quality of its premium in the forward exchange market. Although good for short-term investment purpose, hot money can be dangerous especially when it moves out the way it came. What usually attract it are high interest rate and the new habit of laundering of huge drug money.

Many countries have erected barriers against such money by law. Instances are, Germany, by refusing to pay competitive interest to foreign deposit holders and the United Kingdom that does not accept the laundering of money of any sort.

f. Speculation

This point is very important because it involves the following activities:

- Leads and Lags
- Arbitrage
- Swap
- Hedging

Speculation, in a nutshell, is taking advantage of market distortions to earn phenomenal profits and in an ill-timed instance, phenomenal loss. The unique thing about speculation is that the speculator does not produce any goods or services but is conversant with the print and electronic media and smart with his calculations. In the virtually all investments, he starts with a currency and after exploiting the market(s), he ends up with the same currency either with a starch of profits or bruised fingers to nurse for mis-reading the distortions.

It will now be necessary to consider the four activities and use examples to clarify the speculator's mind.

i. Leads and Lags

These situations arise when there is a fear of imminent devaluation or revaluation of a country's currency. If the fear is devaluation, it means that the country's exports will be cheaper while foreign goods will be more expensive. Businessmen will hurry (LEAD) to pay their foreign debts before the devaluation otherwise; they would pay more after the devaluation. Foreign creditors on the other hand, will delay (LAG) in receiving payment hoping to receive more money after devaluation.

Revaluation hardly occurs these days but when it happens as in the case of the naira in January, 1994, the converse takes place.

ii. Arbitrage

Pronounced as arbitraj (as in entouraj for entourage), it is a high risk but sweet business of buying a currency or any other asset in a financial centre where it is cheap and selling it at another centre where it is expensive with a view to profit.

Arbitrage works not only on foreign currencies but any financial asset that is mis-priced between two financial centres. For now, we shall look at the two key areas of arbitrage, namely:

1. Currency arbitrage
2. Covered interest arbitrage

1. <u>Currency Arbitrage</u> – The arbitrageur often is knowledgeable in the foreign exchange restrictions in the countries he would like to visit. For example, the United Kingdom does not maintain exchange control restrictions. It is a policy that has paid off for it because visitors pour into Heathrow and Gatwick Airports with loads of foreign currencies without fear of molestation from the Immigration or Security agents.

   This is the way currency arbitrage generally works:

- The Lagos arbitrageur is always at home with the movement of exchange rates in the various dealing points in Lagos.

- Through the regular reports of the Cable Network News (CNN), he takes note of the exchange rates in London. He can confirm this by tuning the British Broadcasting Corporation (BBC) or simply by phoning a friend of like mind in London to confirm. Frankly, the CNN is always right.

- With a calculator, he computes what profit he could make from procuring say, the pounds sterling in Lagos and jetting to London to exchange it for the U.S. dollar whose rate seems to beckon on arbitrage. Time is of the essence because the rates could move against him in a twinkle of an eye.

- He now calculates what profit awaits him in Lagos if he exchanges to naira, the U.S. dollars he had exchanged in London.

Example:

Given the following exchange rates, calculate for Mallam Aboki, the profits he can earn in an arbitrage of N5,000,000 on the U.S. dollar if his total overhead costs amount to N100,000.

	Stg. £	**U.S. Dollar**
Lagos Spot rates	178.1200 – 180.0000	128.5000 – 130.2000
London Spot rates	–	1.4554 – 1.5150

Ignore bank charges.

Answer:

Step I: Mallam Aboki buys pounds sterling from Lagos.
Bank sells Stg. £ at spot selling rate i.e. 180.0000
N5,000,000 ÷ 180 = **£27,777.78**

Step II: He flies to London on the first available flight to exchange the £27,777.78 for U.S. dollar at the euro dollar market on the counters of Heathrow or Gatwick Airports.

Bank sells U.S. dollars at spot selling rate i.e. 1.4554.
£27,777.78 multiply by 1.4554 = **US$40,427.78**

Step III: Mallam Aboki will not have the time to see London City because he is on duty and must jet back to Lagos on the first available flight.

In Lagos, he sells the US$40,427.78

Bank buys it off him like a flash at spot buying rate i.e. 128.5000.

= $40,427.78 at 128.5000 = N5,194,969.73

Step IV: He calculates his profit from his arbitrage of 24 hours or less.

		₦
Income		5,194,969.73
Investment	5,000,000.00	
Overheads	100,000.00	5,100,000.00
		94,969.73

He pockets N94,969.73 for being smart and daring.

The above example although simplistic, relates to currency speculation. Arbitration also works on stocks and shares and many other assets. In reality, arbitrage is a specialist function of institutions who have access to cheap funds and expert knowledge of systems technology to gain access to happenings in different markets at the same time.

2. Covered Interest Arbitrage – In open economies, investors are at liberty to move funds between financial centres to take advantage of differences in interest rates. A currency with a high interest rate would be quoted at a discount in the forward exchange market. Why is this so? It is because a high interest rate on the face of it, implies a weak strength which will be interpreted as discount in the forward exchange market. (Weak banks, for emphasis, always offer high interest rate to attract deposits).

   Conversely, the currency with low interest rate is seen as strong and as such, will trade at a premium in the forward exchange market. The exercise of taking advantage of high interest rate in another financial centre is called covered interest arbitrage because the details of both financial centres are known for the picking.

   The first course of action in the exercise is to determine if an arbitrage would succeed in moving funds to the financial centre offering a higher interest rate. This is done by comparing the interest rate differential with the discount margin offered for the duration of the investment. If the discount margin is less than the interest rate differential, be rest assured the covered interest arbitrage will succeed. In order to avoid the uncertainty of exchange rate movement, the end proceeds of the investment is sold forward; thereby making clear how much precisely would be received.

Example:

Using the following hypothetical example, the steps to take to determine the profitability or otherwise of this exercise will come out clearly:

Spot US$ / DM	0.3336		
		US$	**DM**
Interest Rate:		5%	6.5%
1 year forward rate:		0.3300	

Required:

(i) Determine if there exists an opportunity for covered interest arbitrage.

(ii) If the arbitrageur has funds to invest to the tune of DM200,000, calculate the profit or loss over a year.

(iii) Would he have earned more by investing in a security at 5% in US$ over the same period?

(iv) What would you say are the risks in covered Interest arbitrage and how would such risks be mitigated?

Answer:

(i) Opportunity for covered interest arbitrage:

Steps: Note the difference in interest rate between the two currencies i.e. 1.5%

Find the discount on the weak currency, DM over one year thus:

Standard formula: $$\frac{\text{Forward rate minus spot rate}}{\text{Spot rate}} \times \frac{12}{\text{Tenor}} \times \frac{100}{1}$$

$$= \frac{(0.3300 - 0.3336)}{0.3336} \times \frac{12}{12} \times \frac{100}{1}$$

$$= \underline{\mathbf{-\ 1.08\%}}$$

(tenor means the number of months for the placement)

In absolute terms, the 1.08% discount is less than the interest rate differential of 1.5%. Therefore, there is an opportunity for covered interest arbitrage.

(ii) Profit/(Loss) over a year on DM200,000 Placement:

Beginning of year

DM 200,000 at spot rate i.e. 0.3336 = US$66,720

(we multiply because DM was quoted as pence rate)

<u>End of year</u>	
Principal invested	DM 200,000
Interest earned @ 6.5%	13,000
	DM213,000

DM 213,000 @ forward rate i.e. 0.3300	=	US$70,290

<u>Therefore, Profit/(Loss) Earned</u>:	
Proceeds at end of year	US$70,290
Funds placed at the beginning	66,720
	US$ 3,570

(iii) <u>Proceeds of investment in US$ Security:</u>

At 5% US$66,720 for 1 year would fetch		US$3,336
No, he would have earned less by:		
US$3,570 – US$3,336	=	**US$234**

(iv) <u>Risks in Covered Interest Arbitrage:</u>

- The theory of covered interest arbitrage is limited to only the “net accessible interest rates”.

- The theory assumes that only interest rates affect forward exchange margins. In developed economies of Europe and America, this could be so, to some extent, but not in other currencies where several other factors both economic and political, affect forward exchange rates and margins.

<u>To Mitigate the Risks</u>

- Begin and end the investment with the same currency rather than a multiplicity of currencies that could be battered by exchange rate fluctuations.

- For the results to be reliable, compare interest rates applicable only to the same period.

iii. Swap

Swap is a transaction where a currency is sold and repurchased simultaneously but importantly, the delivery dates for sale and purchase are different. The swap rate is the cost of entering into the swap arrangement.

A businessman might like to do business in U.S. dollars and he would like to know when he returns the dollars at the end of it all, what the cost will be to him.

In the scenario just painted, the bank will have to sell to him the dollars and cover him forward during the tenor of his business and at the end, buy the dollar (exactly the same amount) from him. The swap rate will be the cost to the businessman.

Without batting an eye, this looks more like knowing the percentage cost of covering forward because the applicable formula is the same as follows:

$$\frac{\text{Forward margin}}{\text{Forward rate}} \times \frac{12}{\text{Forward tenor}} \times \frac{100}{1}$$

You will recall from the notes on percentage cost of covering forward that the first thing is to calculate the outright forward rate for the transaction before obtaining the cost.

Example:
Given the following rates:

Spot US$ / ~~N~~	125.6500	129.8400
6 months	N12.0400	N16.5220 premium

(i) Determine the outright forward selling rate
(ii) Find the swap selling rate
(iii) What risks would a businessman encounter in this swap transaction?

Answer:

(i) Bank sells at:

Bank sells at:	Spot selling rate	129.8400
	Add 6 months premium	16.5220
		146.3620

(ii) Swap selling rate:

$$\frac{\text{Forward margin}}{\text{Forward rate}} \times \frac{12}{\text{Forward tenor}} \times \frac{100}{1}$$

$$\frac{16.5220}{146.3620} \times \frac{12}{6} \times \frac{100}{1}$$

$$= 22.58\%$$

(iii) The businessman will face the risk of foreign exchange fluctuation because the contract is long term and he is dealing in a weal currency like the naira.

Note: In forward exchange market, any contract in excess of one month is taken as long-term.

iv. Hedging

This is one other method by which businessmen endeavour to avoid risk of losses that could arise from foreign exchange fluctuation in long term contracts by matching the expected foreign assets against foreign liabilities.

As we have just noted, foreign exchange contracts of over a month are considered long-term. In such contracts, businessmen are faced with a multiplicity of risks, namely:

(i) Foreign exchange fluctuations
(ii) Risk in dealing in a weak currency like the naira
(iii) Risk exposure in dealing in several currencies at the same time, if applicable to the problem on hand
(iv) Risk of long term contracts.

Example:
ABC Alternative Goods Ltd. is importing two container loads of 500 second-hand refrigerators at US$20 per refrigerator. They could pay cash now in order to enjoy trade discount of 10 percent. In this event, the funds would be sourced at the prevailing lending rate of 25 percent in Lagos.

Alternatively, they could pay in two months and cover the exchange risk forward in the forward exchange market.

Using the following exchange rates quotation and assuming a clearing cost of N300,000 for both containers, advise the company which of the options is cheaper.

US$ / N	175.6450	180.9610
1 month	10.4518	12.0100 premium
2 months	15.5000	16.9050 premium
3 months	17.0000	17.5080 premium

Answer:

Option I: Borrowing funds at 25% to pay for goods and enjoy 10% trade discount.

2 containers of 500 second-hand refrigerators each at US$20 per refrigerator	=	2 x 500 x $20	=	US$20,000
Less 10% trade discount				2,000
				US$18,000

Bank sells $18,000 at Spot rate i.e. 180.9610	=	N3,257,298.00
Add 25% cost of fund over 2 months	=	135,720.75
Clearing costs	=	300,000.00
Total cost	=	N3,693,018.75

Option II: Cover the transaction forward in the forward exchange market.

Bank sells $20,000 at:

Spot selling rate	=	180.9610
Add 2 months premium	=	16.9050
Forward Rate	=	197.8660

Buy low, sell high – adopt the forward rate.

Therefore, $20,000 at 197.8660	=	N3,957,320.00
Clearing costs	=	300,000.00
Total cost	=	N4,257,320.00

It will be more profitable for the company to adopt option I, that is, borrow funds at 25%, pay cash and obtain 10% trade discount.

3.11 Determination of Future Exchange Rates

All along, we had assumed that the exchange rates and margins would be given in any question to facilitate necessary calculations in forward exchange transactions. This might not always be so in more fairly complex situations.

Two of the methods of determining future exchange rates are purchasing power parity and interest rate parity.

(a) Purchasing Power Parity (PPP)

The concept of purchasing power parity is one of the outstanding methods for determining between countries, the following important variables:

- Inflation Rate Differential
- Exchange Rate
- Exchange Margin.

The concept is the brainchild of David Ricardo, a popular 19th century philosopher. His pioneering work was built on by a Swedish economist, Gustav Cassel in the early part of the 20th century.

PPP states that the exchange rate between two currencies is in equilibrium if the purchasing power of one currency is the same as the purchasing power in the other country. Thus, if U.S.$1 exchanges for N130, this theory says U.S.$1 should buy in the US what precisely N130 can buy in Nigeria. This state of equilibrium is called **the law of one price** and the year, the base year.

With time, the actions of international merchants, arbitrageurs and other speculators in quest of maximum profits and the underlying influences of inflation and interest rate, result in exchange rate differentials which have to be recognized especially in the management of floating exchange rate system. Such exchange rate differentials mirror differences in the purchasing power of the relative currencies using the equilibrium base year as the reference point.

Formulae for Calculating the Important Variables

In determining the variables, the following inputs are necessary:

(i) ***Equilibrium Base Rate*** i.e. the exchange rate at the beginning of the comparison of the currencies.

Symbols: ER^0.
The power ^{0} means at base.

(ii) ***Rate of Inflation of the home currency***
Symbols: $Rht = \frac{PPh^t - PPh^0}{PPh^0}$

Where Rh^t = Rate of inflation of the home currency at period t.
PPh^t = Purchasing power of the home currency at period t.
PPh^0 = Purchasing power of the home currency at base.

(iii) ***Rate of Inflation of the foreign currency***
Symbol: $Rf^t = \frac{PPf^t - PPf^0}{PPf^0}$

Where Rf^t = Rate of inflation of the foreign currency at period t.
PPf^t = Purchasing power of the foreign currency at period t.
PPf^0 = Purchasing power of the foreign currency at base.

With this background, we can now state the appropriate formulae for the three variables.

(i) Inflation Rate Differential between both Currencies

Symbols: RD = $\frac{Rh^t}{Rf^t}$

Where RD = Inflation rate differential between both currencies

Rh^t = Rate of inflation of home currency

Rf^t = Rate of inflation of foreign currency.

(ii) Forward Rate

Symbols: $FR^t = ER^0 (RD)$

Where RD = Inflation rate differential between both currencies

FR^t = Forward rate at t.

ER^0 = Equilibrium rate of base.

RD = Inflation rate differential between both currencies.

(iii) Forward Margin

Symbols: $FM^t = ER^0 \frac{(Rh^t - Rf^t)}{Rf^t}$

Where FM^t = Forward margin at period t.

ER^0 = Equilibrium rate at base.

Rh^t = Rate of inflation of home currency at period t.

Rf^t = Rate of inflation of foreign currency at period t.

If the result of the computation is positive, the forward margin is a premium. In pence or floating exchange rate system, we add the premium to the spot rate to derive the forward exchange rate. In currency or fixed exchange rate regime, we subtract the premium from the spot rate to arrive at the forward rate.

