International Business

Block

2

GLOBAL MARKETS AND INSTITUTIONS

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BLOCK 2: GLOBAL MARKETS AND INSTITUTIONS

The second block to the course on International business gives an overview of international monetary system and foreign exchange markets and international economic integration and institutions. The block contains three units. The first unit discusses about the international monetary system. The second unit deals with the foreign exchange markets. The third unit discusses international economic integration and different institutions affecting global-level cooperation, regional agreements, international commodity agreements, and the strategies adopted by multinational enterprises in response to regional economic integration.

The first unit, *International Monetary System* discusses the history of the international monetary system. It goes into explaining different exchange rate systems. It then discusses the methods that help in determining foreign exchange rates. The unit finally discusses the concept of balance of payments and its accounts.

The second unit, *Foreign Exchange Markets* discusses different concepts in international foreign exchange rate markets. It then goes into explaining the different international capital markets. It finally discusses three perspectives that highlight the causes for the Asian financial crisis.

The third unit, *International Economic Integration and Institutions* discusses the different forms of economic integration. It then goes into explaining the role of three fundamental institutions affecting cooperation among nations at the global level – the World Trade Organization, the International Monetary Fund, and the World Bank. It then discusses different regional agreements and international commodity agreements. It finally discusses the strategic responses of multinational enterprises to regional economic integration.

Unit 4

International Monetary System

Structure

Monetary policy is like juggling six balls.it is not 'interest rate up, interest rate down.' There is the exchange rate, there are long term yields, there are short term yields, there is credit growth.

- Raghuram Rajan

4.1 Introduction

The previous block gave an overview of international business and globalization. It also dealt with trade theories and their application in international business and the trade barriers that hinder international business. It finally discussed the country differences in the cultural, political, and legal environmental contexts.

International business is carried out in an uncertain environment in which the exchange rates are very volatile. The volatile exchange rates increase the risk for international firms. An understanding of the international monetary system helps in managing foreign exchange risk.

Balance of payments records economic transactions between one country and rest of the world.

This unit will discuss the history of the international monetary system. It then goes into explaining different exchange rate systems. It then discusses the methods that help in determining foreign exchange rates. The unit finally discusses the concept of balance of payments and its accounts.

4.2 Objectives

By the end of this unit, students should be able to:

- Trace the history of the international monetary system.
- Describe the different exchange rate systems.
- Identify the methods used for determining foreign exchange rates.
- Explain the concept of balance of payments and its accounts.

4.3 History of the International Monetary System

The international monetary system refers primarily to "the set of policies, institutions, practices, regulations, and mechanisms that determine foreign exchange rates." The system comprises currencies from individual countries in addition to composite currency units such as the European Currency Unit (ECU) and Special Drawing Right (SDR). Foreign exchange refers to "the money of a foreign country, such as foreign currency bank balances, banknotes, checks, and drafts." A foreign exchange rate is "the price of one currency expressed in terms of another currency (or gold)." A system can be classified as fixed or managed exchange rate system if the government of a country regulates the rate at which the local currency can be exchanged for other currencies. If a country's currency is pegged or tied to currency of another country, it is called pegged exchange rate system. "The rate at which the currency is fixed is often referred to as its par value." If a government does not interfere in the currency valuation, it is classified as floating or flexible exchange rate system. The real exchange rate is "the exchange rate after deducting an inflation factor." The nominal exchange rate is "the exchange rate before deducting an inflation factor."

Example

As reported in ceicdata, with an updated information up to 21st February 2018, France's foreign Exchange Rate Index before deducting inflation factor showed an increase of 1.246 points from the previous level of 96.420 as on Dec2016 to 97.666 as on 31st December 2017.This exchange rate is a nominal exchange rate

Source: ICFAI Research Center

The changes in exchange rates may move in one of the two directions. Associated with the fixed exchange rate system, devaluation of a currency refers to "a drop in the foreign exchange value of a currency that is pegged to another currency or gold." Associated with the floating exchange rate system, depreciation refers to "a drop in the foreign exchange value of a floating currency." Appreciation refers to "a gain in the foreign exchange value of a floating currency."

The choice of foreign currencies used by international firms influences their cash flows and income levels. For instance, firms in countries with soft currencies use hard foreign currencies in their export businesses. A soft or weak currency is “one that is anticipated to devaluate or depreciate relative to major trading currencies.” A currency is considered hard or strong if it is “expected to revalue or appreciate relative to major currencies.”

A brief review of the history of the international monetary system can help in understanding the current monetary system and appraise the strengths and weaknesses of different foreign exchange systems.

4.3.1 The Gold Standard Period (1876-1914)

Gold was used as an exchange medium and a store of value since the days of the pharaohs (about 3000 B.C). In the 1870s, the gold standard was accepted as an international monetary system. Under this system, each country pegged its currency to gold.

The governments using the gold standard agreed to buy or sell gold on demand at their own fixed parity rate. Thus, the value of each currency in terms of gold and the fixed parities between currencies remained stable. The system required the countries to maintain an adequate reserve of gold to back their currency’s value. The gold standard worked adequately until World War I that interrupted trade flows and free movement of gold. Thus, the major trading nations suspended the gold standard.

In the version called Gold Specie Standard, the actual currency in circulation comprised gold coins with a fixed gold content. In the version called Gold Bullion Standard, the basis of money remained gold in fixed weight but the currency in circulation consisted of paper notes, where the authorities were ready to convert on demand unlimited amounts of gold into paper currency and vice versa at a fixed ratio of conversion. For instance, a dollar note can be converted into say x ounces of gold, while a pound sterling note can be exchanged for say y ounces of gold on demand.

4.3.2 The Inter-War Years and World War II or Gold Exchange Standard (1914-1944)

During World War I and the early 1920s, currencies were allowed to fluctuate over wide ranges in terms of another currency and gold. This led to the creation of arbitrage opportunities for international speculators. Such fluctuations led to hampering of the world trade in the 1920s thus resulting in the Great Depression in the 1930s. The gold standard broke down during World War I and was reinstated briefly from 1925-1931 as the Gold Exchange Standard. Under this standard, only the US and England could hold only gold reserves but other countries could both gold and dollars or pounds as reserves.

Under the Gold Exchange Standard, the authorities may convert on demand at a fixed rate, the paper currency issued by them into the paper currency of another country which is operating at a gold specie standard or gold bullion standard. Thus if rupees could freely convertible into dollars and dollars into gold, rupee is said to be on a gold exchange standard.

The exchange rate between any two currencies could be determined by their corresponding exchange rates against gold. This is called as the mint-parity rate of exchange.

