**AFRICA CENTER FOR PROJECT MANAGEMENT**

**DEPARTMENT OF PROJECT PLANNING AND MANAGEMENT**

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**INSTRUCTOR: MR. KAREGWA MUCHIRI**

**BY**

**MALISH BENJAMIN AMBAWA**

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**CERTIFICATE COURSE IN BUDGET FORMULATION, IMPLEMENTATION, MANAGEMENT & CONTROL**

**Instructions**

**Attempt all questions**

**All questions have equal marks**

1. How do MNCs come into existence? What steps may an MNC follow in becoming global?

Firstly, exporting may not be the best alternative because of trade barriers, perishability, or a need to produce a product tailored to the local market.

Secondly desire to have control over management, product quality, and patented processes. Sometimes the only way to get access to needed local resources, especially raw materials, is to build a local plant.

However, trade barriers or the needs of the local (foreign) market are much more common reasons for building foreign plants than the attraction of cheap labour. Examples of top ten multinational companies include; General Motors, Royal Dutch/Shell Group (Britain/Netherlands), Exxon, Ford Motor Company, International Business Machines (IBM), Toyota Japan), IRI (Italy – government-owned), British Petroleum (Britain), and General Electric.

On the other hand, there are several steps for the MNC to come global entity include:

The branches are the more straightforward way to expand to another country. Simply take some cash, get the pertinent business licenses, hire a localization team, and set up a branch in a foreign country. You obviously want to set up your branch in a busy, international area - for example, if you company is attempting to expand into South Sudan, you should set up in an office in Juba, and not the nether regions of Upper Nile or Bahr- el Gazal. You'll obviously pay more rent and taxes, but you must make sure your company is highly exposed to other businesses that matter, paving the way to future local partnerships.

Secondly, there is subsidiaries where the company is cash rich, then acquisitions may be a better strategy than establishing branches. Acquiring a local company for vertical or horizontal integration is fast and comparatively easy, if you plan to leave the original business intact. By making the acquired company subsidiary, the advantages of instant localization, name recognition and an experienced team at the wheel. However, homework before acquiring a subsidiary.

Joint venture, to purchase local companies due to the substantial price tag. Maybe a local competitor, which cannot be acquired, is already dominating the market. In this case, the saying "if you can't beat 'em, join 'em" comes into play. Establishing a joint venture, or a partnership with a foreign company in the same industry. Both companies set aside capital, resources and technology in a new, shared company which is separate from the main operations at both companies. This is a popular option in countries, such as China, where the law is extremely strict with foreign businesses. Joint ventures have all the advantages of foreign acquisitions - such as localization and brand recognition - at a fraction of the cost.

Franchises (charters) in foreign countries operate similarly to those in the United States. A foreign affiliate will purchase a license from the company to use your brand in a foreign country. While the foreign affiliate retains ownership of your branded business, the company will receive royalties from each franchise. Franchising is the cheapest option, and the fastest way to build an established presence in a foreign country with minimal risk. The higher risks (sales, profitability) are all absorbed by the foreign affiliate. However, foreign franchises must be monitored closely, since the geographic and cultural divide can mask steeping problems.

Consequently, turn key projects are more common in businesses requiring precise technological expertise - such as power plants, factories or oil drilling platforms. In this setup, your business sells its technological know-how to a foreign firm, which pays your company to build a modified copy of your plant to their specifications, from scratch to the operational stage. This includes all your technologies and trade secrets. Once the plant is completed, you hand over the keys to the fully working plant to the foreign firm. All they have to do is "turn the key" to get started. While selling factories is extremely profitable, you also forfeit your own direct expansion plans in the country, due to another firm already holding the license to your technology. This is the trickiest of the five criteria and the one you're least likely to encounter, unless your company specializes in mass production or resource exploration plants focused on developing markets.

2. Describe the different kinds of international financial flows.

Foreign direct investment occurs when an investor, gains some control over the functioning of an enterprise in another country. This typically takes place through a direct purchase of a business enterprise or when the purchaser acquires more than 10 percent of the shares of the target asset. Several factors affect the flow of foreign direct investment. Trade links between investor and recipient countries tend to increase foreign direct investment, as demonstrated by the establishment of Japanese auto plants in the United States starting in the 1980s. Proximity to foreign markets also plays a role, as shown by the investment of U.S. companies in China to service Chinese consumers and firms.

The political, economic, and legal stability of the recipient country also matters. Investors are reluctant to establish ownership of foreign companies or set up businesses abroad if corruption or political or social instability are likely to jeopardize operations. In 2002, foreign direct investment made up roughly one quarter of world capital inflows. About 40 percent of these flows went to the major industrial countries of the United States, Canada, the United Kingdom, Japan, and countries in the euro zone.