If the answer is negative, the forward margin is a discount. Subtract from the spot rate if quotations are pence rate or add, if currency rate.

Example:

From the following hypothetical details of the price of 1 ton of palm kernel:

	Britain	Nigeria
1st July, 2002	£418	₦28,500
1st July, 2003	£450	₦32,600
Exchange Rate, 1st July, 2002 is:	£1	₦112.50 – ₦115.00

(a) Calculate the rate of inflation in both countries on 1st July, 2003.

(b) What is the inflation rate differential between both countries?

(c) Suppose there is a drop in the naira inflation rate by 3%, what will be the inflation rate differential?

(d) What will be the selling forward rate on 1st July, 2003?

(e) Determine the selling forward exchange margin on 1st July, 2003.

(f) Suppose the inflation rate in Britain is 5%, what will be the forward buying margin same date?

Answer:

(a) **Rate of Inflation in Nigeria**

$$Rht = \frac{PPh^t - PPh^0}{PPh^0}$$

$$= \frac{32,600 - 28,500}{28,500}$$

$$= \frac{4,100}{28,500}$$

= **0.143 or 14%** in absolute terms (i.e. 0.143 x 100)

Rate of Inflation in Britain

$$Rht = \frac{PPh^t - PPh^0}{PPh^0}$$

$$= \frac{450 - 418}{418}$$

$$= \frac{32}{418}$$

= **0.076 or 8%** in absolute numbers

(b) **Inflation Differential between both countries**

$$RD = \frac{Rh^t}{Rf^t}$$

$$= \frac{0.143}{0.076}$$

= **1.88 or 188%**

(c) **In the event of a drop in inflation rate by 3% (i.e. 0.03)**

$$RD = \frac{Rh^t}{Rf^t}$$

$$= \frac{0.143\ 0.03}{0.076}$$

$$= \frac{0;113}{0.076}$$

= **1.487 or 149%**

(d) **Forward Selling Rate**

$FR^t = ER^0 (RD)$

$$ER^0 = \frac{(Rht)}{Rf^t}$$

Spot selling rate is 112.50 (buy low, sell high for pence rate)

$$112.50 \quad \frac{(0.143)}{0.076}$$

$$= \mathbf{211.68}$$

(e) **Forward Selling Exchange Margin, 1st July, 2003**

$$FM^t = ER^0 \frac{(Rh^t - Rf^t)}{Rf^t}$$

$$= \frac{112.50\ (0.143 - 0.076)}{0.076}$$

$$= 112.50 \times 0.88$$

$$= \mathbf{99.18} \text{ discount}$$

To confirm that this figure is correct, do the following:

Forward selling rate	211.68
Less discount for period	99.18
Spot rate	112.50

(f) **Forward buying rate if inflation in Britain is 5% i.e. 0.05**

$$FR^t = ER^0 (RD)$$

$$= ER^0 \frac{(Rh^t)}{Rf^t}$$

$$= \frac{115\ (0.143)}{0.05}$$

$$= 115 \times 2.86$$

$$= \mathbf{₦328.90}$$

To confirm correctness, find the buying margin and subtract from the forward rate to arrive at the spot buying rate.

Forward buying rate	328.9
Less discount for period	213.9 (determine this for practice
	115.0

(b) The Theory of Interest Rate Parity (IRP)

This is the second method of determining future exchange rates and the accompanying forward margins.

Interest rates generally indicate the strength of any economy. Low interest rate clearly signals a strong economy. Such an economy is not a choice for hot money because of the low return. High interest rates are common in weak economies assiduously looking for investment funds hence interest rates are made attractive for investors.

However, for our immediate purpose, we are interested in how given interest rates can be used along with spot rates to determine first, the forward margin from where, the forward rate can be derived.

The following operating formula is pertinent:

$$FMt = SR^0 \frac{(Ehc - Efc)\ f}{1 + Efc \quad n}$$

Where FMt	=	forward margin at period t
SR^0	=	spot exchange rate for home currency
Ehc	=	interest rate for home currency
Efc	=	interest rate for foreign currency
1	=	a whole number
f	=	tenor of interest rate
n	=	days, months or quarter in a year as given.

The second use of interest rates between countries is to determine the future rates for which the following formula is used:

$$FRt = SR^0 \frac{(1 + Ehc)\ t}{1 + Efc}$$

Where FRt	=	future rate at time t
SR^0	=	spot exchange rate at base
1	=	a whole number
Ehc	=	interest rate of home currency
Efc	=	interest rate of foreign currency
T	=	future time

Example:
Bakalori Bakasi Plc is one of your major corporate customers and has received a documentary letter of credit advice dated July 1, 1996, for £1,600,000 on FOB terms for deliveries of cocoa beans under the following terms and conditions:

1st delivery	1 August, 1996	40% of LC value
2nd delivery	1 September, 1996	40% of LC value
3rd delivery	October, 1996	20% of LC value

Your customer wishes to cover forward the receipts so as to minimize the risks of exchange rate fluctuations.

The following prime rates of interest were applicable at the stated centres as at July, 1996 and are expected to remain constant for the period of the contract.

Centre	**Prime rate of interest**
Lagos	35% p.a.
New York	9% p.a.
London	13% p.a.
Frankfurt	6% p.a.

Assuming 360 days a year or 30 days a month,

(a) Calculate the applicable rates for the period covered by the contract using the following spot exchange rates as at July, 1996:

US$	**£**	**DM**
N80.5000 – 81.000	N135.6000 – 137.000	N51.000 – 51.5000

(b) Calculate the total naira receivable if the contract is executed in full. Bank charges and commission are limited to 1 percent of the LC value taken per transaction while stamp duty is 0.25 percent of 1%.

(c) Calculate the applicable rate for revaluing the bank's 5 year contingent liability on guarantees and indemnities denominated in Dutch Marks issued for Bakalori Bakasi Plc on machinery importation transactions. This is required for prospectus issue information only. ***(CIBN, Q1, April, 1999)***

Answer:

(a) Since the spot rates for Stg£ were given, the forward margins must first be ascertained before the forward rates are derived.

First, the forward margins applicable for the bank to buy the export proceeds:

$$FMt = SR^0 \frac{(Ehc - Efc)}{(1 + Efc)} \frac{f}{n}$$

Where FMt = forward margin at period t

SR^0 = spot exchange rate for home currency

Ehc = interest rate for home currency

Efc = interest rate for foreign currency

1 = a whole number

f = tenor of interest rate

n = days, months or quarter in a year as given.

1st August, 1996

$$FMt = \frac{135.6000(0.35 - 0.13)\ 30}{(1 + 0.13}$$

$$= \frac{135.6000\ (0.22)\ 1}{1.13 \quad\quad 12}$$

$$= 135.6 \times 0.1947 \times 0.0833$$

= **2.1992 premium**, because it is positive.

1st September, 1996

$$FMt = \frac{SR^0\ (Ehc - Efc)\ f}{(1 + Efc) \quad n}$$

$$= 135.6 \times 0.1947 \times 60/360$$

$$= 135.6 \times 0.1947 \times 0.1667$$

= **4.4011 premium**, because it is positive.

October, 1996

The question did not state precisely when in October, 1996 the delivery would be made. This therefore makes the October date an option forward contract. By our earlier matrix on the latter, the bank will charge the premium to the end of the period. The end of October is 31st. October, same as 1st November.

$$\text{Hence, } FMt = \frac{SR^0\ (Ehc - Efc)\ f}{(1 + Efc) \quad n}$$

$$= 135.6 \times 0.1947 \times 120/360$$

$$= 135.6 \times 0.1947 \times 0.3333$$

= 8.800 premium.

By the doctrine of buy low, sell high, it will be better for the bank to adopt the rate at the beginning of the option i.e. 6.6003 rather than 8.800 at the end of the option.

At the beginning of the option period, the premium would be 6.600 calculated thus, 135.6 x 0.1947 x 90/360 using the same formula. Beginning of October is 90 days from 1st July.

To adopt 8.800 premium would bloat the exchange rate to 144.2 (135.6 x 6.600). The rate of 142.2 (135.6 + 6.600) means we have complied with the above stated doctrine.

We are now ready to determine the forward rates applicable for the three payments:

	1st August	**1st September**	**31st October**
Spot rate, 1st July	135.6000	135.6000	135.6000
Add forward margin	2.1992	4.4011	6.6000
	137.7992	140.0011	142.2000

(b)	**1st August**	**1st September**	**31st October**
Value of deliveries	£640,000	£640,000	£320,000
Conversion to naira	₦88,191,488	₦89,600,704	₦45,504,000
Less 1% commission	881,915	896,007	455,040
Less stamp duty (1/4 of 1%)	220,479	224,002	113,760
	₦87,089,094	₦88,480,695	₦44,935,200

Total receivables:	**₦87,089,094**
	₦88,480,695
	₦44,935,200
	₦220,540,989

(c) DM is involved in this question and would be 'issued', that is, sold to Bakolori Bakasi Plc at a future rate.

$$FMt = SR^0 \frac{(Ehc - Efc)\ f}{(1 + Efc) \quad n}$$

$$= \frac{51\ (1 + 0.35)^5}{(1 + 0.06)}$$

$$= \frac{51\ (1 + 0.35)^5}{(1.06)}$$

$$= \frac{51\ (4.4840)}{(1.06)}$$

$$= \frac{230.93}{1.06}$$

$$= \textbf{₦217.86}$$

3.11.1 Alternatives to Forward Exchange Contract

One of the reliable ways to reduce or eliminate exchange risks from what we have seen so far in foreign exchange transactions, is forward exchange contract because amongst other things, a businessman is placed in a position to know the final profit sheet long in advance if he wants to (Esezobor, 2009).

There are other options too the customer in international trade could be advised on and they are as follows:

(a) As an exporter, invoice your products in your home currency and insist that payment should be made accordingly. If agreed to buy the buyers, the export proceeds will clearly be insulated from exchange risks.

(b) Invoice the goods in the buyer's currency but state the exchange rate for conversion within the currency of the attached bill of exchange. You expectation in home currency will come intact.

(c) Open a bank account in the buyer's country and direct the buyer to pay the proceeds of the shipment into that account. This is a foreign account which can also be used to import goods from that country subject to the prevailing exchange control regulations.

(d) Invoice the goods on agreed trade-by-barter arrangement whereby the buyer on receipt of his ordered goods will export in settlement, what the overseas partner has requested for in the right quantity and quality. This is also subject to the prevailing exchange control regulations.

(e) Invoice the goods in buyer's currency and borrow such foreign currency from your bank here in Nigeria while selling it forward for naira to enable you to keep financially afloat. When the overseas buyer pays in due course as agreed upon, the loan is paid back.

4.0 CONCLUSION

We note from the discussion that there must be a basis of conversion which both the seller and buyer are agreeable to and that is the exchange rate for the currency desired.

5.0 SUMMARY

In this unit, we have,

- defined the expression 'exchange rates;
- enumerated and explained the broad systems of exchange rates quotations;
- listed the various types of exchange rates;

- appreciated the use of forward exchange control including close-out and extension;
- determined the percentage cost of forward exchange contract and its application;
- appraised the factors that determine exchange rates;
- understood the mechanics of swap arrangement, arbitrage and hedging;
- listed the alternatives to forward exchange contract;
- solved questions in examinations on this subject matter.

6.0 TUTOR MARKED ASSIGNMENT

1. Define exchange rate and discuss currency and pence rate exchange systems.

2. What are the differences between spot, marginal and cross rates of exchange?

3. Define forward exchange contract and brief list out the benefits of forward exchange control.

4. The most exciting thing about the foreign exchange markets is the simplicity of the applicable principles on rate quotation and application such as:

   (i) Buy high, sell low.

   (ii) Premium add, discount deduct.

   (a) Explain the applicability of these principles as regards the foreign exchange market system.
   (b) Outline the current trade modalities on the Foreign Exchange Market.
   (c) Briefly state the impact that can be attributable to effective Bureau de Change operations to the Nigerian economy.
   (d) Calculate the forward rate if the discount on the US$ narrowed further and for 4 months settled at N2.00 or 6.52% to affect all periods up to a year as an indication of unwinding leads and lags.
   (e) What is forward margin, if N94.5950 was quoted before heavy buying and selling activities leading to moderate profit level closing the rate at N95.60 while the operational cost of 6 months contract closed at 4.41% per year? ***(Question 2, October, 2000, CIBN)***

7.0 REFERENCES AND FURTHER READINGS

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UNIT 6 MANAGEMENT OF FOREIGN CURRENCY EXPOSURE

CONTENTS

1.0 INTRODUCTION

In this last unit, we examined the accounting methods of settlement between banks as well as the methods through which transfers are being effected in international trade.

In this unit, you will learn about how to management foreign currency exposure and measures to be taken to avoid risks interested in international trade.

2.0 OBJECTIVES

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

(i) describe the concept foreign currency exposure;
(ii) broadly classify foreign currency exposure;
(iii) enumerate and discuss the techniques for hedging foreign currency exposure.

3.0 MAIN CONTENT

3.1 Foreign Currency Exposure

Any business that is into international trade or relations will be exposed to changes in exchange rate from time to time. Such changes affect the final accounts and balance sheet. For the avoidance of doubt, if a company sells, for example timber processed locally and has nothing to do with international merchandising, it will have no business with foreign currency exposure since all the sales and purchases and supplementary costs will be in naira so long as it is not exposed by government policies to foreign competition on the same product.

Foreign currency exposure is therefore possible where a change to a company's trading accounts because of movements in exchange rates in the currency it deals on. It does not only relate to contingent liabilities but assets and liabilities and the concomitant subheads as well as operational transactions in doing business in any foreign currency.

3.2 Classification of Foreign Currency Exposure

Broadly speaking, foreign currency exposure can be classified into three, (Esezobor, 2009), namely:

5. Transactions Exposure
6. Translation Exposure
7. Economic Exposure.

3.2.1 Transaction Exposure

Exporters will experience transactions exposure from the moment of invoicing until the proceeds of payment have been documented in the home currency.

Importers, on the other hand, would be exposed to movements in foreign exchange rate from the date the exporter does his commercial invoicing to the point that the local currency is converted into the necessary foreign currency to effect payment.

Transactions exposure will therefore arise in the timing of receipts and payments in both visible and invisible trade as well as periodic revaluation of contingent liabilities.

Under the Dutch Auction System and in short, the various methods of foreign exchange allocations tried in the past, the importer has virtually no foreign currency exposure because he pays for the foreign currency before any bidding is done for him by his bank.

Receipts and payments in dividends, leases, interests, royalties, etc. will also suffer transactions exposure as a result of differences in the timing of the receipts and payments.

3.2.2 Translation Exposure

A multinational company with overseas branches or subsidiaries would normally prepare at end of its financial year, its consolidated accounts in the home currency. To do this effectively, the accounts of the overseas subsidiaries would be integrated into the accounts of the parent company. This exercise will involve the integration of the assets and liabilities including their various subheads into the accounts of the parent company.

The issue will arise as to what rate to apply in converting the foreign assets and liabilities to the home currency. Many multinational companies adopt the ruling spot rate at the end of the financial year.

No attempt is being made here to examine the accounting intricacies as this is beyond the scope of this material. However, there must be a basis for such conversion which must be consistent with standard accounting concepts.

In the United Kingdom, Statement of Standard Accounting Practice (SSAP) No. 20 issued by the Financial Reporting Council of UK allows for period and exchange rates or average exchange rates for the year (Esezobor, 2009). In the United States of America, Financial Accounting Standard Board (FASB) No. 52 issued by the Financial Accounting Standard Board permits a weighted average exchange rate as the basis of conversion.