Under the gold standard, the money authorities need to obey the following rules:

1. They must fix once-for-all the conversion rate of the paper currency issued into gold.
2. There should be free flows of gold between countries on gold standard.
3. The money supply must be tied to the amount of gold held by the monetary authorities in reserve. If this amount decreases, money supply must contract and vice versa.

In 1931, England departed from gold in the face of massive gold and capital flows due to an unrealistic exchange rate, and the Gold Exchange Standard was finished. In 1934, the US returned to a modified gold standard, when the dollar was devalued to $35 per ounce of gold from $20.67 per ounce of gold in price. Though the US returned to the gold standard, gold was not traded with individual citizens but only with foreign central banks. From 1934 to the end of World War II, the exchange rates were determined by each currency value in terms of gold. However, during the World War II and its aftermath, many of the major trading currencies lost their convertibility into other currencies. The dollar remained the only major trading currency that continued to be convertible.

4.3.3 The Bretton Woods System (1944-1973)

This period was characterized by a fixed exchange system. Under the provisions of the Bretton Woods Agreement that was signed in 1944, the governments of all the member countries took a pledge for maintaining a fixed or pegged exchange rate for its currency vis-à-vis gold or the dollar. Fixing the gold price of a currency was equivalent its exchange rate in relation to the dollar, because one ounce of gold was equal to $35. The countries participating in the agreement agreed to make effort to maintain their currency values within a 1 percent band by buying or selling gold or foreign exchange as needed. Devaluation could not be used as a competitive trade policy, but in case the currency became too weak to defend, the currency could be devaluated up to 10 percent without formal approval from the International Monetary Fund (IMF).

During this period, the US dollar was the key to the web of exchange rate values and was the main reserve currency held by central banks. Unfortunately, the US grew deficits on it balance of payments. To finance these deficits and meet the growing demand for dollars from businesses and investors, a heavy capital outflow of dollars was required. Eventually, a heavy overhang of dollars held abroad resulted in the lack of confidence in the ability of the US for meeting its commitment to convert dollars to gold. On August 15, 1971, the US gave response to the huge trade deficit by making the dollar inconvertible to gold. A program for wage and price controls was introduced and 10 percent surcharge was placed on imports. Many major currencies were allowed to float against the dollar. Then the dollar began the decade of decline.

Under the Smithsonian Agreement, which was reached in Washington DC in December 1971, among the world's trading nations; the US agreed to devalue the dollar to $38 per ounce of gold. In return, the other countries present decided to revalue their currencies upward by specified amounts relative to the dollar. Actual revaluation ranged from 7.4 percent in Canada to 16.9 percent in Japan. Furthermore, the allowed floating band was expanded from ±1 to ±2.5 percent.

The high inflation in the US resulted in the dollar devaluation remaining insufficient in restoring stability to the system. By 1973, even at devalued rates, the dollar was under heavy selling pressure. By February 1973, a fixed-rate system was no longer feasible given the speculative currency flows. In March 1973, major foreign exchange markets were closed for several weeks and after they reopened, most currencies were permitted to float to levels that were determined by market forces.

4.3.4 The Post-Bretton Woods System: 1973-Present

This period is characterized by a floating exchange rate system. Since March 1973, the exchange rates had become very volatile and less predictable than they were during the fixed exchange rate period. The system became more volatile as it approached the oil crisis in 1973. By October 1973, the Organization of Petroleum Exporting Countries (OPEC) made successful efforts to raise the oil prices. By 1974, the oil prices had quadrupled. Several nations, especially the US, made efforts to offset the high energy bills by boosting spending. This resulted in high inflation and vast deficits in the balance of payments, which eventually caused the dollar crisis of 1977-1978.

During 1981-1985, the US dollar rebounded strongly due to President Regan's economic policy. However, the dollar resumed its downhill slide attributed chiefly to a slowdown in the US and changes in US government policy. After the dollar had declined considerably, the US, Japan, West Germany, France, Britain, Italy, and Canada – also known as Group of Seven (or G-7) met in February 1987 and agreed to slow the fall of the dollar. This agreement, also known as Louvre Accords required the G-7 nations to support the falling dollar by pegging exchange rates within an undisclosed and narrow range. In early 1988, the dollar rallied, thereby ending it dramatic volatility. In 1990, the US dollar fell again and stayed flat during 1991-1992. In 1993, it fell against the Japanese yen and DM.

The third major crisis of the 1990s was the turmoil rocking the Asian foreign exchange markets since June 1997. The predecessors were the crisis in the European Monetary System (EMS) of 1992-1993 and the Mexican peso crisis of 1994-1995. The Asian crisis was started by the collapse of the Thai currency, the baht. In one month, the baht had lost 20 percent of its value against the dollar. The currencies of Indonesia, Malaysia, and the Philippines had also weakened. In August 1997, the Indonesian authorities were forced to allow rupiah, their national currency, to freely move against other currencies. In December 1997, the IMF put a US$ 58.4 billion international bailout for Korea. The Koreans decided to float the won. In August 1998, the Russian authorities devalued the ruble due to the rapidly deteriorating foreign currency reserves. The US Federal Reserve responded to the US credit crunch by lowering the interest rates thrice in quick succession, including a unilateral move by Alan Greenspan, Fed Chairman. In September 1998, other industrialized countries such as Japan, Canada, and most of the European nations also eased monitory policies. In October 1998, the G-7 nations endorsed a plan for allowing the IMF to lend to countries before they get into financial troubles.

4.4 Exchange Rate System

4.4.1 Fixed-rate System

Under a fixed (or pegged) exchange rate system, the value of a currency in terms of another is fixed. These rates are determined by governments or the central banks of the respective countries. The fixed exchange rates result from countries pegging their currencies to either some common commodity.

Under a fixed-rate system, governments can buy or sell their currencies in the foreign exchange market whenever there is a deviation in the stated par values. A few centrally planned economies such as North Korea and Cuba have employed a purely fixed-rate system. In these economies, it is usually mandatory that the foreign exchange earnings of a local firm had to be surrendered to the central bank for which the firm receives a return, a corresponding amount in local currency. The foreign exchange income is allocated by the central bank to state-owned users based on governmental priorities.

Example

As per a report in The Observatory of Economic Complexity (OEC) dated 11th March 2019, there has been a steady decline in exports of North Korea at an annual rate of 9 % resulting in a negative trade balance of $1.69B in the year 2017. In the F Y 2017, North Korea exported $1.74B and imported $3.42B, of which the total exports to India was just $25M.

Contd….