Portfolio investment occurs when investors purchase noncontrolling interests in foreign companies or buy foreign corporate or government bonds, short-term securities, or notes. This type of investment accounted for almost half of world capital inflows in 2002. Economic and financial conditions in the recipient and investor countries are important influences on portfolio investment flows. The market for these assets is typically more liquid than that for direct investments; it is usually easier to sell a stock or bond than a factory. As a result, investors can quickly reshuffle portfolio investments if they lose confidence in their purchases.

**Trade Flows:** Trade could possibly be associated with goods. On the other hand, it may be linked to services. The merchandise trade has two sides. While the first is export, the opposite is import. If a country exports different goods, it will get convertible currencies which will be an inflow of funds. On the other hand, it must make payments in convertible currencies for the imports it makes. Hence export and import of items result in international financial flows.

**Invisibles** consist of trade in services, investment income and unilateral transfers. If a shipping company has products of a foreign exporter/importer and receives the freight charges, it will likely be treated as inflow of funds because of trade in services. In the same way, if a foreign shipping company carries merchandise of an say an Indian exporter, it will be outflow of funds in form of freight charges. There are plenty of examples of international flow of funds resulting from trade in services.

Investment income refers to the receipt and payment of dividend, technical service, royalty, etc. If an international business operating in India remits dividend to its home country it will represent an outflow of funds. Unilateral transfers stand for international financial flows with virtually no services rendered. If an Indian gift something to his/her friend in USA, it will be an example of outflow of funds resulting from unilateral transfer.

**External assistance and external commercial borrowings** are different sum to financial flows. While External assistance normally flows from an official institution, external commercial borrowings flow from international banks or other private lenders. The rate of interest in the former is generally minimal as well as a longer maturity period. The latter has market interest rate and a faster maturity.

**Private loan flows** include all kinds of bank loans as well as other sector loans such as loans to finance trade, mortgages, financial leases, repurchase agreements, etc. They’ve been a fairly ignored category international cash flows but in existence.

3. Comment on the structure of balance of payments. What are the basic principles governing recording of the flows?

The balance of payments of a country is a systematic record of all its economic transactions with the outside world in a given year. It is a statistical record of the character and dimensions of the country’s economic relationships with the rest of the world.

According to Bo Sodersten, “The balance of payments is merely a way of listing receipts and payments in international transactions for a country.” B.J. Cohen says, “It shows the country’s trading position, changes in its net position as foreign lender or borrower, and changes in its official reserve holding.”

Based on the structure, balance of payments account of a country is constructed on the principle of double-entry book-keeping. Each transaction is entered on the credit and debit side of the balance sheet. But balance of payments accounting differs from business accounting in one respect.

In business accounting, debits (-) are shown on the left side and credits (+) on the right side of the balance sheet. But in balance of payments accounting, the practice is to show credits on the left side and debits on the right side of the balance sheet.

When a payment is received from a foreign country, it is a credit transaction while payment to a foreign country is a debit transaction. The principal items shown on the credit side (+) are exports of goods and services, unrequited (or transfer) receipts in the form of gifts, grants etc. from foreigners, borrowings from abroad, investments by foreigners in the country and official sale of reserve assets including gold to foreign countries and international agencies.

The principal items on the debit side (-) include imports of goods and services, transfer (or unrequited) payments to foreigners as gifts, grants, etc., lending to foreign countries, investments by residents to foreign countries and official purchase of reserve assets or gold from foreign countries and international agencies.

Additionally, credit and debit items are shown vertically in the balance of payments account of a country according to the principle of double-entry book-keeping. Horizontally, they are divided into three categories: the current account, the capital account and the official settlements account or the official reserve assets account.

Fist, current account of a country consists of all transactions relating to trade in goods and services and unilateral (or unrequited) transfers. Service transactions include costs of travel and transportation, insurance, income and payments of foreign investments. Transfer payments relate to gifts, foreign aid, pensions, private remittances, charitable and donations, received from foreign individuals and governments to foreigners. In the current account, merchandise exports and imports are the most important items. Exports are shown as a positive item and are calculated f.o.b. (free on board) which means that costs of transportation and insurance are excluded. On the other side, imports are shown as a negative item and are calculated c.i.f. (costs, insurance and freight) and included. The difference between exports and imports of a country is its balance of visible trade or merchandise trade or simply balance of trade. If visible exports exceed visible imports, the balance of trade is favorable. In the opposite case when imports exceed exports, it is unfavorable. Lastly, services and transfer payments or invisible items of the current account that reflect the true picture of the balance of payments account. The balance of exports and imports of services and transfer payments is called the balance of invisible trade.

The invisible items along with the visible items determine the actual current account position. If exports of goods and services exceed imports of goods and services, the balance of payments is said to be favorable. In the opposite case, it is unfavorable. In the current account, the exports of goods and services arid the receipts of transfer payments (unrequited receipts) are entered as credits (+) because they represent receipts from foreigners. On the other hand, the imports of goods and services and grant of transfer payments to foreigners are entered as debits (-) because they represent payments to foreigners. The net value of these visible and invisible trade balances is the balance on current accounts.