In Nigeria however, the Nigerian Accounting Standard Board has not incorporated into its Statements of Accounting Standards (SAS), the method of conversion of translation exposure.

A couple of mammoth Nigerian public companies have overseas branches and subsidiaries to which must be addressed, the problem of translation of overseas branch balances. First Bank of Nigeria Plc and Union Bank of Nigeria Plc have branches in London which have been converted to subsidiaries.

Both banks, the biggest in Nigeria, adopt the same method of translation. Foreign currency holding in Nigeria are converted at balance sheet date to naira and the difference in balances between the date of acquisition and date of balance sheet, credited to the profit and loss account if a gain and debited, if a loss.

Balances of overseas subsidiaries are translated to naira at the spot rate on balance sheet date and differences from the exercise, passed on to the Exchange Difference Reserve Account, a part component of shareholder’s fund.

3.2.3 Economic Exposure

A company exposed to foreign competition will always be subject to long term uncertainty in exchange rates. Economic exposure is the risk long-term fluctuations in relative exchange rates pose to the business of a producer.

Economic exposure risks are not hedgeable because they are difficult to quantify and report in absolute terms. It is possible though, to predict economic exposure risks through the use of special computer software.

3.3 Techniques for Hedging Transactions Exposure

A hedge is simply an action taken to combat a perceived risk.

The chunk of wood put behind the stationary lorry tyre is also a form of hedge against the possible risk of the lorry rolling back uncontrollably.

However, in the business of finance, the following can be used as hedging techniques for transactions exposure:

(a) Forward exchange contracts,
(b) Leads and Lags,

(c) Currency matching and borrowing.

All the above have been extensively dealt with in the next module of your course.

When a company exports and imports in a foreign currency, there will be delay between receipts and payments. Receipts can be put in a domiciliary account to earn interest in the foreign currency if not immediately required. Any delay in receipt, can be made up with overdrafts in the foreign currency from an obliging bank. From the foreign currency received, payment for example, for machine parts and raw materials can be arranged.

(d) Currency option
(e) Currency futures
(f) Multilateral Currency Netting

The above techniques are used by large multinational companies with subsidiaries who maintain some budget period and also have an efficient central treasury department. Such subsidiaries and they could be abroad, report regularly, anticipated receipts and payments in foreign currencies which must not breach local laws and regulations.

The central treasury department hedges for each of the subsidiaries, their foreign currency exposures.

With more common currencies emerging in regional trading blocks like Euro in European Union, multinational currency netting might become irrelevant if trading is limited to member countries in the region.

(g) Currency swap (this is discussed in the next module)
(h) Currency belting

To come to terms with the management of transactions exposure, it is necessary for the multinational companies to prepare periodically, cash budgets, from which the cash flows and exposures in foreign currencies can be determined. The cash flows can be discounted to permit a determination of the usual cost of capital to which would be added, the cost of the hedging technique adopted.

Example:

Nigerian Breweries Plc currently produces locally by a process of backward integration, most of its raw materials for the popular drinks of Gulder and Star beers. A drop in the exchange rate of the German Dutch Mark sequel to persistent inflation and unemployment, will pose an economic exposure risk to the company because in a free market, German beers will now come in cheaply and create problems for the market prices of Gulder and Star beers.

Nigerian Breweries Plc could attend to such economic exposure risk in the following ways:

- Exert strong political influence on the government to clamp down on foreign beers for health hazards e.g. in disposing of the used cans.

- Step up the level of research and development calculated to replacing the unit price of finished products and also to exploit diversity in product range. If there is need to switch production location to match the unit cost of production, it should be considered at the highest level.

- Make operation highly efficient and profitable to make the company less susceptible to adverse economic changes.

- Diversify the sources of raw materials and machine parts and be ready to switch to more stable foreign markets, if need be.

- Avoid high capital gearing which can rob production flexibility.

4.0 CONCLUSION

Foreign exchange exposure risks are a matter of particular importance to anyone involved in any form of international business which involves payment or settlement in a foreign currency. There is therefore the need to mapping out strategies to reduce as much as possible these inherent risks if the trading and commerce could take place profitably.

5.0 SUMMARY

In this unit, we have:
(i) described the concept foreign currency exposure;
(ii) broadly classified foreign currency exposure;
(iii) enumerated and discuss the techniques for hedging foreign currency exposure.

In the next module, you will be introduced to another interesting units including: method of payment, sources of finance for international trade, foreign exchange transactions, and forward exchange contracts: Spot and forward rates and letters of credit.

6.0 TUTOR-MARKED ASSIGNMENT

1. Guinness Nigeria Plc. is having difficulties in competing with floodgate of German beers in Nigeria.

   (a) How would you describe such an exposure?
   (b) Advance the necessary techniques for addressing such a problem.

2. Describe the various classifications of foreign currency exposures.

3. List the various methods of hedging techniques and describe any three in detail.

4. (a) What is currency exposure and how does it arise in international finance?

(b) Explain the nature of currency exposure confronting a multinational company like the Aluminum Smelting Company Plc. (ALSCON) in Ikot Abasi, Akwa Ibom State.

(c) Itemise the types of currency exposure management techniques available under (b). ***(Q. 3, October, 2000, CIBN)***

7.0 REFERENCES/FURTHER READINGS

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UNIT 7 FINANCIAL FACILITIES FOR TRAVELLERS

CONTENTS

1.0 INTRODUCTION

Businessmen, out of necessity, travel within the country and abroad from time to time to source business materials, expand their market and in the process, learn from associates and institutions abroad (Esezobor, 2009). Also, at a point periodically, one needs to take time off duty, on holiday, to travel, to see the world, places of interest and to visit relations and friends.

Unlike in Nigeria where many workers observe their annual vacation by remaining indoors or at best, pay a brief visit to their hometowns, holidays abroad are spent visiting several place of interest within the country and abroad in packaged group tours arranged by professionals in tourism.

Any one leaving his usual place of residence for any length of time will no doubt, have no access to his bank account especially if the trip is abroad. He, at any rate, needs cash to meet his daily needs and perhaps to buy a few gifts for loved ones.

In this unit, an attempt would be made to address the financial facilities available to travellers within Nigeria, the advantages and disadvantages of each of the facilities, the financial facilities for travelling abroad, as well as the advantages and disadvantages of each of such facilities.

2.0 OBJECTIVES

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

(i) list the financial facilities available to travellers within Nigeria;
(ii) enumerate and discuss the advantages and disadvantages of each of the facilities;
(iii) highlight the financial facilities available to travellers outside Nigeria;
(iv) state and explain the advantages and disadvantages of each of the facilities.

3.0 MAIN CONTENT

3.1 Facilities Available to Travellers within Nigeria

Gradually but steadily, holiday companies are emerging in Lagos and Abuja. It is a question of time for the virtue of holiday trips to leave the hustle and bustle of normal life catches on the Nigerian places of interest like Olumo Rock in Abeokuta, Ogun State, Obudu Cattle Ranch in Cross River State, Yankari Games Reserve in Bauchi State, to mention a few.

Travellers to such places and many other centres for business trips can arrange for cash to sustain them while on the trip in any of the following ways:

- Naira Notes
- On-Line Facility
- Cheque Encashment Facility
- Arranged Remittance to Designated Branches/Banks
- Smart Card/Visa Card/Master Card, etc.

3.1.1 Naira Notes

This is undoubtedly the best method because there is no need to purify any instrument by encashment. The cash is handy and ready to be spent at will.

The core disadvantage is that the money can be stolen not only in the street or highway by armed robbers but even in the holiday camp or business centre, if one is careless. The other disadvantage is that naira could be bulky to carry about. If N500 denomination notes are used, the problem of change into smaller denominations to buy simple things and for gifts should be looked into before departure.

3.1.2 On-Line Facility

Most new generation banks and even the conservative old generation banks are now providing on-line real-time services whereby a customer on either savings or current account or whatever product the bank might call it, can operate his account in any of the bank's branches hooked onto the bank's systems terminal nationwide. Some technologically advanced banks provide this service through the automated teller machine. When required, a traveller can stop by in the nearest of such branches to withdraw money and possibly, be relieved of excess cash by paying into his account.

However, it should be noted that not all branches of a bank are hooked on-line. Travellers should therefore endeavour to find out which of the branches are so hooked before setting out. Furthermore, the on-line system could break down when cash is urgently needed. If not the on-line system, public electricity supply or the branch's generating set could fail at the nick of time.

Lastly, systems experts on the other side of reason have of recent, been committing havoc on banks and customers' accounts by stealing huge sums of money through on-line facilities.

3.1.3 Cheque Encashment Facility

A bank in Lagos can arrange with any of their branches within the country to provide cheques encashment facility for a valued customer usually for a small fee or even free to boost the account turnover on which commission is charged as and when due. It is also possible to make this arrangement with another bank and settlement effected in due course, through clearing. Either way, the traveller is provided cash for his needs after necessary identification.

The fear for this facility is that an uninformed officer could throw spanner in the works thereby necessitating the sending of fax messages or making phone calls to clarify issues which could fail at any time in a third world. The traveller too should consider the convenience of travelling to the designated branch and should have handy, a convincing means of identification which could be called for.

3.1.4 Arranged Remittance to Designated Branches/Banks

By prior arrangement, a bank could remit money to a specific branch ahead of a proposed visit or to meet an emergency. By the same token, the remittance could be to another bank in the specified centre while reimbursement arrangement is carried out through banker's payment in Central Bank of Nigeria clearing area or by bank cheques or bank draft depending on the circumstance. Whatever method that is adopted, it would be faster and safer to deal with the bank's head office who would use their Entries/Remittance Department to reach the specified centre through electronics or the bank's courier service which itself is mail transfer. Alternatively, the funds could be remitted by mail transfer, or a bank draft issued to the traveller for encashment in the designated branch or bank on identification. Telegraphic transfer is also one of the options although it is expensive in terms of cost.

The perceived drawback to the arrangement could be failure through an inefficient transfer system or faulty electronic network or armed robber of the courier vehicle. Any of these setbacks would leave the traveller stranded without the cash pre-arranged.

3.1.5 Smart Card/Visa Card/Master Card, etc.

All these cards are gaining popularity in the country although their use is still highly restricted to designated centres in federal/state capitals like Abuja, Port Harcourt, Kano and commercial centres like Warri and Onitsha, to mention a few of such cities.

Travellers are advised to assiduously find out if such cards are accepted in the areas they are visiting and the limitations to their use, if any. The card itself could be lost or stolen thereby creating further problem of stopping the use and requesting for a replacement.

3.2 Facilities Available to Travellers outside Nigeria

For facilities available to travellers outside Nigeria, the following may be used:

- Foreign Notes and Coins
- Travellers' Cheques
- Credit Cards
- Cheque Encashment Card
- Uniform Euro-cheque and Euro-cheque Card
- Debit or Charge Cards
- Open Account/Travellers' Letter of Credit
- Company Credit Card
- Emergency Cash

3.2.1 Foreign Notes and Coins

These could be bought officially from banks through the completion of Form A for service (invisible trade) such as basic travel allowance, personal home remittance, pilgrimage travel allowance, business travel, medical travel (private) etc. Central Bank of Nigeria also approves the sale of foreign notes and coins on authorised Form M. Otherwise, foreign notes and coins are readily available in the parallel market.

Being cash, the traveller can start spending on arrival in the foreign country without looking for a bank or bureau de change to change the currency. Furthermore, the cash would not be affected by exchange rate fluctuation if it is the visiting country's currency. Unused cash can be kept safely for another trip or sold back to the bank on return, although this time at the risk of exchange rate fluctuation.

The disadvantages of this method are:

(a) If the foreign notes and coins bought are for another country not being visited, the traveller would have to contend with exchange rate fluctuation and would seek a bank or bureau de change to change the money into the visiting country's currency.

(b) Foreign cash is a thief's delight and would go for it at all cost if not discreetly handled.

(c) If the cash is lost, it cannot be easily retrieved because cash is a negotiable instrument of the highest order.

(d) If the coins are in hundreds or thousands, the problem of weight and even revealing noise, will arise.

(e) Travellers should check the current exchange control limitations before going to the international airport with large quantities of foreign cash because some arrests including of a prominent musician (now deceased) were made in the past for the possession of not-too-large amounts.

The British are quite happy to travel abroad with their home currency, pound sterling because, like the American dollar, it is convertible worldwide.

Nigerians cannot do that for now because the naira is not convertible. The expected common currency for the West African sub-region, Eco which will be convertible, will cure this handicap for good.

3.2.2 Travellers' Cheques

They can be bought from any bank on completion of Form A within the approved limits prevailing at the time. One does not have to be a customer to buy travellers' cheques from a bank. They can be obtained in large denominations to make travel light. If lost or stolen but reported quickly, it is possible to cancel them and replacement effected for a small fee. The traveller does not have to exchange them at point of entry because hotels and shops and even restaurants accept them abroad because they are issued by well known international banks like American Express Bank, Barclays Bank, HSBC, Commerze Bank etc.

On the disadvantages, the traveller should note:

- If any theft or loss is not reported immediately, the thief could cash it by forging the endorsement of the purchaser.

- Hotels and shopping centres offer different exchange rates for conversion and apply handling charges which might be disappointing.

- Travellers' cheques are susceptible to exchange rate fluctuation.

Travelling within West Africa can now be done with Economic Community of West African States (ECOWAS) travellers' cheques. It was launched on 30th October, 1998 in Abuja, Nigeria by the Authority of the Heads of State and Government under the chairmanship of General Abdulsalami Abubakar, the Head of State of Nigeria at the time.

The primary purpose of the TC was to make handy foreign exchange for use by travellers within the sub-region. It was aimed at facilitating intra-regional trade and related payments and helping member states to preserve their foreign reserves. However, the usage of the TC did not take firm roots until about June, 2003 because of the following reasons:

1. Failure of the majority of the Central Banks to comply with the agreed take-off date for circulation. They did not seem to believe in it. It was alleged that some countries rejected the TC issued by the Central Banks of other countries.

2. Poor printing quality of the TC that left ink on the thumb after counting. The numbering of the TC was found not serial and no wallets were provided.

3. Inadequate sensitization campaigns and workshops.

4. Lack of convertibility of the TC denominated in West African Unit of Account (WAUA) and restriction of usage to West Africa.

5. Non-compliance with the 'Manual of Operating Procedures' on encashment.

6. Non-compliance with the regulation of sending weekly returns to West African Monetary Agency (WAMA) to ensure prompt settlement.

7. Delay in utilizing the Credit Guarantee Fund instituted to mitigate the difficulties of funding for clearing settlement.

With ECOWAS TC, the use of TC issued by international institutions like Thomas Cooke, Travellex, American Express Bank, Commerze Bank etc. would no longer, all things being equal, be accepted within West Africa.

3.2.3 Credit Cards

Virtually all major European banks provide their valued customers with credit cards to facilitate cash-less shopping within the country and abroad. Credit cards have not yet taken a firm rooting in Nigeria because Nigerians generally prefer cash as a means of payment.

It is possible for the big Nigerian banks to arrange with their correspondent banks for credit cards in foreign currencies for their travelling blue chip customers. With a credit card, all that is required within its currency, is a private pin number, credit card number and drawings within specified limits not only within the bank's branches anywhere but from virtually all automatic cash vending machines in the developed world because many banks are technologically linked through shared systems terminals. Through the private pin number, which is confidential, a thief will find grave difficulty in using it to steal money. Apart, it can easily be cancelled if reported lost or stolen.