The companies in North Korea which have exported the goods have to surrender the foreign exchange earnings to the Central Bank of N. Korea and they in turn pay in local currency at an exchange rate determined by them to the companies. Thus whenever there is a change in the stated par value, the government buys the foreign exchange and this is one of the reasons for reduction in exports.

Source: ICFAI Research Center

4.4.2 Crawling Peg System

The peg system is situated between the fixed-rate and float-rate systems. The crawling peg is "an automatic system for revising the exchange rate, establishing a par value around which the rate can vary up to a given percentage point." The par value is regularly revised according to the formula which is determined by the authorities. After the par value is set, the central bank intervenes whenever the market value approaches a limit point. For instance, if the par value of the Mexican peso is 3,000 pesos for one dollar and that it can vary ±2 percent around this rate, between 3,060 pesos and 2,940 pesos. If the dollar approaches the rate of 3,060 pesos, the central bank intervenes by selling dollars and buying pesos. If the dollar approaches the rate of 2,940 pesos, the central bank intervenes by selling pesos and buying dollars.

A government can peg its currency either to a single currency or basket of foreign currencies. Other countries peg their currency to a composite basket of currencies, where the basket comprises a portfolio of currencies of their major trading partners. This basket has base value which is stable than any single currency. Under this regime, a country can peg its currency to the standard basket such as SDRs (e.g. Myanmar, Libya), or its own basket, which is designed to fit the unique trading and investing needs of a country (e.g. Czech Republic, Jordan, Cyprus, Bangladesh, Israel, Iceland, Kuwait, Nepal, Thailand, and Morocco). In the latter approach, the basket contains currencies of major trading partners.

Example
Israel's exchange rate is linked to the currencies of its major trading partners such as US and China. The exchange rate followed by Israel gets automatically revised establishing a par value around which the rate varies up to a given percentage point. The high – low exchange rate between August 2019 to October 2019 of Israel Shakel ILS was 3.510 to 36.445 / US$, a variation around 1.88%.

Source: ICFAI Research Center

The peg system is a universal remedy. When pegged rates get overvalued, countries have to forcibly deplete their foreign exchange reserves for defending the currency peg. When reserves get depleted, countries attempt to manipulate interest rates but are often forced to devalue, repegging at a low rate or giving up the peg in total. With a floating rate system, countries can maintain their reserves and hence can maintain a defense against financial panic. Foreign creditors understand that the central bank has reserves sufficient for paying short-term debts, thus eliminating the possibility of a self-fulfilling creditor panic.

Activity 4.1

A country had fixed its currency against the dollar. Due to high inflation in the country, the currency had to be devalued highly. As the rapid devaluation create instability, the country had to implement an exchange rate system. Which exchange system should be employed by the country in order to ensure that its currency is not devalued significantly? Also discuss the exchange rate system.

Answer:

4.4.3 Target-zone Arrangement

Target-zone arrangement is "virtually a joint float system cooperatively arranged by a group of nations sharing common interests and goals." Under this system, countries make adjustments to their national economic policies for maintaining their exchange rates within a specific margin around fixed central exchange rates that are agreed upon. The target-zone arrangement exists for major European currencies that participate in the EMS. The European Union members have a cooperative agreement for maintaining their currencies within a set range against other group members. The EMS is "a peg of each country's currency to all the others, as well as joint float of all member currencies together against non-EMS currencies." The target-zone arrangement helps in minimizing the instability in exchange rates and enhances economic stability in the group.

Example

European commission on its website dated 27th April 2021 has reported that the total trade in goods between the EU and Algeria in 2020 amounted to €24.9 billion. The imports amounted to €11.4 billion and exports to Algeria amounted to €13.5 billion. Both Algeria and the EU adjust their exchange rates within a specific margin around fixed central exchange rates that were agreed upon. Here, target-zone arrangement is a kind of exchange rate agreement exists between the EU and Algeria.

Source: ICFAI Research Center

However, the target-zone arrangement is not without problems. Due to the divergence of national policies, the trade structure and the level of economic development, it gets difficult for every member to maintain the central exchange rate for a longer time period. Moreover, if the currency speculators attack one of the zone currencies, defense becomes very costly.

4.4.4 Managed Float System

Also known as dirty float, the managed float is designed for eliminating excess volatility. It is employed by governments to preserve an orderly pattern of changes in exchange rates. Each central bank sets the exchange rate of a nation against a predetermined goal, but allows the exchange rate to vary. In other words, the change in exchange rates does not take place automatically, but is based on the view of the government of an appropriate rate in the context of the country's position in balance of payments, foreign exchange reserves, and rates that are quoted outside the official market. The authorities, rather than resisting the underlying forces, sometimes intervene by selling or buying domestic currency for smoothing the transition from one rate to another. At other times, the authorities intervene for moderating or counteracting self-correcting cyclical or seasonal market forces. The rationale for the managed float system is to reduce uncertainty for improving the economic and financial environments. For instance, the intervention of the government may reduce the uncertainty of the exporters caused by disruptive exchange rates. Some of the countries that maintain a managed float system include Brazil, China, Israel, Egypt, Hungary, Korea, Poland, Turkey, Russia, etc.

Example

As per a report in Business Standard dated 13th April 2019, the cotton exports to China from India has increased substantially. India's cotton, textiles and apparel exports increased by about 69 per cent from $ 919.76 million to $1.5 billion between April 2018 and February 2019 over the corresponding period last year. Due to the trade war between US and China, there could have been a considerable volatility in exchange rates which could have affected the export proceeds by Indian companies. However the Chines government in order to eliminate the excess volatility in the exchange rates allows its Central Bank to intervene to keep the exchange rate volatility under control.

Source: ICFAI Research Center

4.4.5 Independent Float System

The independent float system is also known as clean float. Under this system, an exchange rate is allowed to freely adjust to the demand and supply of this currency for another. As a consequence of this, the economy does not have to undergo the painful adjustment process set in motion by an increase or decrease in the supply of money. This category includes currencies of both developed (e.g. the USA) and developing nations (e.g. Peru). The central banks of these countries allow market forces to determine the exchange rates. The central banks may intervene from time to time to alleviate speculative pressures on their currency. They also intervene occasionally as one of the anonymous participants in the free market.

Example

The Hindu dated 5th December 2021 has published an article on the appreciation by the US treasury department on Forex intervention by RBI. The article mentions that India has been exemplary in publishing its foreign exchange market intervention, adding that New Delhi should allow the exchange rate to move flexibly and freely to the demand and supply of the currency for another to reflect economic fundamentals. Here, independent float system is the type of **exchange system** that the US treasury wants India to adopt.