Consequently, capital account of a country consists of its transactions in financial assets in the form of short-term and long-term lending’s and borrowings and private and official investments. Or, the capital account shows international flows of loans and investments and represents a change in the country’s foreign assets and liabilities. Long-term capital transactions relate to international capital movements with maturity of one year or more and include direct investments like building of a foreign plant, portfolio investment like the purchase of foreign bonds and stocks and international loans. On the other hand, short- term international capital transactions are for a period ranging between three months and less than one year. Here, two types of transactions in the capital account, vis private and government. Private transactions include all types of investment example, direct, portfolio and short-term. Government transactions consist of loans to and from foreign official agencies. In the capital account, borrowings from foreign countries and direct investment by foreign countries represent capital inflows. They are positive items or credits because these are receipts from foreigners. On the other hand, lending to foreign countries and direct investments in foreign countries represent capital outflows. They are negative items or debits because they are payments to foreigners. The net value of the balances of short-term and long-term direct and portfolio investments is the balance on capital account. The sum of current account and capital account is known as the basic balance.

Additional to that, official settlements account or official reserve assets account is, in fact, a part of the capital account. The official settlements account measures the change in nations’ liquidity and non-liquid liabilities to foreign official holders and the change in a nation’s official reserve assets during the year. The official reserve assets of a country include its gold stock, holdings of its convertible foreign currencies.

Lastly, Errors and omissions is a balancing item so that total credits and debits of the three accounts must equal in accordance with the principles of double entry book-keeping so that the balance of payments of a country always balances in the accounting sense.

4. How can the trade deficit be reduced or eliminated? Give your arguments based on the elasticity approach,

Trade deficit refers to situation where a country imports more than what it exports. Definition by Adam smith. There for there are three ways in which a country reduce trade deficit as discussed below.

First, consume less and save more. Here the businesses save more than they spend, imports will drop and less borrowing from abroad will be needed to pay for consumption. This means that consumption taxes like those that nearly all other countries in the world have could help reduce the deficit, by discouraging consumption, increasing saving, and reducing the government deficit. In contrast, an unfunded tax cut, such as the one proposed by the administration, will expand the deficit because the government will be consuming more relative to its earnings.

Second, Depreciate the exchange rate. Trade deficit reversals are typically driven by a significant real exchange rate depreciation. A weaker dollar makes imports more expensive and exports cheaper and improves the trade balance. Given the dollar is the world's reserve currency, and still regarded as the safest for investors, it tends to run stronger than other currencies. But when foreign governments actively push the dollar up to maintain their surpluses, the United States could counteract intervention by selling dollars and buying foreign currencies. The administration could also encourage the adoption of other major currencies, such as the shillings, birr, and South Sudan pounds, as alternative reserve currencies. A weaker dollar would be good for the US economy but relinquishing the role as the dominant currency would reduce the power of the United States in global markets and the revenue earned.

Thirdly, Tax capital inflows. One of the reasons that a country rounds a trade deficit is because borrowing from abroad is cheap and easy. If it were more expensive, citizens and the government would borrow less. A tax on (non–foreign direct investment) capital inflows that rises with the size of the inflow could reduce excessive borrowing for consumption and help close the government imbalance. While some worry that capital controls could distort asset prices and reduce investment, they could also curb excessive speculative investment, such as happened before the financial crisis.

However, consume less and save more, depreciate the exchange rate and tax capital inflow reduces the trade deficit in an economy.

5. Why are MNCs driving investments in South Asian Countries like Thailand, Malaysia and Indonesia?

There are reason as to why multinational companies move their investment to words South East Asian countries are discussed below.

First due to macro-economic reforms/performance of South Asian countries.Till the late 1960s, most of the developing economies, including those of East Asia, adopted closed macroeconomic policies with import substitution industrialization policies,

under which self-reliance and indigenous efforts were encouraged. At the same time, a

dominant role was assigned to the state in the development process. These import substitution

strategies, coupled with the large public sectors, resulted in rent seeking activities and

uncompetitive production processes. Therefore, export-led industrialization and liberalization was advocated to make the production process efficient and competitive. Following the export-oriented growth argument and the success of East Asian countries with higher exports and economic growth during the period from the early seventies to mid-nineties, most of the South Asian countries started opening up their economies from the early eighties. The South Asian

economies are currently enjoying the benefits of economic reforms, particularly reforms related

to trade and investment. These countries undertook reform processes and opened up their

economies after having experienced sluggish growth rates throughout the seventies and

eighties.