With credit cards, the user is not debited until after about a month, which itself is a form of free credit. The use of credit card is helpful in garnering credit points for free shopping in some obliging supermarkets, airlines and even insurance companies.

The fear for this means is that if the credit card is lost or stolen, it takes some delay for the bank to issue a replacement while the traveller may be stranded in a distant foreign land.

3.2.4 Cheque Encashment Card

By this method, all a traveller has to do is to take his cheques book and the encashment card and ensure his account is funded or adequate arrangement had been made for overdraft, and travel (within the developed world).

The cheques encashment card is a guarantee by the issuing bank to honour drawings up to the amount stated on it. To avoid abuse, the bank determines the maximum amount drawable under the card from the picture of the customer's income over six months.

It is safe because banks generally accept it. Where the traveler appears unconvincing, the genuineness can be found out in a moment through a phone call to the issuing bank.

It provides cash on the spot. That the issuing bank sends a monthly statement is helpful to the holder in checking his urge to overspend which seems to be the main disadvantage. The other disadvantage is that the cheque encashment card could be lost or stolen, thereby rendering the cheque book useless in a foreign land. Furthermore, the cheque encashment card attracts additional cost.

It is doubtful if a cheque encashment card issued by a Nigerian bank, without disrespect, would be accepted in the West African sub-region, not to talk of Europe or Americ.

3.2.5 Uniform Euro-cheque and Euro-cheque Card

This facility is similar to cheque encashment card excepting that to brighten its acceptability all over Europe, a bank issues a Uniform Euro-cheque and a Euro-cheque card simultaneously. Since the Euro is the common currency in Europe with the exception of a few observing countries still undecided to join the convergent countries, this method is instant cash to the traveler in Europe and to some extent, other developed countries and even South Africa at any market outlet where the 'EC' symbol is displayed. Banks issue them without upfront payment from the traveler, if in account. The debit is only applied when the used cheques come in through the clearing.

Like the cheque encashment card, the Euro-cheque and Card attract additional retainer fee for usage abroad. If the card is lost or stolen, the traveler could be stranded. The traveler is funded by not paying interest between when he uses the cheque and his account, debited. It is expected that if the proposed common currency for Economic Community of West African States, Eco, eventually takes off, such facilities could be arranged for travelers not immediately though but in due course, after basic infrastructures like regular power supply could be assured.

3.2.6 Debit or Charge Cards

Some major shopping centres and banks in Europe print their debit or charge cards which they issue to their regular patrons on payment of an annual subscription. It is a smart way of retaining valued customers.

Any time the card is used within the maximum stated amount in the issuer's shop or in other obliging shops, the user's account is debited outright. Settlement is effected at month-end (when workers have taken their pay) by direct debit. It is not a good experience with the bank or shopping centres, to fail to provide for this direct debit as a user.

The card companies gleefully publish the outlets where their cards are accepted worldwide. If the card is lost or stolen but reported promptly to the issuing company, it can be cancelled although the traveler may experience some delay and inconvenience before a replacement is issued.

3.2.7 Open Account/Travellers' Letter of Credit

By application and subject to the prevailing exchange control regulations at the time, a bank I n Nigeria can introduce the Nigerian traveler to their correspondent bank in the country the Nigerian is visiting with definite instructions that an account should be opened for him with the freedom to draw credit up to a stated amount during a specified period. Attached to the introduction, will be the customer's name, signature, passport number, passport photograph and proposed address in the country to be visited. At month-end or periodically as acceptable to the correspondent bank, payments in the form of maintenance allowance are passed to his account to clear the credits used.

This method is quite helpful to a valued customer or the bank's staff member who is going abroad for a few months to attend a course. The traveler can organise his requirement and draw cash when required within the limit. He would not bear any risk of loss or theft as in travellers' cheques although the commission on the travellers' letter of credit could be high.

The only aspect where he might suffer some inconveniences is that irrespective of where he lives, he must travel to the said correspondent bank to make his withdrawal.

3.2.8 Company Credit Card

Credit card companies accept applications from corporate bodies for company credit cards. Once approved and a limit is granted in accordance with the status of the corporate body, individual credit cards are issued to the executives; all within the limit approved.

Such executives travel freely without cash (within the developed world) and pay expenses with their individual credit card. It is a prestigious thing to flash a company credit card in a pub house in the midst of business associates or friends. Airlines, restaurants, shopping centres know the credit card companies and gladly honour their cards.

The company's account is debited monthly and a statement for each card user sent. This also serves as a control on the executives.

If the card is lost or stolen, it can be cancelled without loss if promptly reported. In the event, the user may have to bear some inconveniences until a replacement is sent.

3.2.9 Emergency Cash

If, for example, the Managing Director/Chief Executive of a bank in Nigeria or a multinational company like Julius Berger is stranded in say, New York City because his wallet containing all his money was lost or stolen, is there anything his bank in Nigeria can do to rescue him? The answer is YES, of course but within reasonable limits for which a special application on Form A must be made to Central Bank of Nigeria for authorization.

Swiftly, the action will be to contact the correspondent bank in the United States of America with a comprehensive detail of the amount remitted and means of identification of the stranded executive. For this purpose, SWIFT or telegraphic transfer would be advised. Reconciliation between both banks would be done by the debiting of the Nigerian bank's nostro account.

What holds for the bank's Managing Director/Chief Executive, on paper, also applies to all other Nigerians of whatever hue.

4.0 CONCLUSION

It is important to know what financial facilities are available to travellers; not only to those travelling abroad but also within Nigeria. This would facilitate invisible trade transactions and also prevent them from being stranded unduly.

5.0 SUMMARY

In this unit, we have,

- listed the financial facilities available to travellers within Nigeria;
- enumerated and discuss the advantages and disadvantages of each of the facilities;
- highlighted the financial facilities available to travellers outside Nigeria;
- stated and explained the advantages and disadvantages of each of the facilities.

6.0 TUTOR MARKED ASSIGNMENT

1. Mrs. A. Adetayo, a long standing customer called today to request your assistance for foreign cash of about £1,000 that will last her business trip for one month.

   Advise her on what financial facilities are available from the Nigerian background.

2. State the financial facilities to a family going on holiday from Lagos to Obudu Cattle Ranch in Cross River State for two weeks.

3. (a) What do you understand by Travellers' Letter of Credit? When would you recommend it to a traveller?

(b) Why is the use of credit card not popular in Nigeria? what do you advise should be done to enhance the popular use?

(c) Describe briefly how remittance of funds through on-line facility works.

7.0 REFERENCES AND FURTHER READINGS

Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

UNIT 5: SOURCES OF FINANCE FOR INTERNATIONAL TRADE

CONTENTS

1.0 INTRODUCTION

In the last unit we examined the various ways of placing orders for goods from abroad and at the same time, look at the different methods by which export products can be sold abroad in order to ensure that the proceeds of payment are received intact.

In this unit, we shall be discussing the various sources of finance for international trade. We will define import and export, enumerate and discuss the procedures for import and export goods and services and highlight as well as explain the sources available for financing import and export of goods and services.

a. OBJECTIVES

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

- define import and export
- discuss the procedures for importing and exporting goods and services
- highlight and explain the sources available to finance import and export of goods and services.

3.0 MAIN CONTENT

Trading with another sovereign state whether on the visible or invisible account is fundamentally different from intra-Nigeria trade because of differences in the following factors:

- Monetary system and exchange rates;
- Economic policies and political stability;
- Mobility in the factors of production;
- Languages and customs;
- Human attitudes;

- Complications in freighting of goods;
- Documentations.

Similarly ‘export’ to an economy, is like engine oil to a machine. A machine deprived of necessary servicing knocks without delay. This is also true of an economy which allows a floodgate of impost without raising commensurably, its level of exports.

3.1 Import and Export – Definition

This will be discussed under the following sub-topics.

3.1.1 Import

Esezobor (2009) sees import, within the context of international finance simply as to bring in’ or ‘introduce’ especially goods from abroad.

Earlier on in the course, we saw reasons why countries import goods and services. It was noted that all such goods can conveniently be separated into visible and invisible trade for the purpose of balance of payments. While importation is good for boosting local availability of required merchandise, it easily creates problems for an economy because such foreign goods and services have to be paid for in hard currencies, gold tranche or IMF Special Drawing Rights.

3.1.2 Export

Hornby (2006) defines export from international trade point of view as ‘to sell and to send goods or services to another country’, ‘to introduce an idea or activity or product to another country or area’.

Anything of economic value including expertise can be packaged and marketed abroad (Esezobor, 2009). Individuals, corporate bodies including financial institutions have roles to play to ensuring that our natural products like cocoa, palm produce, groundnuts, rubber, etc. and finished products like plastic products, pharmaceuticals, apparels, electronics, home videos etc. have continuous demands in the international markets.

Self Assessment Exercise 5.1

Define import and export.

3.2 Procedures for Importation and Exportation of Goods

This topic will be discussed under the following sub-topics.

3.2.1 Procedures for Importation of Goods

The procedure that follows covers the following acts of importation:

- Goods imported for home consumption;
- Goods imported under Form M and freighted either by sea, air, rail or road;
- Temporary importation of goods for Trade Fairs;
- Any other importation.

Listed below are the procedures for engaging in importation activities in Nigeria:

- Register a limited liability company
- Avoid Import Prohibited Goods
- Find a Reliable Seller
- Bid for Foreign Exchange
- Scanning and Risk Assessment
- Opening of Documentary Letter of Credit
- Receipt of Shipping Documents
- Clearing of the Goods and Duty Payment

(a) Register a limited liability company

This is because letters of credit, the only means by which foreign currency is bid for in the CBN organised foreign exchange allocation system e.g. Dutch Auction, are only open to registered limited liability companies. In other words, only the registered limited liability companies can bid for foreign exchange to open letters of credit for importation in Nigeria.

(b) Avoid Import Prohibited Goods

The prospective importer should be familiar with the Eligible Transactions and Prohibited Goods as enunciated in the Appendix I of CBN's Foreign Exchange Instructions Manual as updated from time to time.

The importance of knowing the prohibited items is to save time and cost in avoiding trade items for which foreign exchange cannot be legitimately procured and for which clearing at the wharf would not be tenable.

The prospective importer should therefore concentrate on those goods for which, there will be ease in obtaining foreign exchange and freedom to clear on arrival at the port. There should also be a ready market for the goods.

(c) Find a Reliable Seller

Through the following facilities, the prospective importer can find a suitable seller for the products desired:

- Friends, relations and associates;
- The internet;
- Nigerian Export Promotion Council;

- Local Chamber of Commerce;
- National Association of Chambers of Commerce, Mines, Industries and Agriculture (NACCIMA);
- Manufacturers Association of Nigeria (MAN);
- Import Agencies and Consultants.

The merchant should ask the seller for his catalogue and inside it there will be pro forma invoice for placing an order. The cost of goods, discounts required, INCOTERMs and method of payment (i.e. letters of credit, collections, open account trade or advance payment) should be negotiated in line with the prevailing exchange control regulations in Nigeria (Esezobor, 2009). For example, importation into Nigeria of commercial products is conducted by letters of credit.

It is of paramount importance that the credit standing of the seller is known if huge orders are contemplated. This can be done through the banking system initiated by the importer's bank to the seller's bank abroad preferably through their correspondent bank in the seller's country.

(d) Bid for Foreign Exchange

The merchant approaches his bank for foreign exchange by completing Form M to which must be attached:

(i) Original pro forma invoice;
(ii) Certified copy of certificate of incorporation;
(iii) Current tax clearance certificate;
(iv) Applicable license, if necessary e.g. license issued by Pharmaceutical Board of Nigeria for medicines;

(ii) Completed Provisional Import Duty Assessment Form C-186A;
(iii) National Maritime Authority Shipment Notification Form C-31. NMA would retain the first three copies and release the fourth copy to CBN;
(iv) Local Insurance Certificate.

The Naira cash margin for the foreign exchange sought is provided to enable the bank to bid in the prevailing auction system. 'An approved Form M shall be valid for 180 days and an Authorised Dealer may grant extension for another 180 days. Consequently, an approved Form M has a maximum life span of 360 days. However, in the case of machinery, plant and equipment made to specification, the initial validity period shall be 360 days subject to extension for a maximum of 180 days thereafter on application to and approval by CBN'.

(e) Scanning and Risk Assessment

Any of the Scanning and Risk Assessment companies – Globascan, Societe Generale due Surveillance (SGS) or Cotecna undertakes a preliminary scanning and risk assessment of the proposed importation based on the details on the completed Form M. Their role is important to avoid importing goods that may not be approved for clearance on arrival since the inspection regime is now destination inspection. This preliminary job is done with swiftly same day. If satisfied, the company retains a copy of the Form M and sends the other two copies to the head office of Nigeria Customs Service and the Custom Area Command that would clear the imported goods ultimately.

(f) Opening of Documentary Letter of Credit

On successful bid for the foreign currency (always the American dollar), the authorised dealer opens the documentary letter of credit by using their correspondent bank in the seller's country or the correspondent bank closest to the seller's country, to advice the credit.

(g) Receipt of Shipping Documents

The shipping documents would be sent directly from the beneficiary through the advising confirming bank to the issuing bank in Nigeria. The first hurdle to clear is the procurement of Risk Assessment Report (RAR) by the scanning and risk assessment company. It is to this company, the importer must head with the shipping documents collected from the bank. The minimum shipping documents the bank would release are:

1. Bill of lading if shipped by sea or air transport document (airway bill) if procured by air.
2. Attested commercial invoice.
3. Packing list if relevant.
4. Necessary import authorization e.g. current license by Pharmaceutical Board of Nigeria for pharmaceuticals etc.

The Nigeria Customs Service (NCS) would require the risk assessment report to generate the duties payable using ASYCUDA, a software on valuation and verification developed by UNCTAD

(h) Clearing of the Goods and Duty Payment

The Nigeria Customs Service handles the assessment and collection of import duties in Nigeria. They do this by first analyzing the Risk Assessment Report issued by the scanning company – SGS, Globascan or Cotecna. A physical inspection of the goods is carried out for which an Assessment Notice using ASYCUDA is issued. Thereafter, the importer:

(i) Pays the duties only in bank certified cheques and drafts to 'Federal Government of Nigeria Import Duty Account' issued by the authorised dealer that endorsed the Form M for the importer.

(ii) Ensures that each certified cheque/draft is endorsed at the back with the following information:

- The importer's name;
- The importer's address;
- Form M number(s) covered by the payment instrument;
- Import duty report number;
- Name and address of the clearing agent (where necessary).

3.2.2 Procedures for Export

The Federal Government of Nigeria issues new guidelines from time to time on exports which in the opinion of Nigerian Export Promotion Council (NEPC), are "aimed at ensuring strict adherence to accountability and transparency in the conduct of international business by Nigerians as a first step towards building a good image for the country. These objectives would be achieved by ensuring that the quality and quantity of all exports as well as the true value of goods to the consignee tally with the claims on all accompanying documents'. Thus, the following procedure holds for exports (Esezobor, 2009):

1. Register a limited liability company. NEPC prefers companies for the export trade because their details are documented in Corporate Affairs Commission (CAC) and can easily be traced should the need arise.

2. Register the company as an exporter with NEPC in the following way:

   (a) Obtain a registration form on payment of a small fee, N250.00 currently.
   (b) Tender the completed registration form with copies of the certificate of incorporation and memorandum and articles of association of the company duly certified and stamped by CAC.
   (c) Pay the prescribed fee for registration, N3,000.00 currently.
   (d) Pay a surcharge, N500.00 currently, for registering in a NEPC office not closest to the company's registered office.