Under this system, an exchange rate is allowed to freely adjust to the demand and supply of this currency for another which is the crux of the US treasury inputs and suggestions on India's exchange rate system.

Source: ICFAI Research Center

4.4.6 Floating system – Advantages and Disadvantages

The flexible exchange rate system offers a less painful adjustment mechanism to trade imbalances than fixed exchange rates and prevents a country from large persistent deficits. Flexible exchange rates only lower the foreign exchange value of a currenc9y unlike the fixed-rate system, which requires recession to reduce real income or prices when trade deficits arise.

Flexible exchange rates do not require central banks to hold foreign exchange reserves as there was no need for intervention in the foreign exchange market. They also avoid the need for strict imports and exports regulations such as import restrictions, foreign exchange control, and tariffs, Finally, floating exchange rates can help in ensuring the independence of trade policies.

However, the role of flexible rates is limited in balancing trade after a certain time period. A currency devaluation or depreciation will help the balance of trade if it reduces the relative prices of goods and services produced locally. However, after a short-time period, domestic prices of tradable goods will rise following devaluation or depreciation. This results in an increase in cost of living, which in turn puts upward pressure on wages. In addition, flexible rates could increase the difficulty for the government in controlling inflation and also creates less motivation for the governments for combating it. Finally, free floats may lead to more uncertainty, which may in turn hamper the stability and growth of economies vulnerable to international financial and export markets.

4.5 Determining Foreign Exchange Rates

During the gold standard regime (1876-1914), the base level of the exchange rate could be determined by the stated value of the gold per unit of the currency. However, under other foreign exchange rate regimes, there is no direct way for valuing a currency against other currencies in terms of flows as well as stocks. Moreover, the current international monetary system is a blend of free floating, managed floating, pegged or target zone, and fixed exchange rates. There is no single general theory that forecasts foreign exchange rates under all conditions. But it is agreed widely that the purchasing power parity (PPP) principle helps in explaining both the stocks and the flows of exchange rates. Other principles that help in analyzing foreign exchange movements include interest rate parity and international Fisher parity. The PPP approach lays emphasis on the role of prices of goods and services in determining exchange rates whereas the role of capital movements is focused by interest rate parity.

4.5.1 Purchasing Power Parity

The purchasing power parity (PPP) principle states that in the long run, the exchange rate between two currencies should reflect differences in purchasing power, that is, the exchange rate should equalize the price of identical goods and services in two countries. The PPP principle has two perspectives such as absolute PPP and relative PPP. Absolute PPP suggests that the exchange rate can be determined by the relative prices of identical baskets of goods and services. For instance, if the identical basket of goods cost ¥ 100 in Japan and $ 1 in the US, the PPP-based exchange rate would be ¥ 100/$ 1.

Due to difference in consumption behaviors and demand structures, different basket of goods is used in different countries. This deficiency can be avoided by relative PPP which focuses on the relationship between price changes of two countries and change in exchange rates during the same period. According to relative PPP, if the exchange rate starts in equilibrium between two countries, any change in the differential inflation rate between them tends to be offset in the long term by an opposite equal change in the exchange rate. The exchange rate depreciates if the domestic inflation level rises faster than the foreign inflation level. The exchange rate appreciates if the foreign inflation level rises faster than the domestic inflation level. In this situation, if there is no change in the exchange rate, the export of goods and services in a country will become less competitive with comparable products produced elsewhere. Imports would also become more price-competitive than domestic products that are highly priced.

The PPP principle offers an economic foundation that determines and adjusts exchange rates. However, in the real business world, PPP conditions may not always hold. Thus the exchange rates are always not determined by PPP.

4.5.2 Interest Rate Parity (IRP)

The PPP principle focuses only on goods and services and excludes the importance of capital flows while determining exchange rates. This limitation is addressed by the interest rate parity (IRP) principle which explains how interest rates are linked between different countries through capital flows. The IRP principle suggests that “the difference in national interest rates for securities of similar risk and maturity should be equal to, but opposite in sign of, the forward rate discount or premium for the foreign currency.” A forward rate is “the rate at which a bank is willing to exchange one currency for another at some specified future date.” If the exchange takes place immediately, it is termed as spot rate. A forward rate discount measures the percentage by which the forward rate is more or less than the spot on a specific date. The IRP implies that the forward premium of exchange rate will match the interest rate differential between two countries. This relation holds because of efficient arbitrage in risk-free assets. It can be applies to international lending as well as international investments. The rationale underlying IRP is that for financing projects, borrowers compare the costs in domestic market with that of the foreign market. For investment projects, investors compare the return from the domestic market with the return from the foreign market. When interest parity is established, equilibrium will be achieved.

Like PPP, IRP also faces deviations due to tax factors and transaction costs in financial markets. The deviations from interest parity between countries is also caused by political risks because expect to be compensated from the greater risk of investing in a foreign country.

In general, IRP is applicable to securities that have maturities of one year or less since forward contracts are not available for period more than a year.

Similar to the principle of IRP but involving securities with maturity for over a year, the international Fisher effect addresses the relationship between the change in percentage in the spot exchange rate over time and the differential between interest rates that are comparable in different national capital markets. The international Fisher effect states that “the spot exchange rate should change in an equal amount but in opposite direction to the differences in interest rates between two countries.”

4.5.3 Implications for MNEs: Foreign Exchange Forecasting

Participants in international financial markets can never for sure what the exchange rate would be after a month as future exchange rates are uncertain. Hence, forecast should be made. Some forecasters believe that for major floating currencies, forward exchange rates are unbiased predictors of future spot exchange rates and forward exchange rates are efficient. On the other hand, this hypothesis was rejected by empirical studies. Though reference to forward rate is necessary, international managers should take into account many economic and non-economic factors to predict foreign exchange rates.

Economic factors influencing long-term exchange rates include balance of payment, foreign exchange reserves, relative interest rates, relative inflation rates, and the longterm properties of PPP. The long-term exchange rates of a country are also influenced by the strength of a focal country's economy, which is reflected often in its Gross Domestic Product, national income, export growth, and investment growth. As governments differ in which they exert influence on foreign exchange rates, even under the floating system, managers should have awareness about government declarations and agreements regarding exchange rate goals. Non-economic factors include political or social events, market speculations against the currency, bilateral relations between the two countries, the confidence of market participants, and natural disasters.

In emerging markets where the foreign exchange control is set by the government, there usually exists a foreign exchange black market where the buyers and sellers transact foreign currencies using the market rate, which is different from the official rate. International managers also take into consideration the country's foreign exchange rate system in predicting exchange rates. For predicting a long-term fixed rate, managers should also see if the government has the capability to control domestic inflation for generating hard currency reserves and to run trade surpluses. For predicting a long-term floating rate, managers should focus on inflationary fundamentals and PPP as well as economic health indicators such as stability and growth.