Secondly, Foreign investment is permitted in virtually every sector, except those of strategic

concern such as defense and transport. Foreign companies are permitted to set up 100

percent subsidiaries in India. No prior approval from exchange control authorities (the Reserve

Bank of India, or RBI) is required, except for certain specified activities. Under current policy,

FDI can come into India in two ways

Thirdly, Taxation Policy in Thailand, Malaysia and Indonesia offer Tax Incentives. Thy are moving towards a reform of its tax policies and systems to facilitate the globalization of economic activities. Tax holidays are available in Special Economic Zones set up to make industry globally competitive. Infrastructure Sector Projects enjoy special tax treatment and holidays. Since 31 March 2004, a user-friendly tax administration has been introduced with round-the-clock electronic filing of customs documents.

Fourthly, foreign nationals working in Thailand are generally taxed only on their Thai income. Income received from sources outside Thailand is not taxable unless it is received in Thailand. Further, foreign nationals have the option of being taxed under the tax treaties that Thailand may have signed with their country of residence.

However, Though the Indonesia, Thailand and Malaysia governments give different kinds of investment incentives, major incentives are given in the form of tax exemptions on profit from the development and operation of infrastructure projects

including power.

6. Why are China and India emerging as attractive centres of FDI in recent years?

The china and India economic stature of is widely recognized, the factors underlying their success are in foreign direct investment are as follows:

To begin with, there is advantage of a large low-wage workforce, this has attracted many investors to the economy of China and India. These resulted to high-quality high-technology goods and services and to create innovative new products and technologies. To appreciate the long-term potential of China and India, we need to take a comprehensive look at their innovative capacity. Here, China and India are the two most populous countries, accounting for 20.4% and 17.0% of the world’s population. Although they are still developing countries with per capita incomes of just $1,740 and $720 (2005), they already are the fourth and eleventh largest economies in the world at nominal exchange rates. However, in terms of purchasing power parity (PPP), they already have been for some time the second and fourth largest economies. Moreover, they are growing more than three times faster than the world average. Even though the percentage of persons with higher education in their populations is still low by developed country standards, because of their enormous size, they have a critical mass of highly educated people and of scientists and engineers. In addition, they have a critical mass of expenditures on research and development (R&D). As a result, they have a large innovation capacity that is being deployed not only for their own needs but also to perform R&D for multinational companies. They are becoming increasingly important players on the global stage.

Innovation in China and India should be understood to include not just knowledge that is new to the world, but also knowledge that is new to these countries. It is important to consider this second dimension of innovation because it helps to understand why these economies are growing so fast and how rapidly they are likely to grow in the future.

Consequently, China and India illustrious histories are among the world’s oldest civilizations, stretching back three to four millennia. To put their current rising prominence in perspective, it is useful to briefly review their relative importance over the past two millenniums. For most of the first millennium AD, China and India accounted for a quarter and a third of total world economic activity. During the last 200 years of the first millennium and for most of the second millennium they lost prominence with the rise of Japan and Western Europe. This loss of relative economic size was particularly rapid in the past 250 years, a period of rapid economic growth in Western Europe, the United States, and Japan. The main reason for this was not that their economies collapsed, but that they missed the Industrial Revolution. Thus, they did not benefit from the rapid growth that came to the countries that pioneered and quickly adopted industrial production technology. Thus, in their success stories has lied the based for inflow of foreign direct investment in their countries.

Not only that rapid rise in global gross domestic product (GDP). In the past 25 years China and India have been rapidly increasing their share of global gross domestic product (GDP). To a large extent it is because they are tapping into global knowledge and integrating themselves more into to the global economy. They are reemerging as major global players. Thus, above attributes lead to inflow of foreign direct investment. As well in the middle of the 20th century both countries underwent a radical regime change. India won its independence from England in 1947, and Mao’s communist revolution triumphed in China in 1949. Initially, both countries followed a development strategy heavily influenced by Russia, including five-year industrial development plans marked by state control of the economy and strongly autarkic trade policies.

More so, China began to move to a market economy and to open itself up to the rest of the world in the late 1970s. Its pace of reform speeded up in the 1980s and the 1990s. This included the proliferation of special economic zones, increasing receptivity to direct foreign investment, and the decision to join the World Trade Organization in 2001. Since then, the movement to a market economy has accelerated with the growing recognition of private property rights and rapid integration into the world’s trading system. China is now a major global player on the world trade and investment scene. The speed, scope, and scale of its entry into the global system are unprecedented in economic history. It has been growing at 8% to 10% per year since the late 1970s and has become the third largest exporter of merchandise goods. It has earned the reputation as the manufacturing center for the world. Thus, lead to inflow of foreign direct investment in China.

One of the reasons for China’s faster growth has been its much higher investment rate. In the past 10 years, for example, investment has averaged 36% of GDP in China and 25% in India’s. Another reason for China’s high per capita income growth is that as a result of its one-child policy, its average annual population growth during the period 19902004 was only 0.9%, compared with India’s rate of 1.7 %. Demographers project that by 2040 India will surpass China to become the world’s most populous country.