   All registered exporters are expected to renew their registration every year by paying the renewal fee, currently N1,000.00 and the submission of the following documents:

   (i) Certified true copy of Form C07;
   (ii) Original copy of exporter's registration certificate;
   (iii) Payment of renewal fee;
   (iv) Evidence of export performance during the previous year.

3. Exporter should source a buyer (NEPC offers some assistance) and negotiate carefully, the following:

   (a) Unit price of product(s);

(b) Discount;
(c) Minimum order quantity;
(d) Method of packaging appropriate;
(e) Incoterms e.g. FOB, C&F, C.I.F. etc;
(f) Mode of shipment e.g. by sea, air or road;
(g) Method of payment e.g. collections, letters of credit, etc. Letters of credit of the order of confirm irrevocable, to all intents and purposes, are preferred. If it is Letter of Credit, whether it is red clause (good for natural products), transferable, revolving etc;
(h) Last date of shipment;
(i) Shipping documents required as evidence of shipment.

Other sources of finding buyers are:

(a) NACCIMA
(b) Chamber of Commerce and Industry
(c) Embassies and High Commissions
(d) Manufacturers Association of Nigeria
(e) Export Agencies and Consultants
(f) Internet
(g) Private sources e.g. from friends.

4. Approach the bank to complete necessary forms including Form NXP. Form EUR-1 should be obtained from NEPC or the Chamber of Commerce and Industry for completion for exports to member countries of the European Union in order to help the buyers to take advantage of the duty concessions. Recall that for exports to Portugal, the correct form to complete is PSG.

5. Identify a suitable carrier in accordance with the contract.

6. Put the ordered goods together in the right quantity and quality and approach an inspection agent for the Certificate of Clean Inspection. The Federal Produce Inspection Service is one of such respected inspection agents.

7. Commence the packaging of the goods after inspection while guarding against corruption by rodents, insects or unnecessary exposure.

8. Move the goods to the port of shipment for Customs inspection at the Customs Processing Centre available at all the major ports in Nigeria and payment of NESS and ad valorem charges at 1 percent and 0.5 percent respectively.

9. Goods can thereafter be loaded on the carrier for shipment as agreed in the contract. For shipment by sea, a bill of lading would be obtained from the carrier.

10. Gather all shipping documents which will include as a minimum, the following:

(a) commercial invoice, issued by the exporter;
(b) insurance document;
(c) bill of lading; etc;
(d) certificate of inspection.

The documents to tender would have been agreed with the buyer and stated in the letter of credit received and any amendment thereof.

11. Tender the shipping documents to the advising/confirming bank here in Nigeria as evidence of shipment and get paid according to the terms of the letters of credit within 90 days.

12. Payments should be credited to the Exporter's domiciliary account with the bank.

Self Assessment Exercise 5.2

1. List and describe five out of the procedures for importation of goods.

2. Describe the steps to be taken by an exporter who wish to enter into international market.

3.3 Sources of Finance for Importers and Exporters

This topic will be discussed under the following sub-topics.

3.3.1 Sources of Finance for Importers

The following sources can be exploited in raising funds to import goods and services (Esezobor, 2009):

- Overdraft or Loan
- Produce Advance/Hypothecation
- Accommodation Finance
- Documents against Acceptance Collection
- Acceptance Documentary Letter of Credit
- Open Account Trading
- Hire Purchase and Leasing
- Importer's Own Finance

(a) Overdraft or Loan

The prospective importer fills the bank's standard form and furnishes all the bank's requirements which amongst other things, will include:

- The pro forma invoice from the overseas exporter;
- Marine insurance policy contracted here in Nigeria;

- Completed Form M obtainable from the bank;
- Special import license or certificate where applicable e.g.

- Certificate of Registration with the Pharmaceutical Board of Nigeria for the importation of drugs;
- Vaccine and Inoculation Certificate issued by the Federal Ministry of Health for the importation of live animals and birds;
- Firearms License issued by the Federal Ministry of Defence for importation of firearms;
- Certificate of Registration with National Agency for Food, Drugs Administration and Control (NAFDAC) for the importation of any food item;

- Completed application form to bid for foreign exchange;
- Security, which must be adequate.

Needless to say those other things like experience, competence, evidence of substance e.g. a good account and a careful scrutiny of the records of the prospective importer will all be considered along with the canons of lending. Other issues as customs duty and cost of clearing should be reckoned with at the onset.

Overdrafts or loans can also be accessed under Small and Medium Industries Equity Investment Scheme (SMIEIS). This facility is a voluntary pool of 10 percent profit before tax by all banks as a contribution to support small and medium scale enterprises in national development.

(b) Produce Advance/Hypothecation

This consists of a facility granted the importer to enable him to import and clear the desired goods while the bank retains control of the goods as security for the advance until it is completely paid back from the sale.

The bank must take the following steps to protect its advance:

- Take possession of the title documents to the goods, especially ensure the bills of landing are a full set and blank endorsed and that the insurance is adequate and current.

- On arrival, take delivery of the goods and warehouse the lot in a secured warehouse in the bank's name.

- Obtain a letter of pledge/hypothecation embodying a power of sale from the customer.

- Ensure all other documentation e.g. clean report of inspection, are right.
- Open a separate loan account for it and monitor it.

- Issue warehouse warrants for release of goods on payment across the counter. Avoid releasing goods against a trust letter issued by the importer because it can easily be abused.

- The other but important considerations which the bank must have undertaken before granting the advance are taking up a favourable reference on the exporter and also surveying the market to confirm that the product is in demand locally.

All through the currency of the loan, it must be noted especially for the lending banker, that the advance will only be paid back from the proceeds of sale.

(c) Accommodation Finance

There are two types, namely:

(i) Bank Acceptances
(ii) Commercial Paper

(i) ***Bank Acceptances*** **–** It is granted by a bank through a tenor bill of exchange to fill a gap in a sight documentary collection which of course, must be paid for before the shipping documents are released to enable the importer to clear his goods at the port. Often, the importer turns up without the money to redeem a sight collection but would ask the bank to accommodate him for a few days to enable him to clear the goods and sell. If the bank obliges, the importer draws a tenor bill of exchange for a period adequate to enable him to clear the goods and sell. The obliging bank would simply accept the bill by signing at the left hand bottom of the bill. If the tenor bill was drawn on a willing investor, he accepts it before presentation to the obliging bank who reinforces the acceptance with its own signature. Provided the bank is not distressed, the accepted bill, also called bank acceptance, can be discounted easily in the money market and even in the bank that accepted it. The exercise provides the importer the funds to pay for the sight bill and clear the goods for sale with a view to lodging in funds to accommodate the accepted bill at maturity. The discounting bank earns a small commission for its service while the investor earns the interest for the tenor.

If the bank however accepted the tenor bill to be drawn on it directly and it accepts it, which would be a direct bank acceptance. In the circumstance, the bank would earn both the interest for the tenor and the commission.

Depending on the goodwill of the importer, bank acceptances can easily and quickly be arranged. The liability of the accepting bank to the accepting investor is akin to a guarantee, which crystallizes only if the importer fails to pay at maturity of the discounted bill.

It must be stressed that this is a substance of lending and must be protected along the line of produce advance to avoid abuse.

(ii) ***Commercial Paper –*** It is a money market instrument used by blue chip companies to raise short-term finance for 90 days. Where the tenor is up to 270 days, it must be registered with Securities and Exchange Commission (SEC).

To issue, finance houses serve as brokers for the high net-worth companies by raising tenor bills of exchange which are sold to banks and the public in tranches of thousands or millions of naira. The interest element is discounted upfront. That is to say, the buyer pays the value less the interest for the tenor of the commercial paper. The proceeds provide the necessary finance for any desired importation for the blue chip company. In view of the status of the borrowing company, investors are happy to put their money without any form of security. At maturity, the commercial papers are presented on the finance company for redemption.

Huge sums of money can be raised quickly through this medium if the company commands public respect for sustained business performance and ethical standards.

However, commercial papers are expensive to execute because the interest offered must be attractive enough to encourage patronage and the commission of the finance company must also be taken into account. As already noted, it is not a facility open to all and sundry but a selected few with top class corporate identity.

(d) Documents against Acceptance Collection

If the importer can persuade the exporter to sell to him under this method of collection, he would not need any bank support. All what would happen is that the exporter ships the goods directly to the importer but routes the shipping documents through his bank to their correspondent in Nigeria with definite instructions called collection order which amongst other things, require the importer to accept the tenor bill of exchange attached to the shipping documents.

After the acceptance, the shipping documents are released to him, the importer, to clear the goods at the port and sell at his own pace provided he pays in the sum of the bill right before the expiry of the tenor. In this case, the Nigerian bank has not parted with money but will only become worried if at expiry of the tenor, the importer fails to honour the bill he had accepted.

(e) Acceptance Documentary Letter of Credit

This source is against a documentary letter of credit, which can only be revocable because the importer does not put money upfront before it is opened. It is a weak form of letter of credit (L/C) from the exporter's point of view because he ships the goods to the importer who is only required to accept the covering tenor bill of exchange as above. The method is a deliberate attempt by the exporter to finance the importer by allowing him to clear the goods at the port and sell before paying up within the terms of the tenor which could be 30 days, 60 days, 90 days or in fact, any number of days.

If the exporter wants finance during the tenor, he could appeal to his bank to either discount the accepted bill or provide him accommodation finance against he exportation.

(f) Open Account Trading

It is a liberal method of settlement in international trade between an exporter and importer who know each other quite well and over a long period of time. Through this method, the exporter ships the goods to the importer and sends the shipping documents directly to him to enable him to clear the goods and sell; only to pay later according to their agreement.

Asian parent companies sell to their Nigerian subsidiaries through this method. It is a juicy method of finance to the importer although an expensive gable to the exporter because the former can easily abuse the privilege.

(g) Hire Purchase and Leasing

It can be arranged through a merchant bank or finance house either in the exporter's country or here in Nigeria. in hire purchase, the asset is not legally acquired until the last payment is made while in leasing, the ownership of the asset rests with the lessor although the lessee (importer) is allowed the usage of it.

(h) Importer's Own Finance

There is no reason why the importer cannot raise the finance from his own working capital or by selling off share holdings or any other asset of value so as to retain a zero or minimal gearing.

3.3.2 Sources of Finance for Exporters

Like the case of an importer, the facilities available to an exporter are as follows:

- Overdraft or Loan
- Accommodation Finance

- Acceptance Credits
- Advance against Collection
- Red Clause Letter of Credit
- Commercial Paper
- Stocks and Shares
- Avalisation of Inward Documentary Collection
- Negotiating or Discounting the Bill of Exchange
- Factoring
- Hire Purchase
- Lease
- Forfeiting
- Matching Foreign Currency Borrowing
- Capital Market Sources

- **Overdraft or Loan**

The bank would as a rule, appraise the facility from a professional point of view using the canons of lending as a checklist. The exporter must tender the following documents to show seriousness:

- Completed NXP form in sextuplicate
- Certificate of incorporation
- Pro-forma invoice
- Nigerian Export Promotion Council (NEPC) Registration Certificate, where appropriate.
- Letter of credit (inward L/C) from the buyer abroad.

It should be noted that shipments from Nigeria must be by documentary letter of credit. The bank must reckon with the cost of taking the shipment through Customs Processing Unit and the payment of NESS charge of 1 percent and 0.5 percent ad valorem for non-oil and oil exports respectively.

Small and Medium Industries Equity Investment Scheme (SMIEIS) can also be accessed through overdrafts or loans from banks.

- **Accommodation Finance**

Although exports from Nigeria should be by way of documentary letter of credit, this point and the following relevant points on other methods of settlement, should be noted.

Accommodation finance relates to documentary collections against acceptance by which the exporter on arrangement with his bank writes a bill of exchange for an agreed proportion of the accepted bill, on the obliging bank. The bank accepts the bill and on the strength of the bank's name, the bill is easily discounted in the money market at a good or fine rate.

The accepting bank would thereafter, naturally handle the collection and ensure that proceeds come in before the accepted bill is presented at maturity through the clearing. Therefore, the accepted bill will have a fairly longer maturity period than the tenor on the bill of exchange that accompanied the exportation.

- **Acceptance Credits**

Documentary letters of credit are always either sight or acceptance depending on the terms of contract signed between the exporter and the importer. In the former, the exporter is paid on the spot if he tenders all the required shipping documents to justify the shipment of the specified products. Recall that banks deal only on documents.

In the case of acceptance credit, the negotiating bank is contracted at the onset to accept the bill drawn by the exporter on presentation. Being a bank acceptance as in the above case, the bill of exchange could be discounted at a fine rate in the money market.

- **Advance against Collection**

A bank can advance money on documentary collections provided the overseas buyer is well known with good references.

It must be emphasised that the security for such an advance is the consignment for export. It will thus be preferable for the bank's interest to be noted on the insurance and the loan to be a fraction of the collection and importantly, with recourse to the customer in the event that something goes wrong in obtaining full payment from the overseas buyer e.g. the buyer refusing to pay because the goods missed the market like Christmas toys or decorations by arriving after the Christmas celebration.

The instructions to the Collecting Correspondent Bank abroad in the collection order should also recognize the need for extra care to avoid loss. The exporter's bank should obtain a letter of pledge/hypothecation to strengthen its security.

- **Red Clause Letter of Credit**

This item had been extensively taken under Documentary Letters of Credits in Unit 2 of this module. It is being mentioned here because it is a good source of finance to the exporter of natural products like kolanuts, cassava chips, cocoa, rubber, palm products, processed wood etc.

All that is required is for the exporter to insist in the initial discussion with the buyers, that he would need some finance to process the products into an acceptable form. For this purpose, he would prefer a red clause letter of credit with say 60 percent credit facility. If the buyers accept the proposal, it means that the advising bank of the letter of credit in Nigeria would advance 60 percent of the value of the credit to the exporter for a stated period as in the credit. The balance of 40 percent would be paid when the shipment had been concluded and the specified shipping documents called for in the credit, tendered and accepted by the advising bank. Exporters who stick to a few buyers and get known for doing business above board, are more likely to enjoy this facility from trusting buyers.

- **Commercial Paper**

Like importers, exporters of repute with blue chip corporate identity can also exploit this facility to raise large-scale finance. Please refer to the earlier discussion on sources of finance for importers for further details.

- **Stocks and Shares**

Only public companies quoted on the stock exchange can enjoy the facility of raising permanent finance or equity in the capital market. It is an important source of long-term finance but the process could be slow and expensive. The success rate would also depend on the quality of the financial reports (track record) and the publicity mounted to attract public investment in the shares or stock.

- **Avalisation of Inward Documentary Collection**

Avalisation is the addition of the presenting bank's name to a usuance (tenor) bill of exchange already accepted by the drawee in the following format:

> Endorsed by way of aval for (name of acceptor)
> for and on behalf of
> ABC Bank Plc. (presenting bank)
>
> ………………………
> Authorised Signatories

In effect, only a tenor bill of exchange that had already been accepted by the drawee can be avalised. The avalisation comes in the form of the bank's guarantee on the bill.

Being a contingent liability, the avalising bank treats it as a substance of lending to avoid honouring the bill at maturity without proper arrangement for reimbursement from the drawee. The importance of the exercise is that the bill immediately becomes a bank acceptance and could be traded at a fine or low rate of interest thereby providing funds for the exporter.

Although avalisation is not yet recognized in relative banking laws even in the United Kingdom, an inward collection that bears the word(s) 'aval' or 'pour aval' or 'avalisation' should be handled specially. Such words will arise from the initial discussion between the exporter and importer with the exporter insisting on it as a means of facilitating the discounting of his accepted tenor bill.