Time-series analysis is a technique widely applied for predicting foreign exchange rates, particularly short-term trends.

Activity 4.2

If the price of a movie ticket in the US is US$ 5, the correct exchange rate would be one that exchanges US$ 5 for the amount of Japanese yen it would take to purchase a movie ticket in Japan. If the ticket price is ¥540, what should be the exchange rate between two currencies so that a moviegoer can purchase a ticket regardless of which country he/she goes in? Identify the concept and discuss it in brief.

Answer:

4.6 The Balance of Payments

The exchange rate system is a tool essential for international transactions that involves multiple currencies. The national goal of international transactions is to accomplish gains from investment and trade activities, which are recorded in the balance of payments account. The balance of payments is "an accounting statement that summarizes all the economic transactions between residents (individuals, companies, and other organizations) of the home country and other countries." It reports the international performance of a country in trading with other nations and the volume of capital that flows in and out of the country. The balance of payments uses the double-entry bookkeeping system, which means that every credit or debit in the account is reflected as credit or debit somewhere else. In the balance of payments sheet, inflows of currency are recorded as credit (plus sign) and outflows of currency are recorded as debit (minus sign).

A standard balance of payments includes current account, capital account, and official reserves account. Statistical discrepancy is also included in the balance of payments account for maintaining the balance of total credit and total debit. Statistical discrepancy reflects omissions and net errors in collecting data on international transactions.

4.6.1 Current Account

The current account records "flows of goods, services, and unilateral transfers." It includes service transactions (also called as invisible items) and exports and imports of merchandise (trade balance). The service account includes several service income and fees (e.g. royalty, interests, and dividends). Service income includes transportation charges (i.e. shipping and air travel), financial charges (i.e. banking and insurance), and tourism income. The investment income account separates investment income from service income and records income payments on foreign-owned assets within the country and income receipts on the country-owned assets abroad. Unilateral transfers include remittances, pensions, and other transfers for which specific services are not furnished.

Example

The Hindu dated 1st of October 2021 has reported that India's merchandise exports grew 21.3% year-on-year to $33.44 billion in September 2021 and were 28.5% higher than pre-COVID levels of September 2019. Merchandise imports grew faster to $56.38 billion, 84.75% higher than September 2020 and nearly 50% over pre-pandemic levels, as per preliminary estimates. Here, in the current account the above transactions of imports and exports of merchandise be recorded.

Source: ICFAI Research Center

4.6.2 Capital Account

The capital account records "private and public investment or lending activities and is divided into portfolio (short and long-term) and foreign direct investment." Direct investments include wholly-owned subsidiaries, joint ventures, and foreign branches. Portfolio investments include mutual funds, foreign bonds, and notes.

The portfolio account includes both short-term (e.g. cash, bills, deposits, etc.) as well as long-term (e.g. securities, mortgages, bank loans, etc.) investments or lending. Government lending and borrowing are also part of the capital account.

Example

Reuters dated 14th September 2021 has reported that India has attracted foreign direct investment at record levels even during the COVID-19 pandemic with total FDI inflows amounting to $81.72 billion in 2020-21, 10% higher than the previous financial year and this has resulted in BoP surplus for FY21 at a robust $87.3 billion. In the given case, capital account is the BoP account where the FDI inflows of $81.72 billion be accounted for.

Source: ICFAI Research Center

Check Your Progress - 1

1. The ________ refers primarily to the set of policies, institutions, practices.
   a. European monetary system
   b. Domestic monetary system
   c. International monetary system
   d. Fixed exchange rate system
2. ___________refers to the money of a foreign country, such as foreign currency bank balances, banknotes, checks, and drafts.
   a. Fixed exchange
   b. Floating rate
   c. Foreign exchange
   d. Domestic exchange
3. A _______ is the price of one currency expressed in terms of another currency (or gold).
   a. Foreign exchange rate
   b. Forward rate
   c. Spot rate
   d. None of the above
4. The ____________ is the exchange rate after deducting an inflation factor.
   a. Nominal exchange rate
   b. Foreign exchange rate
   c. Real exchange rate
   d. Spot exchange rate

5. The_________ is the exchange rate before deducting an inflation factor.
   a. Real exchange rate
   b. Nominal exchange rate
   c. Foreign exchange rate
   d. None of the above
6. ______refers to a drop in the foreign exchange value of a floating currency.
   a. Revaluation
   b. Appreciation
   c. Devaluation
   d. Depreciation
7. ______refers to a gain in the foreign exchange value of a floating currency.
   a. Devaluation
   b. Revaluation
   c. Appreciation
   d. Depreciation
8. Under the provisions of the ______that was signed in 1944, the governments of all the member countries took a pledge for maintaining a fixed or pegged exchange rate for its currency vis-à-vis gold or the dollar.
   a. Gold standard period
   b. Post Bretton Woods system
   c. Smithsonian agreement
   d. Bretton Woods Agreement
9. Under a_________, governments can buy or sell their currencies in the foreign exchange market whenever there is a deviation in the stated par values.
   a. Floating rate system
   b. Crawling peg
   c. Fixed-rate system
   d. Target-zone arrangement
10. The ________is an automatic system for revising the exchange rate, establishing a par value around which the rate can vary up to a given percentage point.
    a. Target-zone arrangement
    b. Fixed-rate
    c. Floating rate
    d. Crawling peg

11. ___________ is virtually a joint float system cooperatively arranged by a group of nations sharing common interests and goals.
    a. Crawling peg
    b. Target-zone arrangement
    c. Fixed-rate
    d. Floating rate
12. In a/an _______, an exchange rate is allowed to freely adjust to the demand and supply of this currency for another.
    a. Independent float system
    b. Managed float system
    c. Fixed-rate system
    d. Crawling peg system
13. The_______ principle states that in the long run, the exchange rate between two currencies should reflect differences in purchasing power, that is, the exchange rate should equalize the price of identical goods and services in two countries.
    a. Interest rate parity
    b. Purchasing power parity
    c. Floating system
    d. Crawling peg
14. The ________principle suggests that the difference in national interest rates for securities of similar risk and maturity should be equal to, but opposite in sign of, the forward rate discount or premium for the foreign currency.
    a. Managed float
    b. Fixed rate
    c. Interest rate parity
    d. Purchasing power parity
15. The _________ is an accounting statement that summarizes all the economic transactions between residents of the home country and other countries.
    a. International monetary system
    b. Profit and loss
    c. Cash flow
    d. Balance of payments