As a result, of India’s much higher population-growth rate, the population age pyramid is much wider at the bottom in India than in China or the United States. Nearly one-third of the population in India is less than 15 years old. China will be facing the challenge of a more rapidly aging population and a rapidly increasing dependency ratio. India has the demographic surplus of much younger population, but it needs to educate that young population to reap its benefits. Both China and India are still largely rural economies— 60% of the population in China, 71% in India.

The rapid per capita growth rate in China has helped to lift many people out of poverty. The share of persons below the international poverty line of $1day has been reduced to just 17% in China. In India the share of persons below the $1/day poverty line has also been reduced, but to 35%. In addition, in both countries a large share of the population is just barely above this poverty line. The percentage earning less than $2/day 47% in China and 52% in India. Moreover, there has been a significant increase in inequality as result of rapid and uneven growth. In China, the gini coefficient (a measure of income inequality that ranges from 0 for perfect equality to 1 for complete inequality) has increased from 0.30 in 1990 to 0.45 in 2000, which is higher than the U.S. rate. In India is was just 0.32 in 2000, but it is most likely to have been increasing over the past five years because of India’s recent unevenly distributed growth.

China has advanced much more rapidly than India in improving literacy and overall educational attainment. Literacy in China is 91%, but only 61% in India. The average educational attainment of the Chinese population 15 years old and above in 2000 was 6.4 years in China and only 5.0 in India (compared to 12 in the US and most other developed countries). Moreover, in the past 10 years, China has been investing very heavily in expanding its higher education system. China raised its tertiary enrollment rate from 5.3% of the population of the tertiary age cohort in 1995 to 19.1% by 2004. India, on the other hand, increased its rate from 6.6% in 1995 to 11.8% by 2004. The tertiary enrollment rate in the US is 82.4%, one of the highest in the world. However, as of 2005 there were a greater absolute number of tertiary students in China than in the United States, and 40% of them were studying math, science, or engineering.

The overall quality of tertiary students from China and India is still very low. Nevertheless, the graduates of the best institutions are very capable and are one of the main reasons why there is so much foreign investment in R&D facilities by U.S. companies in China and India. Also, the large number of Indian graduates who are fluent in English has been one of the main reasons for India’s reputation as the source of off-shored services than can be delivered over the Internet.

The Chinese economy has undergone significant industrial restructuring over the past 25 years. Agriculture’s share of GDP has fallen to 13%, while industry’s share has risen to 46% one of the highest percentages in the world. The Indian economy has not undergone such drastic structural change. Agriculture’s share of GDP is still 21%, and industry’s share is just 27%. In fact, the share of the manufacturing sector has not changed over the past 20 years. However, there has been a significant growth of the service sector. Part of this has been forced growth of self-employment in low-value service activities because the modern sector of the economy has not been able to absorb the rapidly growing labor force. However, there has been a rapid increase in high-value business services. These include not just offshore services, but also the establishment of many banking and consulting service operations in India, including many managed by major multinational companies such as General Electric, IBM, other technology firms, and investment banks.

7. What is internationalization theory of FDI? Discuss strengths and weaknesses of the theory?

Foreign direct investments are firms which operate across national boundaries replace various market functions with internationally, transactions whenever the "cost" of international transactions is less than the "cost" of market internal transactions. Internationalized transaction will arise in the presence of imperfections or failure in domestic markets. International markets encompassing the various activities with which a firm is involved may be difficult to organize, monitor and control.

The strength is that When companies are in multiple countries around the world, they are strengthened by the different cultures they are exposed to daily. We all have something to teach each other if we’re willing to listen. The international business has a natural advantage because the differences of each culture make it stronger while exposing their products or services to more overall people.

**The visibility of the business brand will increase.** When a company’s market can expand, the visibility of its brand expands along with it. A growing international presence will therefore also make it easier in the future to continue expansion opportunities because of the increased brand recognition. This helps a business be able to recruit locally, negotiate better deals with distributors, and create media contacts that will help continue the marketing push.

**Increased Sales when customers are exposed to a business.** It is rather easy to recruit an international sales force these days. From suppliers to distributorships to the internet, marketing can happen at a local level better than ever before in almost every corner of the world. This increased localization helps to establish local relationships, develop customer loyalty, and ultimately promote an increased level of sales.

**Minimal competition is attained.** While it seems like it would be the opposite of this, there is less competition for a business that can expand internationally. This is because a good product that sells well will devalue internal competition. There will always be customers who desire the local shops over an international business, of course, but more markets internationally mean a greater global market share and that drives away the competition.

**Work force is shared,** instead of company stakeholders involving themselves, it is possible to expand internationally by bringing in agents and distributors who can do the work. Some businesses forge partnerships with local companies to help balance their risks, like a joint venture or a franchise. It might even be possible to manufacture goods through an international subsidiary to further limit risk.