While retaining the right of recourse against the exporter, the avalising bank will quite naturally ask for some form of security support from the remitting bank.

- **Negotiating or Discounting the Bill of Exchange**

As a way of finance, most bills are negotiated by the exporter's bank, which is, bought from the exporter with a right of recourse to provide the exporter with immediate cash. Negotiation is possible to both sight and term bills as well as to both types of collections and tenor letters of credit. The implication of this facility is that before the shipping documents covering the export are dispatched to the overseas buyer through the collecting or advising bank, the exporting company receives payment either in full or part of it to enable it to prosecute other orders.

To protect itself, this bank will obtain a satisfactory status reference on the overseas buyer (drawee), scrutinize the shipping documents carefully against the contract and take a letter of pledge/hypothecation over the goods. Discounting of bills is the specialty of acceptance houses (merchant banks).

- **Factoring**

It is the practice of a debt collecting agency taking over the outstanding overseas collections of an exporter without recourse. To be effective, such debt collecting agencies have offices abroad and know from experience, the credit quality of the buyers. They buy off for a fee, the overseas book debts of the exporter thereby providing liquidity for the latter while they collect for self. This type of finance is more appropriate where the exporter sells on open account trading terms. To facilitate the collection, the identity of the factor is disclosed to the overseas buyer.

- **Hire Purchase**

The exporter is the hire purchase provider and the importer, the hirer. The products involved are huge capital items like bulldozers, dredging equipment, aircraft et. and from the point of view of the hirer, is long term finance. The exporter after a signed contract provides the equipment preferably through a hire purchase company in the hirer's country. He receives his payment for the hire in full at a time and without recourse while the hirer pays periodically as agreed over a long time for the use of the product. Ownership only passes to the hirer on the last payment of the last installment. Interest rate charged for the transaction is usually higher than short-term finance.

- **Lease**

The exporter has substantial equipment for lease and leases it to a leasing company who in turn leases it to an overseas buyer for a definite period. The exporter receives his fee in full without recourse once the equipment is installed. Leasing is a medium to long-term finance to both the exporter and importer.

- **Forfaiting**

  This is the scenario for Forfaiting: By agreement, the importer (buyer) contracts with a first class international bank preferably, a European bank, to guarantee the importation or a block of revolving importations not less than Stg£50,000.00 in value and for a period of up to 10 years.

  On the strength of the first class guarantee, the exporter ships the goods and writes his bill of exchange, which the guaranteeing bank will accept. The exporter presents the bills to his bank who happily discounts them at a fine rate because of the acceptance of the first class bank. The exporter's bank is called the forfaitist.

  Forfaiting is ideal when a country is constructing for example, mammoth institutions like an iron and steel factory, stadium or a university. The forfaiting finance will enable the supplier of materials or expertise to continue without fear about the ability of the buyers to pay as and when due. It could be quite expensive to the importer who in addition to the usual bank charges, would pay fees for the international guarantee.

- **Matching Foreign Currency Borrowing**

  If the exporter had shipped goods under documents against collection or tenor letter of credit for future receipt of the export proceeds, he could approach his bankers to lend him the foreign currency against the expected proceeds. To protect himself against foreign exchange fluctuations, he could sell the expected proceeds forward from which the loan granted would be paid back.

- **Capital Market Sources**

  Either: (a) Convert business to a public quoted company and float shares under the auspices of the Nigerian Stock Exchange, or (b) Convert business to a public quoted company and under the auspices of the Nigerian Stock Exchange, issue bonds for purchase by investors.

Self Assessment Exercise 5.3

Itemise the sources of finance to an importer and an exporter. Discuss any four of the sources.

4.0 CONCLUSION

There are very many sources available for importers and exporters to finance their business in international trade.

These sources include overdraft or loan, accommodation finance, acceptance credits, advance against collection, commercial papers, stocks and shares, hire purchase and leasing, etc.

5.0 SUMMARY

In this unit, we have examined in detail the procedures for importing and exporting as well as sources of finance available to an importer and exporter for dealing in international trade.

In the next module, we shall dwell into the documents used in for transaction purpose in international trade.

6.0 TUTOR-MARKED ASSIGNMENT

1. Examine the importance of red clause credit in the financing of export order like kola nuts.

2. What details must an exporter see to when negotiating an order with a prospective buyer?

7.0 REFERENCES/FURTHER READINGS

Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

MODULE 3: GLOBALIZATION

UNIT 1 NON-MONETARY INCENTIVES AVAILABILE FOR EXPORTERS

CONTENTS

1.0 INTRODUCTION

In this last unit, we have listed the financial facilities available to travellers within Nigeria, enumerated and discuss the advantages and disadvantages of each of the facilities highlighted the financial facilities available to travellers outside Nigeria, and stated as well as explained the advantages and disadvantages of each of the facilities.

In this unit, we shall discuss the efforts of the Federal Government of Nigeria in promoting export drive by encouraging more entrepreneurs to delve into exportation business in Nigeria. We will be discussing on the role of Nigerian Export Promotion Council (NEPC) and the Nigeria Export-Import Bank (NEXIM).

2.0 OBJECTIVES

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

(i) Discuss the two major operators of the Export Credit Incentive;
(ii) Enumerate the types of Incentives;
(iii) State and explain the role of Nigeria Export Processing Zones; and
(iv) List and discuss the other Export Incentives available for exporters in Nigeria.

3.0 MAIN CONTENT

3.1 Operators of the Export Credit Incentive

At different times, the Federal Government of Nigeria had formulated policies through its various agencies to boost the level of exports from the country. While strenuous efforts have been made to cut back on imports, it is surprising that not much of publicity is given to the array of facilities, although essentially non-monetary, to boost export derive. By the new arrangement, anybody provided it is an incorporated body, can undertake export business.

In the United Kingdom, the activities of Export Credit Guarantee Department, the official institution of the British Government that promotes exports, are well known and published. Even where the emergent exporter in that country does not know his entitlements, he is readily briefed not only in the banks but in all the support services he would need, to put his products together for shipment.

In Nigeria, the export credit incentive scheme is operated by two key players on behalf of the government (Esezobor, 2009). They are:

- Nigerian Export Promotion Council (NEPC), and
- Nigeria Export-Import Bank (NEXIM).

3.2 Nigerian Export Promotion Council (NEPC)

NEPC is the main government organ directly sponsored to promote export trade in Nigeria. According to its pamphlet titled "Why Exports?", it offers the following services to exporter:

(i) Provides information on domestic and foreign markets and undertakes the development of markets for made-in Nigeria products;

(ii) Advises on product design, quality, packaging and packing;

(iii) Undertakes human resource training and development;

(iv) Plans and organizes Nigeria's participation in international trade fairs exhibitions;

(v) Liaises with other international agencies on export matters.

It was established by Decree No. 26 of 1976 and was formally inaugurated in March, 1977 (quoted in Esezobor, 2009). Decree No. 41 of 1988 refined its functional responsibilities. These functional responsibilities are numerous but can be grouped into the following:

1. New Manufacture-in-Bond Scheme;
2. Trade Procedures and Documentation.

1. New Manufacture-in-Bond Scheme;

This scheme was a decision of World Trade Organisation (WTO) of which Nigeria is an active member, to consciously replace cash incentives with non-cash incentives in the promotion of exports among member countries. Nigeria adopted this scheme as was conveyed in the annual budget of 1999.

To quality for this scheme, an exporter is required to obtain a Bond from either a bank, an insurance company or Nigeria Export-Import Bank which would be held by the NMIBD Committee until the Central Bank of Nigeria confirms that the goods manufactured had been exported and the foreign exchange proceeds repatriated to Nigeria.

Where an exporter qualifies under any of the four sub-schemes we shall treat shortly, a Negotiable Duty Credit Certificate (NDCC) would be issued by the NMIBS Committee which could be utilised by the exporter in the payment of import duties on imported raw materials inputs or completely knocked down spare parts whether prohibited or not, for the production of export goods as stated or in the alternative, transferred to another exporter if the benefiting exporter has no use for it. Once again, no cash incentive is given.

The following four component schemes have their respective Committee with secretariat in the office of NEPC:

(i) Manufacture-in-Bond Scheme
(ii) Duty Drawback Scheme
(iii) Export Expansion Grant Scheme (EEGS)
(iv) Export Development Fund (EDF)

(i) Manufacture-in-Bond Scheme

The Manufacture-in-Bond Scheme is designed to encourage manufacturers to import duty-free raw material inputs and other immediate products whether prohibited or not for the production of exportable goods, backed by a Bond issued by any recognised Commercial Bank, Merchant Bank, Insurance Company or NEXIM. The Bond will be discharged after evidence of exportation and repatriation of foreign exchange has been produced.

Guidelines:

(i) The Manufacture-in-Bond Scheme (MIBS) shall be applicable to export manufacturers only.

(ii) Interested manufacturers should apply to the Federal Ministry of Finance using the prescribed forms.

(iii) For a manufacturer to enjoy the scheme, the factory premises must be approved for that purpose by the Nigeria Customs Service.

(iv) Approval including the Import Requirement Certificate (IRS) should be obtained within a period of two months and transmitted to the Nigeria Customs Service for implementation.

(v) The Nigeria Customs Service will determine acceptable guarantee Bond issued by Commercial or Merchant Banks or NEXIM or Insurance Companies covering not less than 110 percent customs duty payable on each consignment.

(vi) Under this scheme, manufacturers of export commodities will be entitled to import duty-free raw material inputs, CKDS and intermediate inputs whether prohibited or not for the manufacture of export commodities.

(vii) The Manufacture-in-Bond Scheme shall operate on an annual (12 calendar months) importation basis as the export prohibited items. However, the scheme shall operate on Import by Import basis.

(viii) The Bond which shall be effective from the date of its issuance by the Bank shall be discharged when the conditions stipulated therein have been fulfilled.

(ix) The Nigeria Customs Service will periodically monitor the utilizations of raw materials imported under this scheme until the Bond is fully executed.

(x) In the event of inability of any manufacturer to fulfill the conditions stipulated in the Bond, the manufacturer shall apply to the Nigeria Customs Service through its approved dealer Bank, for an extension of the Bond particularly when the life of the Bond has expired. The extension of the Bond shall not exceed three months.

(xi) Repatriation of the foreign exchange realised from the transaction shall be confirmed by the Central Bank of Nigeria before the Bond is discharged.

(xii) Bill of Entry marked "Manufacture-in-Bond Scheme" shall be used for the clearance of goods under the Scheme.

(xiii) A Committee comprising the Ministry of Finance, representatives of the Nigeria Customs Service, Nigerian Export Promotion Council, Standards Organisation of Nigeria and the Central Bank of Nigeria shall monitor the scheme. The Monitoring Body shall render a quarterly report to the NMIBS Committee.

(xiv) In the event of default by the Manufacturer, the Nigeria Customs Service shall redeem the Bond by calling on the guarantor to pay up the appropriate customs duties and other associated charges.

(xv) In case of "Force Majeure", the Company may be allowed to sell the goods in the local market with the approval of the Honourable Minster of Finance on condition that the appropriate customs duty and other associated charges have been paid.

(xvi) A manufacturer participating in the Manufacture-in-Bond Scheme is expected to designate a warehouse or store in his factory premises for the storage of inputs and finished goods; and

(xvii) Import Duty Report (IDR), Clean Report of Findings (CRF), shall be clearly marked "MIB Scheme".

It is meant only for manufacturers of export goods to encourage exporters to boost their export market by issuing them NDCC if qualified for the payment of import duties on raw materials or parts whether prohibited or not but required for the manufacturing cycle of the export commodities. In order to prevent abuse by exporters, they are required to be bonded by their bank or an insurance company or NEXIM to the tune of 110 percent of the customs duty payable on each consignment.

(ii) Duty Drawback Scheme

The Duty Drawback Scheme provide duties/surcharges on raw materials including packing and packaging materials used for the manufacture of products upon effective exportation of the final product. The new Duty Drawback Scheme shall give automatic refunds (60 percent) on initial screening by the Duty Drawback Committee and upon the presentation of a Bond from a recognized Bank, Insurance Company or any other financial institution. The Bond will cover 60 percent of the refund to be made to the exporter and will only be discharged after the final processing of the application has been made.

At the end of the processing of exporters claims, the Duty Drawback Committee shall grant any balance where applicable or request for refunds for any overpayment made.

Duty Drawback Facilities

The Scheme provides for fixed drawback and individual drawback facilities. The fixed drawback facility is for those exporters/producers whose export products are listed in the Fixed Drawback Schedule to be issued from time to time by the Committee. When the import content of the export products is more or less constant, and import prices (including exchange rate), tariff rates and technology used are relatively stable or "fixed", it is possible to calculate a standard Input-Output Coefficient Schedule (ICS) for these category of products on the basis of which a fixed drawback rate can be computed to be rebated per unit of export product.

Whereas the individual drawback is for producers/exporters who do not qualify under the fixed drawback facilities, it is therefore a straight forward traditional drawback mechanism under which duty is paid on all imported inputs. The duties are subsequently, rebated on inputs used for export production.

As a general rule, the final exporter/producer can apply for the Scheme.

Eligibility

A trading company which collects industrial products from one or more manufacturers as well as a trading Company which imports raw materials inputs including packing and packaging materials used for the production of goods exported by him could also apply for the production of goods exported by him could also apply for the Scheme. Such trading Company must have entered into a contract with the final producer of the product in such a way that the Duty Drawback Committee can obtain necessary information and documents to enable the Committee act appropriately.

Applicants must be Companies incorporated in Nigeria.

Time Limit

Duty Drawback application must be filled within a maximum of two years from the date of exportation. In order to qualify for the drawback payment (both individual and fixed drawback) exportation of the product which was produced with imported inputs must be completed 18 months after the importation of the inputs.

Application Procedures

Applicants for either Fixed or Individual Drawback Facilities should file the following documents to the Duty Drawback Committee.

1. Completed new application form for Duty Drawback Rate /Refund obtainable from the Duty Drawback Secretariat and all Zonal Offices of the Nigeria Export Promotion Council.

2. Attach clear photocopies of the following documents in triplicates:

    (i) Import Bill of Entry for Home use (Customs and Excise Form C 188) for the respective raw material inputs used for the export production.

(ii) Import Bill of Lading for the raw material inputs used for the export production.
(iii) Letter of Contract agreement between the Trading Company and producer in cases where the Trading Company is applying for the facility.
(iv) Current Registration Certificate with NEPC.

3. In addition to the above documents, all applications for refunds should be filed with the following in triplicates:

   (i) Export Bill of Entry for Non-Domestic Goods (Customers and Excise Form Sale 98); and
   (ii) Form NXP.

4. Bank Bond to be issued by a recognized Bank or Insurance Company to the tune of 60 percent upfront payment approved by the Committee as duty drawback refund and to guarantee the refund of any overpayment made to the exporter.

Rules for Duty Drawback Application and Processing

The following rules have to be observed to simplify the processing procedures:

i. For the same export product defined in an export entry document, all inputs used to produce a given export article should be treated as part of a single application and therefore cannot be divided into separate duty drawback applications.

ii. If imported inputs, registered in a single import entry document are sub-divided and used for production of more than one export consignment, the import entry document should include information on the production of inputs and the balance remaining to be used.

From the above, you will note that the facility is in two states and it also provides for refunds where an export company collects locally (without importing), necessary raw materials including packing and packaging and tenders evidence of an export order. The refund shall only be for the duties/surcharges content of the cost of the local purchases in prosecuting an export order.