4.7 Summary

- The international monetary system refers primarily to the set of policies, institutions, practices, regulations, and mechanisms that determine foreign exchange rates.
- In the 1870s, the gold standard was accepted as an international monetary system. Under this system, each country pegged its currency to gold.
- During World War I and the early 1920s, currencies were allowed to fluctuate over wide ranges in terms of another currency and gold. This led to the creation of arbitrage opportunities for international speculators.
- Under the provisions of the Bretton Wood Agreement that was signed in 1944, the governments of all the member countries took a pledge for maintaining a fixed or pegged exchange rate for its currency vis-à-vis gold or the dollar.
- The Post-Bretton Woods system is characterized by a floating exchange rate system.
- Under a fixed-rate system, governments can buy or sell their currencies in the foreign exchange market whenever there is a deviation in the stated par values.
- The crawling peg is an automatic system for revising the exchange rate, establishing a par value around which the rate can vary up to a given percentage point.
- Target-zone arrangement is virtually a joint float system cooperatively arranged by a group of nations sharing common interests and goals.
- Also known as dirty float, the managed float is designed for eliminating excess volatility. It is employed by governments to preserve an orderly pattern of changes in exchange rates.
- The independent float system is also known as clean float. Under this system, an exchange rate is allowed to freely adjust to the demand and supply of this currency for another.
- The purchasing power parity (PPP) principle states that in the long run, the exchange rate between two currencies should reflect differences in purchasing power, that is, the exchange rate should equalize the price of identical goods and services in two countries.
- The Interest Rate Parity principle suggests that the difference in national interest rates for securities of similar risk and maturity should be equal to, but opposite in sign of, the forward rate discount or premium for the foreign currency.

- The balance of payments is an accounting statement that summarizes all the economic transactions between residents (individuals, companies, and other organizations) of the home country and other countries.
- A standard balance of payments includes current account, capital account, and official reserves account.

4.8 Glossary

Appreciation: Appreciation refers to gain in the foreign exchange value of a floating currency.

Balance of payments: Balance of payments is an accounting statement that summarizes all the economic transactions between residents (individuals, companies, and other organizations) of the home country and other countries.

Crawling peg: Crawling peg is an automatic system for revising the exchange rate, establishing a par value around which the rate can vary up to a given percentage point.

Depreciation: Depreciation refers to a drop in the foreign exchange value of a floating currency.

Devaluation: Devaluation of a currency refers to a drop in the foreign exchange value of a currency that is pegged to another currency or gold.

Foreign exchange: Foreign exchange refers to the money of a foreign country, such as foreign currency bank balances, banknotes, checks, and drafts.

Foreign exchange rate: A foreign exchange rate is the price of one currency expressed in terms of another currency (or gold).

Forward rate: Forward rate is the rate at which a bank is willing to exchange one currency for another at some specified future date.

Hard currency: A currency is considered hard or strong if it is expected to revalue or appreciate relative to major currencies.

International fisher effect: International Fisher effect states that the spot exchange rate should change in an equal amount but in opposite direction to the differences in interest rates between two countries.

International monetary system: The international monetary system refers primarily to the set of policies, institutions, practices, regulations, and mechanisms that determine foreign exchange rates.

Interest rate parity: The Interest Rate Parity principle suggests that the difference in national interest rates for securities of similar risk and maturity should be equal to, but opposite in sign of, the forward rate discount or premium for the foreign currency.

Purchasing power parity: Purchasing Power Parity principle states that in the long run, the exchange rate between two currencies should reflect differences in purchasing power, that is, the exchange rate should equalize the price of identical goods and services in two countries.

Soft currency: Soft or weak currency is one that is anticipated to devaluate or depreciate relative to major trading currencies.

Target-zone arrangement: Target-zone arrangement is virtually a joint float system cooperatively arranged by a group of nations sharing common interests and goals.

4.9 Self-Assessment Test

1. Define the international monetary system. Give a brief history of the international monetary system.
2. Explain in brief the different exchange rate systems.
3. Describe the principles that help in determining foreign exchange rates.
4. Define balance of payments.
5. A standard balance of payments includes current account, capital account, and official reserves account. Explain these accounts in detail.

4.10 Suggested Readings/Reference Material

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4.11 Answers to Check Your Progress Questions

1. (c) International monetary system

The international monetary system refers primarily to the set of policies, institutions, practices, regulations, and mechanisms that determine foreign exchange rates.

2. (c) Foreign exchange

Foreign exchange refers to the money of a foreign country, such as foreign currency bank balances, banknotes, checks, and drafts.

3. (a) Foreign exchange rate

A foreign exchange rate is the price of one currency expressed in terms of another currency (or gold).

4. (c) Real exchange rate

The real exchange rate is the exchange rate after deducting an inflation factor.

5. (b) Nominal exchange rate

The nominal exchange rate is the exchange rate before deducting an inflation factor.

6. (d) Depreciation

Depreciation refers to a drop in the foreign exchange value of a floating currency.

7. (c) Appreciation

Appreciation refers to a gain in the foreign exchange value of a floating currency.

8. (d) Bretton Woods Agreement

Under the provisions of the Bretton Woods Agreement that was signed in 1944, the governments of all the member countries took a pledge for maintaining a fixed or pegged exchange rate for its currency vis-à-vis gold or the dollar.

9. (c) Fixed-rate system

Under a fixed-rate system, governments can buy or sell their currencies in the foreign exchange market whenever there is a deviation in the stated par values.

10. (d) Crawling peg

The crawling peg is an automatic system for revising the exchange rate, establishing a par value around which the rate can vary up to a given percentage point.

11. (d) Target-zone arrangement

Target-zone arrangement is virtually a joint float system cooperatively arranged by a group of nations sharing common interests and goals.

12. (a) Independent float system

In an independent float system, an exchange rate is allowed to freely adjust to the demand and supply of this currency for another.

13. (b) Purchasing power parity

The purchasing power parity (PPP) principle states that in the long run, the exchange rate between two currencies should reflect differences in purchasing power, that is, the exchange rate should equalize the price of identical goods and services in two countries.

14. (c) Interest rate parity

The Interest Rate Parity principle suggests that the difference in national interest rates for securities of similar risk and maturity should be equal to, but opposite in sign of, the forward rate discount or premium for the foreign currency.

15. (d) Balance of Payments

The balance of payments is an accounting statement that summarizes all the economic transactions between residents (individuals, companies, and other organizations) of the home country and other countries.