**It reduces vulnerability to changing trends.** Business trends change from time to time. Customers tend to work in mobs more than individuals because everyone likes to be popular. An international business is guarded against the changing trends of business because there is more access to markets within their targeted demographics. If a product isn’t popular due to changing trends in one market, it may be in high demand somewhere else, allowing the international business to transfer their inventory.

**It creates timing differences in accelerating business operations coefficients.** A business with an international presence must deal with the different time zones that exist on the planet. You know the saying that it’s always 5 o’clock somewhere? It’s true. It also means that when it is 8am in Seattle and you’re just getting to work, it’s 11pm in Singapore where your other business might be. The changes in hours can make it difficult for an international business to coordinate.

**Language can become a tremendous barrier.** If a business is entering into a new market, especially a new business, then the local language can become a barrier toward success. This barrier is slowing coming down with apps and software that translate words into a workable language, but this technology is still very imperfect. What a small business owner may think is a compliment might be a grievous insult.

**Currency fluctuations can eliminate profits.** American companies experienced this in 2015. With the dollar strengthened against the Euro at near historical levels, anticipated profits suddenly disappear based on the fluctuations of value in international currencies. There might also be fees in currency exchanges, especially through credit card transactions, that further dip into the profit margins. When the home monetary unit trades lower, it’s better for business, and that isn’t always better for the consumer.

**There is no possible way to ignore local politics.** The political environment internationally can look very different than the domestic political environment. It isn’t uncommon for international governments to seize control of a business if they determine it is their best interest to do so. Should that happen, the entire operational profits can disappear, yet there would still be an expectation to work and function as normal. Not every country lets a company operate as it wants, so this must always be considered.

8. Gold standard provided domestic price stability and automatic adjustment in balance of payments and in exchange rate. Discuss.

Standard refers to a country’s money supply was linked to gold. The necessity of being able to convert fiat money into gold on demand strictly limited the amount of fiat money in circulation to a multiple of the central banks’ gold reserves. Most countries had legal minimum ratios of gold to notes/currency issued or other similar limits. International balance of payments differences was settled in gold. Countries with a balance of payments surplus would receive gold inflows, while countries in deficit would experience an outflow of gold.

Theoretical, international settlement in gold meant that the international monetary system based on the Gold Standard was self-correcting. Namely, a country running a balance of payments deficit would experience an outflow of gold, a reduction in money supply, a decline in the domestic price level, a rise in competitiveness and, therefore, a correction in the balance of payments deficit. The reverse would be true for countries with a balance of payments surplus. This was the so called price-specie flow mechanism set out by 18th century philosopher and economist David Hume.

Additional to that, the underlying principle of how the Gold Standard operated, although in practice it was more complex. The adjustment process could be accelerated by central bank operations. The main tool was the discount rate which would in turn influence market interest rates. A rise in interest rates would speed up the adjustment process through two channels. First, it would make borrowing more expensive, reducing investment spending and domestic demand, which in turn would put downward pressure on domestic prices, enhancing competitiveness and stimulating exports. Second, higher interest rates would attract money from abroad, improving the capital account of the balance of payments. A fall in interest rates would have the opposite effect. The central bank could also directly affect the amount of money in circulation by buying or selling domestic assets though this required deep financial markets and so was only done to a significant extent in the UK and, latterly, in Germany. This elastic balances in interest rate regulation adjusts the BOP of the country under gold standards.

More to that there is ‘rules of the game’ is a phrase attributed to Keynes (who in fact first used it in the 1920s). While the ‘rules’ were not explicitly set out, governments and central banks were implicitly expected to behave in a certain manner during the period of the classical Gold Standard. In addition to setting and maintaining a fixed gold price, freely exchanging gold with other domestic money and permitting free gold imports and exports, central banks were also expected to take steps to facilitate and accelerate the operation of the standard, as described above. It was accepted that the Gold Standard could be suspended in times of crisis, such as war, but it also was expected that it would be restored again at the same parity as soon as possible afterwards. This also adjusts the BOP of the country.

9. Mention the features of the fixed parity system of exchange rate. What were the causes behind its collapse?

In fixed exchange rate system exchange rate is fixed by the government in relation to other currencies. Rate may be fixed against a dominant currency like USD or Kenya shillings a bucket of currency. The features include the following.

To begin with, fixed exchange rate system is controlled by the government and not by the market forces. However, government does consider the market condition while fixing the rate under this system.

Secondly is its Stability, this system offers high degree of stability because the exchange rate is fully controlled by government. Hence back market is regulated.

Not only that it is Strictly Controlled exchange rate system, this system works under the strict exchange control by the central bank of the country. Monitoring the black market, and money laundering is closely monitored.