The Duty Drawback Scheme ceased in year 2003 since, according to the Committee, enough incentives already exist in the Export Expansion Grant Scheme.

- **Export Expansion Grant Scheme (EEGS)**

The Export Expansion Grant Scheme provides for cash inducement to exporters who have exported a minimum of five hundred thousand Naira (₦500,000) worth of processed products.

Objective

The objective of this Scheme is to stimulate exporters to expand the volume of their exports and diversify export product and market coverage.

Eligibility

Exporters of duly processed products are entitled to 4 percent grant on their total annual export turnover subject to the receipt of confirmation of repatriation of export proceeds from the Central Bank of Nigeria and subject to the presentation of a Performance Bond from any of the recognized Banks, Insurance Company, NEXIM or Financial institution.

Procedure

1. Application Forms for the Scheme could be obtained from the Headquarters of the Nigeria Export Promotion Council (NEPC) or any of its Zonal Offices at Lagos, Port Harcourt, Enugu, Jos and Kano. All forms should be accompanied with the sum of ₦5,000 (Five thousand Naira) in bank drafts payable to the Nigeria Export Promotion Council, Headquarters, Abuja, as non-refundable fees for the application forms.
2. The NEPC Committee on Export Expansion Grant reserves the right to approve or reject an application and could subject a Company for inspection to confirm the status of the export product(s).
3. Please note that, to facilitate the administration of the scheme, Government has approved the deduction of a ten percent (10%) processing fee on each grant approved.

Subject to tendering of the mandatory bond, evidence of repatriation of export proceeds by CBN and an application fee of N25,000, the EEGS Committee would process the application form for the refund of 4 percent of the exporter's annual turnover in NDCC.

The following is the new guideline for submission and processing of application under the scheme published by NEPC on 17th November, 2003 in the Guardian newspaper (Esezobor, 2009):

New Guidelines:

1. All applications must be on prescribed application form not later than 6 months from the date of repatriation of export proceeds.

2. Completed applications to be supported with:

   i. NXP form duly certified by processing bank and NCS;
   ii. Single Goods Declaration (SGD) form, duly signed by NCS (both at front and back);
   iii. Final commercial invoices;
   iv. Bill of Lading;
   v. Evidence of current registration with NEPC as an exporter;
   vi. Evidence of incorporation with Corporate Affairs Commission.

3. Applicants are to pay a non-refundable processing fee of N25,000 per application in bank draft payable to NEPC.

4. To avoid delays, applicants are advised to ensure that their applications are vetted by the Schedule Officer at NEPC when application is being submitted.

5. Only accredited employees of the benefiting companies will be allowed to collect the Negotiable Duty Credit Certificate. The annual accreditation of a maximum of 2 employees of a company is put at a sum of N100,000. As from 1st January, 2004, only duly accredited employees of the benefiting companies will be allowed to collect NDCC from the Council.

6. Applicants are to submit video clips of their production process, production lines, packaging and export prices.

7. These guidelines are with immediate effect.

On Tuesday, 17th August, 2004, the Secretary to the Federal Government announced the suspension of the scheme on the ground that since inception in 1986, $30 billion had been spent on it without any impact on the volume of exports. The suspension was lifted in 2006.

- **Export Development Fund Scheme (EDF)**

Export Development Fund Scheme is a scheme set up by the Federal Government of Nigeria to provide financial assistance to private sector exporting companies to cover part of their initial expenses in respect of the following export promotion activities.

(a) Participation in training courses, symposia, seminars and workshops in all aspect of export promotion. All local and overseas courses, study tours, including symposia, seminars, workshops, conferences, etc. in all aspects of export promotion organised by NEPC for the benefit of government agencies who have bearing with export promotion as well as exporting companies will be sponsored from the Fund.

(b) Advertising and publicity campaigns in foreign markets including Press Radio/Television, Catalogue, Brochures, etc. Grants may be made to exporting firms in the context of the total marketing plans towards the cost of advertising/promotional campaigns in overseas market, brand promotion, joint export market group promotion, point of sale materials and in store demonstration subject to the general conditions set out about and the regulations below:

i. The scheme applies only to promotional campaigns.
ii. The Scheme applies to markets in which the brand products have not previously been advertised and promoted.
iii. A draft of the proposed advertisement must be submitted to NEPC in advance for approval and also the report on the results of the campaign must be submitted as soon as the project is completed.
iv. The maximum grant to any company will be 50 percent of the total direct costs approved subject to a ₦200,000 (Two hundred thousand Naira).

(c) Export market research and studies.

(d) Product design and consultancy.

(e) Participation in trade missions, buyer-oriented activities, cost of collecting trade information.

(f) Cost of collecting trade information, and

(g) Backing up the development of export oriented industries.

Conditions for Financial Assistance

For any exporting Company to benefit, the following conditions must be satisfied:

i. The Company must be registered as an exporter with the NEPC.
ii. It must be an exporter of any product of Nigerian origin or services e.g. Engineering, Consultancy, Shipping, Communications, etc.
iii. It must have its marketing control in Nigeria.
iv. All applications for EDF assistance must be made in the prescribed application forms and must be accompanied with a detailed work plan of the project and a project document.
v. The Committee on EDF shall communicate to the exporter the amount of assistance that has been approved for the Company out

of which 50 percent shall be paid on presentation of a bond covering that amount by the Company.

vi. Exporters should submit a detailed report of their undertaken activities which should contain among other things evidence of expenditure related to the Company and arrange for the discharge of the Bond.

Export Market Research and Studies

Grants may be made to exporting firms towards the cost of undertaking market research studies in foreign markets and other studies related to export promotion subject to the general conditions set out above, and the regulations below:

i. The research proposal must be approved well in advance by NEPC.
ii. A copy of the report of the research must be submitted to NEPC on return.
iii. Grants up to 50 percent of the approved direct costs incurred or a maximum of N200,000.00 (Two hundred thousand Naira).
iv. Where NEPC carried out the research/studies on behalf of the Company / groups of companies, the total cost of such research will be met from the fund.

Products Design and Consultancy Grants

Grants may be for exporters towards the cost of engaging experts for product adaptation and designing. (Size weight, composition, packaging, labeling) of the products depending on the demand of the export market. Apart from the general conditions listed earlier on, the exporter must:

i. Submit to NEPC the project proposal well in advance for approval.
ii. Submit to NEPC a copy of the consultants report of the project.
iii. Grants payable will be 50 percent of the approved consultant's fees and expenses subject to a maximum grant of N200,000 (Two hundred thousand Naira).

Participation in Trade Missions, Buyer Oriented Activities, Overseas Trade Fairs, Exhibitions and Store Promotion.

Grants to the maximum of N200,000 (Two hundred thousand Naira) may be made to exporting companies towards the cost of undertaking approved fairs or exhibitions, etc. subject to the general conditions set out earlier on and the regulations below:

i. The activities must be manned by officials or agents of the company.
ii. All products to be exhibited and promoted must be an exportable product.

The cost of NEPC participation in any of these activities will be borne by the Fund. In case of buyer-oriented activities, the cost of sponsoring buyer from overseas to participate in local buyer-oriented activities will be borne by NEPC.

Backing up the Development of Export-Oriented Industries

The cost of undertaking studies in respect of setting up export-oriented industries will be covered from the fund. If NEPC is carrying out the studies, grant of 50 percent of the approved cost of studies or N200,000 (Two hundred thousand Naira) will be paid to exporting companies for the purpose of the studies.

2. Trade Procedures and Documentation.

The documentation aspect of exports which until recently, was handled solely by CBN, is now full-time job for an agent of NEPC called Nigeria Committee for Trade Procedures and Documentation (NITPRO). It is a committee comprised of representatives of NEPC, Customs and Excise, CBN and NEXIM with secretariat in the premises of NEPC.

NITPRO serves the following functions:

(i) To simplify trade procedures and documentation not only for exports but imports as well. In other words, they take stock of the direction of exports in particular, the companies into it, the amount involved and the record of the overseas buyers. Expectedly, their main form of operation is the NXP (the non-crude oil export form) which is sent to them from Customs and Excise for documentary analysis.

(ii) To educate Nigerian merchants on recent developments in the international markets.

(iii) To guide Nigerian merchants through seminars, workshops and other training programs on trade information.

(iv) To serve as an important link between merchants and government regulatory agencies.

(v) To also serve as a link and in the process, smoothen relationship between foreign trade agencies, merchants and the government.

(vi) To help Nigerian traders source dependable buyers for their products.

In performing the above-stated functions, the Nigerian economy gains in the following ways:

(a) Diversification of the export base from petroleum products. There are yawning markets for natural products which richly abound in Nigeria like palm products, cocoa, cassava, gum Arabic, ginger, soya beans etc. as well as manufactured products like insecticides, leather products, body creams, home-made videos, medicines, plastic products, fanciful attires and many other products.

(b) The public enlightenment program of Committee exposes traders to the requirements of foreign trade and how to go about it.

(c) It more serious hands can be put into the export sector, the economy will witness improved employment and increased volume of trade.

(d) Exports bring in foreign exchange; a scarce commodity needed to balance the equation of international payments.

(e) That the Committee's Officers in Apapa and Abuja are open to the public is a good omen for the future of the Nigerian economy because under-employed persons in full-time employment and workers looking for alternative jobs in self-employment throng in for information especially as the banks now seem to soften on credit to the export sector with the hope to be considered in the annual award of the "Best Bank in Export Financing" of the Merit Award Committee of the Bankers Committee.

(f) Their activities help to improve adherence to good ethical culture in international trade for Nigerian merchants which gradually will win for Nigeria, the respect it deserves in the international market.

3.3 Nigeria Export-Import Bank (NEXIM)

It was initially called Nigeria Export Credit Guarantee and Insurance Corporation (NECGIC) on formation in 1988 but changed to NEXIM by Decree No. 38 of 1991. Outlines of some of their main services are herewith reproduced from their pamphlet titled 'Guide for Exporters':

(a) Re-discounting and Re-financing Facility (RRF)

This is a facility designed to assist banks to provide pre-and-post-shipment finance in local currency in support of non-oil export. RRF enables exporter to have access to the increased / expanded export portfolio of banks at preferential rate.

(b) Foreign Input Facility (FIF)

The Foreign Input Facility provides the export sector with immediate foreign exchange requirement needed for importation of raw materials, packaging materials and capital equipment needed for production of goods for export. It is a facility made available in foreign currency and repayable in foreign exchange.

(c) ***Stocking Facility***

The facility is made available in local currency and it enables manufacturers of exportable goods to procure adequate local raw materials (which may be seasonal) needed to keep their production at optimal levels particularly during the period of scarcity of the raw material.

(d) ***Treasury Operations***

(i) Counter Guarantee Funds

Here, in fact, exporters who group themselves into associations (known as Mutual Export Guarantee Association – MEGA) contribute to a fund which NEXIM may apply as a counter guarantee fund for direct guarantee offered to banks on behalf of exporters.

(ii) Funds Management/Placement

NEXIM places funds with banks, which are known to be active in export finance on attractive terms for the banks in order to encourage them to continue supporting exports.

(e) ***Price Guarantee Contracts***

This is a financial instrument, which insures its holders/purchasers against adverse movements in price, exchange rate or interest rate. Exporters may have access to these facilities through commercial and merchant banks operating in the country. However, as far as advisory service and market information are concerned, exporters may approach NEXIM directly.

In another of their publication titled 'NEXIM at a Glance', two other services were added to their core facilities as follows:

Risk Bearing Services – NEXIM is also established to provide risk-bearing facilities to the export sector and to financial intermediaries engaged in exports. Some of the facilities to be introduced include:

- Export Credit Guarantee Facility (ECGF)
- Export Credit Insurance Facility (ECGIF)
- Investment Guarantee and Investment Insurance Facilities

- Inter-state Road Transit Scheme, to guarantee goods transiting Nigeria to other member states of the Economic Community of West African States (ECOWAS).

Export Advisory Service and Market Information – As an institution responsible for developing non-oil export, NEXIM aspires to become a reference institution for quality information on international commodity markets and other Export Credit Agencies and similar institutions around the world. NEXIM has a well-stocked library and the research department complements this by publishing periodicals, journals and handbooks for the guidance of exporters. The Bank also offers other miscellaneous services such as treasury services, etc.

Central Bank of Nigeria (CBN) – By the provisions of various laws in Nigeria, CBN remains the engine room in the management of foreign exchange. Some of these laws are:

- Banks and Other Financial Institutions Act No. 25, 1991.
- Central Bank of Nigeria Act No. 24, 1991.
- Foreign Exchange (Monitoring & Miscellaneous Provisions) Act No. 17, 1995.

That NEPC is the key institution that promotes exports and manages the incentives to exporters along with NEXIM and banks too, does not subtract from the fact that major policies pertaining to exports as well as imports, flow from the stable of CBN. A while ago, we saw that even the business of export procedures and documentation previously handled by CBN had been ceded to NITPRO, a Committee under NEPC.

Suffice it to say that CBN is still the overall boss in foreign exchange management and where some of its functions were transferred to other government establishments, it maintained its presence in the various Committees.

3.4 Nigeria Export Processing Zones (NEPZ)

NEPZ are geographical enclaves within the country designed by the federal government to achieve the following purposes:

i. To stimulate production for exports.

ii. To attract foreign and local investors who would do business free from the prevailing regimes on taxes, levies, duties, bureaucracy and any other form of bottlenecks.

iii. To diversify from petroleum oil, in foreign exchange earning capacity.

In a nutshell, NEPZ like NEPC and NEXIM is an additional incentive to exporters by the Federal Government to make the export market attractive.

The President of the Federal Republic of Nigeria on 22nd November, 2001 changed the name of Export Processing Zone to Free Trade Zone. However, the philosophy of NEPZ remains the same until a law is passed to give teeth to the change and possibly an enhancement of the facilities and incentives.

3.4.1 Functions of Nigeria Export Processing Zone Authority (NEPZA)

To put structures into place and ensure the successful implementation of the above objectives, the enabling law, NEPZ Act, 1992, Section 3, appointed NEPZA which according to Section 4, shall perform the following functions:

i. The administration of the Authority and management of all the Export Processing Zones.

ii. The approval of development plans of the Authority and Zones, the provision and maintenance of services and facilities.

iii. The establishment of customs, police, immigration and similar posts in the Zones.

iv. The supervision and coordination of the functions of various public sector and private sector organisations operating within the Zones and resolving any disputes that may arise amongst them.

v. The resolution of trade disputes between employers and employees in the Zone in consultation with the Federal Ministry of Employment, Labour and Productivity.

vi. The adoption of investment promotion strategies in the Zones, including the opening of Investment Promotion Offices abroad.

vii. The recommendation to the Federal Government of additional incentive measures for the Zones.

viii. The establishment and supervision of Zonal Administrations for the purpose of managing the Zones and the grant of all requisite permits and licenses to approved enterprises.

3.4.2 Incentives to Companies in the Zone

Companies duly registered in the Zones according to Section 18(1) of the Act, shall be entitled to the following incentives:

i. Legislative provisions pertaining to taxes, levies, duties and foreign exchange regulations shall not apply within the zones. Unfortunately, the Federal Inland Revenue Service (FIRS) has refused to honour this incentive citing the non-promulgation of an appropriate law for the Export Free Trade as an excuse.

ii. Repatriation of foreign capital investment in the zones at any time with capital appreciation of the investment.

iii. Remittance of profits and dividends earned by foreign investors in the zones.

iv. No import or export licenses shall be required.

v. Up to 25 percent of production may be sold in the customs territory against a valid permit, and on payment of appropriate duties.

vi. Rent-free land at construction stage, thereafter rent shall be as determined by the NEPZ Authority.

vii. Up to 100 percent foreign ownership of business in the zones allowable.