Unit 5
Foreign Exchange Markets

Structure

A nation's exchange rate is the single most important price in its economy; it will influence the entire range of individual prices, imports and exports, and even the level of economic activity. So it is hard for any government to ignore large swings in its exchange rate.

\- Paul Volcker

5.1 Introduction

The previous unit discussed the history of the international monetary system. It then discussed different exchange rate systems. It then discussed the methods that help in determining foreign exchange rates. The unit finally discussed the concept of balance of payments and its accounts.

International monetary system and international financial markets are inherently linked such that the former impacts the operations of a firm or company decisions through the latter. International financial markets are composed of international foreign exchange markets and international capital markets.

The Asian financial crisis illustrates how a financial crisis is reflected simultaneously in the international foreign exchange markets and international capital markets.

This unit will discuss different concepts in international foreign exchange rate markets. It then goes into explaining the different international capital markets. It finally discusses the three perspectives that highlight the causes for the Asian financial crisis.

5.2 Objectives

By the end of this unit, students should be able to:

- Discuss various concepts of international foreign exchange markets.
- Narrate different international capital markets.
- Explain the causes for Asian financial crisis from financial, political/institutional, and managerial perspective.

5.3 International Foreign Exchange Markets

5.3.1 Background of the International Foreign Exchange Market

A foreign exchange market is where foreign currencies can be bought and sold. It is the institutional and physical structure through which currency exchange takes place, exchange rates are determined, and foreign exchange transactions are completed. A foreign exchange transaction is "an agreement between a buyer and seller for the delivery of certain amount of one currency at a specified rate in exchange for some other currency." The US dollar was the most actively traded currency. The second and third most traded currencies were deutsche mark and Japanese yen, respectively.

The global foreign exchange business is concentrated in four centers – London, New York, Tokyo, and Singapore. Other important foreign exchange markets are located in Paris, Amsterdam, Zurich, Frankfurt, Toronto, Hong Kong, Milan, Bahrain, and Brussels. The foreign exchange market is dominated by dealers, and is becoming increasingly concentrated and automated.

5.3.2 Participants and Functions

The foreign exchange market includes individuals, banks, corporations, and brokers who buy or sell currencies. The foreign exchange brokers intermediate to conduct currency trading in each country, match currency bids and offers of banks and also trade directly among themselves internationally. Banks throughout the world are linked by telephone, telex, Internet, and satellite communications network called the Society for World-wide International Financial Telecommunications (SWIFT) based in Brussels, Belgium.

Though the market is global, the exchange market in each country has its own identity and regulatory and institutional framework. An efficient communication system can substitute for the need of participants to convene in some specific location (bourse). Indeed, the US-UK type of market is based on communication networks, whereas the European approach is traditional where the participants meet physically at the bourse. Daily meetings take place in some markets such as Paris and Frankfurt, where representatives of central banks and commercial banks meet and determine a fixing rate. In those countries, the posted fixed rate acts as guide for pricing small and medium- sized transactions between banks and their customers. Major industrial countries such as Italy, Belgium, France, Japan, and the Benelux and Scandinavian countries have a daily fixing. The US, the UK, Canada, and Switzerland do not have a daily fixing.

Foreign exchange trades in a 24-hour market. As the market in the Far East closes, trading in the Middle East financial centers begins for a couple of hours, and then trading in Europe begins. As the London market closes, the New York market opens. After a few hours, the market in San Francisco opens and trades with the Far East and the East Coast of the US. The foreign exchange market is dominated by banks with about 90 percent of foreign-exchange trading comprising interbank trading. Nonbank participants in foreign-exchange trading include multinational corporations, commodities dealers, and nonbank financial institutions.

The three major functions performed by foreign exchange market are described below:

1. It is part of the internationals payment system and offers a mechanism for exchange or transfer of the national currency of a country into currency of another country, thus facilitating international business.
2. Its assists in supplying credits those are of short-term through swap arrangements and the Eurocurrency market.
3. It offers foreign-exchange instruments to hedge against risk.

Foreign-exchange trading sharply expanded under the floating exchange rate system and the number of banks participating in the market significantly increased as they entered the market for servicing their corporate clients. Increased hedging by companies of their balance sheets and cash flows was accompanied by the entry of new corporate participants in the market.

5.3.3 Foreign Exchange Rate Quotations

A foreign exchange rate quotation is “the expression of willingness to buy or sell at a set rate.” In foreign exchange businesses, several pairs of quotations are used. Quotations can either be in European terms or in American terms. European quotes are given as number of units of a currency per US dollar. For instance, CHF 0.93 per USD, EUR 0.91 per USD are quotes in European terms. In American terms, quotes can be given as number of US dollars per unit of a currency. For instance, USD 1.07per CHF and USD 1.30per GBP are quotes in American terms.

Direct and Indirect

We often come across terminology such as direct quote and indirect quote. In a country, direct quotes are “those that give units of the currency of that country per unit of a foreign currency.” Thus INR 76 per USD is a direct quote in India and USD 1.90 per EUR is a direct quote in the US. Indirect quotes or reciprocal quotes are stated “as number of units of a foreign currency per unit of the home currency.” Thus USD 0.013 per INR is an indirect quote in India. Similarly for currencies like Italian lira or Japanese yen, quotations may be in terms of 100 lira or 1000 yens. In the foreign exchange activities, US banks adhere to the European method of direct quotation.

Bid and Offer

Banks usually do not charge a commission on their currency transactions. They profit from the spread between the buying and selling rates. Quotes are given in pairs always because the dealer usually does not know whether a prospective customer is in the market to buy or to sell a foreign currency. The first rate is the buy or bid, price. The second rate is the sell, ask, or offer. For instance, if a pound sterling is quoted at \$ 1.7019-36, the quote means that the banks are willing to buy pounds at \$ 1.7019 and sell them at \$ 1.7036. In practice, the dealers quote only the last two digits of the decimal. In the above example, sterling would be quoted as 19-36.

The bid-ask spread i.e. "the spread between bid and ask rates for a currency is based on the breadth and depth of the market for that currency as well as currency's volatility. The bid-ask spread is usually stated as a percentage cost of transacting in

$$\text{Percent spread} = \frac{\text{Ask price} - \text{Bid price}}{\text{Ask price}} \text{ X } 100$$

For instance, if the pound sterling quoted at \$1.7019-36, the percentage spread equals 0.1%.

$$\text{Percent spread} = \frac{1.7036 - 1.7019}{1.7036} = 0.1\%$$

Widely traded currencies such as the pound, yen, the spread might be on the order of 0.1 to 0.5%. less heavily traded currencies have higher spreads.