Consequently, Periodical Change fixed systems do not mean that rate are fixed forever, the rate are periodical changed by the regulator keeping in view the market demand and other factors. All the changes are monitored against inflation.

Last but not the least, Parallel Market refers to unofficial trade in currencies.Neither the rate is controlled by the market forces therefore there is fair chance of developing a parallel market and advantages of this system may be at stake.

On the hand the main factors that led to the collapse of this system were as follows:

Elaboratively, there is confidence Problem, by the end of 1950’s many European countries were having BOP surpluses and the USA was running counterpart deficit. For the continued economic expansion, it was essential for the United States to maintain this deficit as it was the only way through which the growth of international reserves could be sustained in the absence of any other reserve asset including gold. In the event, the USA continued to run bigger and bigger deficits while its gold assets remained constant. It was just a matter of time when the foreign holders of dollars, including central banks, doubted the ability of the United States to maintain the price of gold at $ 35 per ounce and rushed to convert dollars into gold before the dollar was devalued. Similar crises of confidence continued to occur during the 1960’s. Britain faced in 1967 a continuing BOP deficit and dwindling official reserves creating the expectations of devaluation of pound. The outflow of funds from England put pressure upon the pound sterling and led eventually to the devaluation of pound sterling in November 1967. A similar episode occurred in 1968-69. The persistent BOP surplus of West Germany led to widespread expectation of upward revaluation of the Mark.

Another setback is the issue of Seigniorage: this refer to the situation where government accrue profit by issuing money based on the face value of the coin.It was argued that the Bretton Woods System gave rise to the seigniorage of the United States over other countries, since dollar became the international reserve currency that conferred some undue privilege upon the Americans. The question of seigniorage arose because the United States was the issuing country of dollar. On the other hand, another country that wanted to increase its holding of dollars could do so only by creating an export surplus by forego real resources in exchange for the dollars. The central bank of the United States could obtain a much higher rate of return for dollars from the foreigners than what it could obtain in the home country. The existence of seigniorage was the cause of irritation among some of the countries including France and the third world countries. This factor, in the long run, undermined the Bretton Woods System.

Furthermore, Adjustment in (balance of payment) BOP mechanism poses a Problem. To the long run point of view, a serious of weakness in the Bretton Woods System was the absence of an efficient balance of payments adjustment mechanism. No country can afford to have a persistent BOP deficit. The principal types of adjustment mechanism include adjustment through changes in relative incomes, through relative price changes, through the movements in exchange rates and through the imposition of direct controls over foreign transactions. The Bretton Woods System almost prohibited the use of direct controls. About exchange rate variations, the system prescribed that exchange rate should be held stable with scope only for ±1 percent variation unless a fundamental disequilibrium warranted a greater degree of variation. So, the crucial issue was to determine whether the disequilibrium was temporary or fundamental. The operational difficulty had been the timely recognition of the presence of fundamental disequilibrium. There was a general tendency among the member countries of IMF to resist changing the par value of the currency. Devaluation was often opposed on the ground that it amounted to the acceptance of the failure of government policies and also on account of loss of national prestige. The upward revaluation was frequently opposed by the export industries of the surplus countries. The alternative adjustment mechanism through changes in prices and incomes was found to conflict with the domestic goals of full employment and price stability. The adjustment through quantitative controls was opposed because of possible distortion of resource allocation and reduction in economic efficiency. In such circumstances the countries adopted wait-and-see policy rather than taking a decisive and speedy action for BOP adjustments. The undue delay led to an aggravation of maladjustment and deepening of the BOP crisis. However, this led to the collapse of the fixed exchange parity.

Not only that there is bottle neck in Triffin paradox which refers to skirmish of economic interest between short term domestic and long term international aims for countries whose money serve as global reserve notes. Historically, a serious inbuilt contradiction in the system was exposed by Triffin as early as 1960. It is often referred as “Triffin dilemma” say either the United States corrected its deficit and created a liquidity shortage, or it continued to run the BOP deficit. The latter alternative could only cause the crisis of confidence. The existence of this dilemma clearly showed that the system was intrinsically unbalanced and was meant to collapse.

Again, to that there is Problem of Symmetry. was a general problem of balancing between deficit and surplus countries or between the USA and the rest of the world. Although the Bretton Woods System intended that both deficit and surplus countries should share the burden of adjustment in payments imbalances, yet the brunt of adjustment fell practically entirely upon the deficit countries. While the surplus countries could continue to run surpluses so long as they were willing to accumulate reserves, the deficit countries could not run down their reserves indefinitely. This asymmetry between the deficit and surplus countries exposed a serious weakness in this system exchange parity and became partly responsible for its eclipse.