3.4.3 Approved Activities in NEPZ

Section 6 of the Third Schedule of the Act, which repeals that of 1991, lists the approved activities as:

i. Manufacturing of goods for exports.
ii. Warehousing, freight forwarding and customs clearance.
iii. Handling of duty-free goods (transshipment, sorting, marketing, packaging etc).
iv. Banking, stock exchange and other financial services, insurance and re-insurance.
v. Import of goods for special services, exhibitions and publicity.
vi. International Commercial Arbitration Services.
vii. Activities relating to integrated zones.
viii. Other activities deemed appropriate by Nigerian Export Processing Zone Authority.

3.4.4 Duty Free Articles

The Fourth Schedule, Section 12(3) lists them as follows:

i. Building materials
ii. Tools
iii. Plant
iv. Machinery
v. Pipes
vi. Pumps
vii. Conveyor belts
viii. Other appliances and materials necessary for construction, alteration and repair of premises.
ix. Capital and consumer goods, raw materials components of all articles intended to be used for the purpose of and in connection with reconstruction, extension or

repair of premises in the zones or for equipping such premises and any other items approved by the Authority.

3.4.5 Procedures for Registering an Export Processing Factory

They are as listed below:

1. Application should be made to Federal Ministry of Commerce.
2. Applicant must be a limited liability company.
3. Applicant must have registered with NEPC.
4. Factory should be open to inspection to ascertain that the necessary facilities to produce export goods are available and functional.
5. Factory should be for production of export goods only.
6. Applicant should have a domiciliary account in a bank to absorb export proceeds.

3.5 Other Export Incentives

The other export incentives are:

- ECOWAS Trade Liberalisation Scheme
- Tax Relief on Interest Earned by Banks
- Currency Retention Scheme
- Abolition of Export License
- Pioneer Status Scheme

1. ECOWAS Trade Liberalisation Scheme

It is a common policy of the 15 members strong Economic Community for West African States (ECOWAS) to promote intra trade amongst members with effect from 1st January, 1990.

To benefit from the incentive, exporters are expected to source at least, 40 percent of their raw materials locally or must have created 35 percent value-added to the export product. The export company is also expected to employ indigenes in the businesses.

The scheme is targeted at mounting a Common External Tariff (CET) for all member countries.

2. Tax Relief on Interest Earned by Banks

It is a fiscal relief to encourage banks to finance exporters. The incentive is graduated according to the tenor of the facilities granted starting from a minimum of 2 years with grace period (moratorium) as follows:

Term of Facility	Moratorium	Tax Exemption on Interest Earned
2 – 4 years	Minimum of 12 months	40%
5 – 7 years	Minimum of 18 months	70%
7 years and above	Minimum of 24 months	100%

Source: Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

The end-of-year accounts of an export financing bank should take record of all such advances and the tax relief on the interest earned as tabulated above.

3. Currency Retention Scheme

Exporters are allowed the freedom to retain 100 percent of their export proceeds in a domiciliary account to use as they please in furtherance of their business.

4. Abolition of Export License

Export business ranks under the preferred sector of the economy and is open to any serious-minded entrepreneur without the stress of export license as of old. All what the exporter needs to do is to visit the Nigerian Export Promotion Council to be briefed on export opportunities and necessary rules to ensure success.

5. Pioneer Status Scheme

To emphasise government's seriousness in export drive, any company that exports up to 50 percent of its turnover is granted tax holiday of between 1 and 5 years on the appraisal of the Nigerian Export Promotion Council and Nigerian Investment Promotion Council. In effect, a good exporter may never pay corporate income tax.

4.0 CONCLUSION

International trade is still a virgin area to most Nigerian businessmen. The few who are conscious of such a trade concentrate on the import aspect; hence Nigerians are quite happy to import all sorts of things from fruit juices we can easily produce to second hand items and appliances (Esezobor, 2009).

The non-monetary incentives appear quite attractive, if properly administered. Public awareness has to be stepped up to move the focus on international trade away from the importation to exportation, at least, to give strength to the local currency, the Naira.

The role of Nigerian Export Processing Zone is good for massive mobilization for the export market.

5.0 SUMMARY

In this unit, we have

- Discussed the two major operators of the Export Credit Incentive;
- Enumerated the types of Incentives;
- Stated and explained the role of Nigeria Export Processing Zones; and
- Listed and discussed the other Export Incentives available for exporters in Nigeria.

6.0 TUTOR MARKED ASSIGNMENT

1. (a) Describe the procedure for registering an export business with the NEPC.
   (b) What details must an exporter see to when negotiating an order with a prospective buyer?
   (c) List the sources for obtaining potential foreign buyers for groundnuts.

2. (a) List the facilities provided exporters by NEXIM.
   (b) What benefits accrue to the economy in sustained export drive?

3. Ikot Spring Water and Beverage Plc has just opened its ultra modern bottled water plant at Ikot Abasi, Cross River State and as part of its sales plan to export its products to the neighbouring countries of Gabon, Cameroon, Congo Democratic Republic, etc.

   The Finance Director, in a letter addressed to your Managing Director, made enquiries on the following and you are expected to draft the points for response:

   i The procedure for export in Nigeria.
   ii. Benefits of export to the Nigerian economy.
   iii. What is the procedure for registration as an export processing factory?
   iv. What are the benefits of an export processing zone? ***(Q. 6, April 2004, CIBN)***

4. In an attempt to reduce Nigeria's over-dependence on crude oil/natural gas export and thereby diversify her economic base, government promulgated the Export Incentives and Miscellaneous Provision Act, 1986 as amended by Act No. 65, 1992. This Act contains a package of incentives aimed at stimulating non-oil exports from Nigeria.

   Required:
   Mention 10 (ten) of such incentives by the government.
   (Q. 6(b), October 2008, CIBN)

7.0 REFERENCES AND FURTHER READINGS

Esezobor, E.A. (2009). International Finance (2nd edition). Lagos: The CIBN Press Limited, 7 Turton Street, Sabo-Yaba. ISBN: 978-37278-4-2.

UNIT 2 GLOBALIZATION

CONTENTS

1.0 INTRODUCTION

In the last unit, we discussed the two major operators of the Export Credit Incentive; enumerated the types of Incentives; stated and explained the role of Nigeria Export Processing Zones; and listed and discussed the other Export Incentives available for exporters in Nigeria.

In this unit, we shall be discussing globalization and its impact on the world economy.

2.0 OBJECTIVES

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

(i) define the concept globalization;
(ii) list the features of globalisation;
(iii) enumerate the arguments for and against globalization;
(iv) highlight the arguments against globalization;
(v) state and explain the challenges of globalization to the developing economies;
(vi) discuss the new international economic order.

3.0 MAIN CONTENT

3.1 What is Globalisation?

Yip (1989 quoted in Czinkota, Ronkainen and Moffett, 1996) define Globalisation as a business initiative based on the belief that the world is becoming more homogenous. Further, distinctions among national markets are not only fading but, for some products, will eventually disappear. As a result, companies need to globalise their international strategy by formulating it across country markets to take advantage of underlying market, cost, environmental, and competitive factors. Farley (1985) was of the opinion that globalisation differs from the multidomestic approach in the following ways:

1. The global approach looks for similarities among markets. The multidomestic approach ignores similarities.

2. The global approach actively seeks homogeneity in products, image, marketing, and advertising message. The multidomestic approach results in unnecessary differences from market to market.

3. The global approach asks, "Is this product or process suitable for world consumption?" the mutlidomestic approach, relying solely on local autonomy, never asks the question.

Globalisation, according to Gimba (2003) is a worldwide expansion of trade and investment aided by developments in communications, transport and technology. Since the 1980s, the world has experienced an upsurge in global trade. Some of the factors which have contributed towards this include:

1. The progressive lowering of trade barriers by governments all over the world in particular developing economies including that of Nigeria.

2. Removal of restriction on the movement of capital or foreign investment by most countries even socialist economies such as China, North Korea and Vietnam.

3. Improvements in telecommunications, transport and technology.

Quelch and Hoff (1986) therefore defined globalisation as the centralisation of decision making. According to them, changes in philosophy concerning local autonomy are delicate issues, and the "not invested here" syndrome may become a problem. It can be solved by utilizing various motivational policies:

1. Encourage local managers to generate ideas;

2. Ensure that local managers participate in the development of marketing strategies and programs for global brands;

3. Maintain a product portfolio that includes local as well as regional and global brands;

4. Allow local managers control over their marketing budgets so they can respond to local consumer needs and counter local competition.

Finding the balance between overglobalising and underglobalising is indeed difficult. While the benefits of cost reduction and improved quality and compeititiveness of products and programs are attractive, there are pitfalls that can leave the marketing effort catering to no one (Kashani, 1989).

3.2 Features of Globalisation

As observed by Ezeigwe (2002), the gospel of globalisation is mainly spearheaded by multinational corporations (MNCs) of mainly US and European origin. This is because these MNCs are the chief benefactors of this trend. MNCs freely move job-creating capital around the world with little or no regard to the interest of government or workers. The MNCs move the capital around the world, manufacture goods wherever they could find the best combination of price and quality, and distribute them whenever they could discover or create demand (Gimba, 2003).

The trend in corporate mergers since the 1990s show that a handful of corporate firms are busy carving up the world between themselves to the detriment of others (especially in developing economies of Africa).

3.3 Arguments for Globalisation

The Bretton Woods institutions, namely the International Monetary Fund (IMF); the International Bank for Reconstruction and Development (World Bank); and the World Trade Organisation (WTO), are actively promoting globalisation. IMF and World Bank sponsored policies such as Structural Adjustment Programmes (SAP) are used to open economies of developing countries like Nigeria to MNCs.

The WTO regulates world trade. Government of the industrialised economies like US, Britain, Italy, Japan, Germany, France, Canada, etc. are actively in support of globalisation since the benefiting MNCs are based in their economies at the expense of the third world economies (Gimba, 2003). Furthermore, they are also active promoters of the economic philosophy of free markets which underpins the phenomenon known as "Globalisation".

3.4 Arguments against Globalisation

The main opponents of globalisation are the Trade Unions. The unions in both the advanced and developing worlds are uncomfortable with globalisation particularly as it inflicts job losses on their constituencies without any warning; the growing and wholesome practice of casualisation of labour is very distasteful to labour.

Politicians are also uncomfortable with the trend since they can hardly enforce employment policies favourable to their constituencies or countries on the MNCs, who are always ready to transfer their capital or plant at the slightest provocation or threat from the host government. Furthermore, governments, particularly in the third world are fearful to hurt the interest of MNCs as such tendencies may induce capital flight.

3.5 Challenges of Globalisation to Developing Economies

The whole world has become an arena for competition among individuals, corporate firms and nation states. Nation states are challenged to harness their resources efficiently, corporate firms must demonstrate ability to manage resources efficiently or go under, while individuals are exposed to several opportunities the world market offers them as consumers, products and investors (Gimba, 2003).

It is commonly observed that developing countries like Nigeria lack the necessary ingredients to succeed in reaping the benefits of globalisation. It is argued that the developed economies and the MNCs are in better position to reap the benefits of globalisation. Globalisation is also seen as an imposition on developing economies since the global market does not offer a level playing field to participants. The industrial base in most of the developing economies is very weak and vulnerable or fragile to such type of competition. Several of them are weighed down by infrastructural problems, debt burden, high unemployment rate and other disabilities.

3.6 New International Economic Order (NIEO)

The New International Economic Order (NIEC) can be traced to the North-South dialogues and this has continued to dominate international meetings. The advanced (developed) countries represent one coalition. A second world is provided by the centrally planned economies of the former Soviet Union and her allies in Eastern Europe and mainland China. Banding together as the third world are the uncommitted "have not" nations: India, Brazil, Mexico, Argentina, Nigeria, Egypt and a lot of others.

Most of the affluent (rich) first world group is found in the temperate North while most of the third world are from the semi-tropical south therefore, the popular term North-South Dialogue. Most of these dialogues take the following caricature:

(a) **South** say we need more from the international economy, but **North** say work harder and save more.

(b) **South** argues that prices for our staples, oil, rubber, cocoa, sugar, uranium, tin, etc. are too low and therefore, let us form cartel like OPEC. Also, if OPEC can raise the price of oil, then let us form more cartels to force out a 'fair' price or we can use international buffer-stock pools to stabilize prices. But the **North** gospel is "have faith in the market".

(c) The **South** argues that Laissez faire is keeping us poor. However, **North** maintain that you should have some grant in aid (i.e. some World Bank long-term loans and IMF short-term loans/credits).

(d) The **South** say we want more and deserve more. We demand for a New International Economic Order (NIEO). To the **North**, the multinational or transnational corporations, if you give them a fair break on their investments, they will raise your

Technology (know-how), productivity, inflow of foreign capital, employment and real wages which will benefit you as they benefit themselves.

A very strong argument from the **South** is, note if they bribe our governments, appropriate for themselves our raw materials, keep us primitive, exploit our resources and labour, force on us technologies appropriate not for our stage of development as a third world but only for the affluent stage. To **North**, borrow from the experience of Japan, South Korea, Hong Kong and others. For **South**, you are not always listening and considerate!

3.7 Areas of Debate in the New International Economic Order

At various international meetings like the United Nations Conference on Trade and Development (UNCTAD), World Trade Organisation (WTO), etc. the developing countries have always pressed their genuine demands.

We can cite the following few new reforms that have received debate in different fora (Gimba, 2003):

1. Insistence on a code of behavour for multinational corporations (MNCs) and limitations on investment of key industries.

2. The rich countries (first world) to keep their markets open to rising exports from poor countries (third world). “Trade and not just aid”.

3. The rich countries to give outright aid amounting to at least 1 percent of their GNP. According to Samuelson (1981, quoted in Gimba, 2003), the US and Japan in the 1980s give less than a quarter of 1 percent. Scandinavia and Holland were better with almost 1 percent, while France, Canada, Belgium and UK came closer to half of 1 percent.

4. The ocean as a source of revenue to be turned over to the Less Developed Countries (LDCs) that is deep-sea fishing rents, oil royalties, profit tax on Manganese modules, other sea metals, etc.

5. Tax on brain drain from LDCs to developed countries (DCs).

6. Commodity stabilization pools like cartel of OPEC.

7. The IMF is to create new special drawing rights (SDRs) and give them to the poorer nations which are found mostly in the South.

All these provide a sample of controversies that have always bedeviled most discussions between North and South. While some have been resolved to a relative extent, some are still standing like ‘Iroko’ trees.

4.0 CONCLUSION

We note from the discussion so far that companies need to globalise their international strategy by formulating it across country markets to take advantage of underlying market, cost, environmental, and competitive factors.

5.0 SUMMARY

In this unit, we have,

- defined the concept globalization;
- listed the features of globalisation;
- enumerated the arguments for and against globalization;
- stated and explained the challenges of globalization to the developing economies;
- discussed the new international economic order.

7.0 TUTOR MARKED ASSIGNMENT

1. (a) What is meant by "Globalisation"?
   (b) What are the features of Globalisation?
   (c) State a case for and against Globalisation.

2. (a) What is the prospects of Globalisation?
   (b) To what extent can Nigeria benefit from the "hurricane wind" of globalisation?

3. (a) Trace the origin of New International Economic Order (NIEO).
   (b) What are the existing areas of contentions in NIEO today?

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