Calmingly, The Liquidity termed to Problem in fixed exchange parity. **o**ne of the predominant causes of the breakdown of the Bretton Woods System was the problem of liquidity. Any system of fixed or stable exchange rate could work efficiently only if there were sufficient international reserves. During the 1950’s and 1960’s, the U.S. deficits in BOP continued to increase on account of overseas investments and escalation of Vietnam War. The European countries and Japan at the same time could create surpluses in their BOP.

The U.S. balance of payments deficit could be financed by either the export of gold or through the acquisition of dollars by the foreign surplus countries. In either of the two cases, the United States reserves deteriorated. The rest of the world continued to have large demand for dollars for making the BOP adjustments among themselves as dollar was the key currency. Even for maintaining the exchange rates stable in terms of dollars, countries started keeping a large fraction of their international reserves in the form of dollar balances and the short-term dollar securities. Apart from persistently increasing demand for dollars, this currency also emerged as the principal ‘intervention currency’ a currency which monetary authorities bought or sold in foreign exchange markets to keep exchange rates within +/-1 percent margin round the par values. However, the problem of liquidity continued to become grave raising the worldwide expectation of the impending devaluation of dollar. But since other countries were tied to the dollar, that did not permit the United States to make readjustment of the exchange rate of dollar with other principal currencies. Hence led to collapse of the fixed exchange parity.

Another one is Speculation and Short-Term Capital Movements.After the development of Euro-dollar market in the late 1950’s, there was rapid growth of highly mobile short-term capital. The anticipated changes in par values on account of heavy pressure upon dollar resulted in large scale speculative capital. It led to the speculative capital movements from the United States to other surplus countries such as Germany, Japan and Switzerland. These large-scale capital movements were bound to have destabilizing effect upon exchange rate as well as the BOP adjustments. Hence it led to collapse of the fixed exchange parity.

**Purely, Conditions of Inflation, this refers to drastic fall in the domestic currency with prices of goods and services.** An important factor to cause the collapse of the Bretton Woods System was the domestic inflation in the United States particularly after the escalation of Vietnam War from 1965. Both Johnson and Nixon administrations were unwilling to finance the war efforts by increased taxes. Instead easy money policies were pursued.These policies intensified inflation in the United States and the balance of current account got weakened. The surplus countries of Europe feared the transmission of inflation to their own countries, when their balance of payments surpluses had been bringing about an increase in their money supplies. Hence led to the collapse of fixed exchange rate parity.

10. Do you agree that fixed exchange rate is better than floating rates? Explain.

Despite the weakness of the fixed exchange parity indeed it has some advantages that deserve mentioning as below.

To begin with, there is elimination of Uncertainty and Risk. The necessary condition for an orderly and steady growth of trade demands stability in exchange rate. Any undue fluctuations in exchange rate cause problems to the plans and programmes of both exporters and imports. In other words, incomes of export-earners and the cost of imports of the importers tend to become uncertain if the exchange rate fluctuates. This uncertainty can be removed by a fixed exchange rate method. Further, the risks associated with international trade and investment get minimized largely if exchange rates are not allowed to vary.

Another advantage is that Speculation Deterred/ Discouraged. As exchange rate re­mains unchanged for a fairly long period of time, people expect that such rate would not change in the immediate future. This then eliminates speculation in the foreign exchange market. Further, as stability in the exchange rate over longish period eliminates the threat of speculation, it discourages the flight of capital. In a world of free fluctuating exchange rate, the danger of the flight of capital is rather high as this kind of exchange rate induces people to speculate. As exchange rates remain fixed, traders have a sense of confidence that international payments can be made safely without the danger of losses.

Not only that, it Prevents Depreciation of Currency. In poor developing countries, one experiences BOP difficulties of a permanent type. Under the circums­tances, any frequent changes in exchange rate will tend to aggravate the BOP crisis, like continuous depreciation of home currency in terms of curren­cies of other countries. In other words, unstable exchange rates result in depreciation of currencies. This can be prevented by the stable exchange rate.

Consequently, there is adoption of responsible Macroeconomic Policies in place. Stable exchange rate system prevents government from adopting irresponsible macro- economic policies like devaluation of currencies. Above all, under the fixed exchange rate system, deflationary policies can even be pursued to tide over the BOP deficit, even without bringing any change in domestic policies.

Additional to that there is also attraction of foreign investment in an economy. Exchange rate stability may encourage foreigners to incentive their investible funds in a country. If the exchange rate changes rather frequently, it will deter them to invest in a country. Of course, such foreign investment having multiplier effect leads to higher economic growth.

Not excluding the anti-inflationary measures in the use of the policy. Fixed exchange rate system is anti-inflationary in character. If exchange rate is allowed to decline, import goods tend to become dearer. High cost import goods then fuels inflation. Such a situation can be prevented by making the exchange rate fixed.

However, the fixed exchange regime despite its set backs have some merits in place that had work to stabilize the world economy after Bretton woods conference of 1944.

**Good luck!**