Spot and Forward

Spot rate and forward rate is used for foreign exchange transactions between dealers in the interbank market. A spot rate is "the exchange rate for a transaction that requires almost immediate delivery of foreign exchange." A forward rate is "the exchange rate for a transaction that requires delivery of foreign exchange at specified future date (e.g. 30-day, 90-day or 180-day)."

Example

As per the ET dated 29th January 2022, the spot rate of USD/ INR is 75.04 and the forward rates of USD / INR for the next three months are as follows

28.02.22- ₹ 75.240

31.03.22- ₹ 75.525

30.04.22- ₹ 75.915

Contd….

Banks have fixed the **forward rates** based on certain criteria between the constituents of the forex market. The constituent is 'between forex dealers' to whom these rates apply to.

Source: ICFAI Research Center

Cross Rates

The cross rate is "the exchange rate between two infrequently traded currencies, calculated through a widely traded third currency." For instance, an importer in Argentina needs the Hong Kong dollar for paying a purchase in Hong Kong. The Argentinean peso is not quoted against the Hong Kong dollar. On the other hand, both the currencies are quoted against the US dollar. Suppose:

Argentina Peso: ARS 112.95/US$1 Hong Kong Dollar: HKD 7.83939 HKD/ US$1

Cross rates between Argentina Peso and Hong Kong Dollar: ARS 112.95/7.83939

= ARS 14.08/HKD

or HKD 7.83939/ARS 112.95 = HKD 0.0694/ARS

As most currencies are quoted against the dollar, it might be necessary to work out the cross-rates for currencies other than dollars. For instance, if the Deutsche mark is selling for $0.30 and the buying rate for the French franc is $0.075, then the DM/FF cross-rate is DM 1= FF4.

Activity 5.1 William Jack, an Argentine importer needs a Hong Kong dollar to pay for a purchase in Hong Kong. The Argentinean peso is not quoted against the Hong Kong dollar. Both currencies are quoted against the US dollar. Identify the foreign exchange rate quotation. Also discuss other foreign exchange rate quotations.

5.3.4 Transaction Forms

Spot Transactions

Spot transactions include spot transactions between banks and bank notes transactions for individuals. Spot transactions are usually settled on the second working day on which the transaction concludes. Bank notes transactions include currency changes for individuals that are exchanged for each other instantaneously over the counter. The largest financial market in the world is interbank foreign exchange. On the settlement date, most dollar transactions in the world are settled through the computerized Clearing House Interbank Payments Systems (CHIPS) in New York, which provides for calculating new balances owed by any one bank to another and for payment the same day in Federal Reserve of New York funds.

When an individual or a company needs foreign exchange to be paid for a foreign company, it can either use international wire transfers or customer drafts. Under a wire transfer, the payment instructions are sent through SWIFT or other electronic means. The bank sells this individual or company a foreign exchange draft that is payable to the stated foreign company.

Forward Transactions

A forward transaction occurs "between a bank and a customer calling for delivery at a fixed future rate, of a specified amount of foreign exchange at the fixed forward exchange rate." The exchange rate is set at the time of the agreement, but until maturity, payment and delivery is not required. International companies may either buy a foreign currency forward from a bank or sell a foreign currency forward to a bank. The position where the initial transaction represents an asset or future ownership claim to foreign currency is termed as long position. The position where the cash market position represents future obligation or liability to deliver foreign currency is termed as short position.

Example

Mr. Rajeev Agarwal is one of the largest producers of groundnuts on his 500 acres farm near Bhavnagar in Gujarat. He obtains an export order from Senanayike Oil mills (SOM), Galle Sri Lanka to sell 5,000 tonnes of the produce six months from 01.01.2022. Rajeev Agarwal enters into a forward contract with his banker, as he is concerned about a potential decline in the exchange rates. Here the Bank and Mr. Agrawal set the exchange rate for the transaction at the time of agreement.

Source: ICFAI Research Center

Swap Transactions

A swap is "an agreement to buy and sell foreign exchange at prespecified exchange rates where the buying and selling are separated in time." A swap transaction involves simultaneous sale and purchase of a given amount for two different dates of settlement. A same counter-party carries out both sale and purchase. Swap transactions are of two types –spot forward swap and forward-forward swap.

In a spot-forward swap, "an investor sells forward the foreign currency maturity value of the bill, and simultaneously buys the spot foreign exchange to pay for the bill." Because a known amount of the home currency of the investor will be received according to forward swap component, no uncertainty would exist from exchange rates. Similarly, those borrowing in foreign currency can buy forward the foreign currency essential for repaying foreign currency loan at the same time as they convert the foreign funds that are borrowed on the spot market.

A forward-forward swap involves two forward transactions. For instance, a dealer sells Euro 1,000,000 forward for dollars for delivery in three months at US$

0.94/Euro, and simultaneously buys Euro 1,000,000 forward for delivery in six months a2t6US$ 0.94/Euro.

The two preceding swaps are popular with banks as it is difficult to avoid them when making a market for future currencies and dates.

Example

As per a report in ET dated 1st July 2019, many large Indian banks have sought RBI's intervention about the sharp increase in hedging cost of corporates as banks are finding it difficult to handle surplus dollar. Many companies have borrowed foreign currency and exchanged for INR in Banks since foreign currency swap deals and diluted norms on Forex borrowings of RBI had encouraged many corporates to step up their foreign currency borrowings to hedge their risks due to currency fluctuations. However the difference between the interest on dollar and the interest on rupee which the corporate is required to pay at a later date was putting stress on their finances.

Source: ICFAI Research Center

5.3.5 Foreign Exchange Arbitrage

In the foreign exchange market, the information related to price is easily available through computer networks, which makes it easier for price comparison in other markets. As such, exchange rates tend to equal worldwide but temporary discrepancies do exist. These discrepancies offer profit opportunities for buying a currency in one market while simultaneously selling it in another. This activity is called as arbitrage. It continues until the exchange rates in different locales are so close that it is not worth the costs incurred in additional buying and selling.

Example

As per a report in ET dated 19th September 2019, there is a sharp increase in imports in oil market as India imports 75 % of its oil needs via overseas shipments. Due to volatility in crude price, there is a sharp movement in in the local currency against the dollar. There has been a continuous rise in onshore forwards premium in the past one month and forwards premium rose to 4.42 per cent from 4.03 per cent leading to an arbitrage. This has prompted traders to borrow dollars overseas, and sell them in the local markets thereby making a profit of almost a quarter rupee / $ between offshore and onshore forwards.

Source: ICFAI Research Center

5.3.6 Black Market and Parallel Market

Due to legal prohibitions or government restrictions on foreign exchange transactions, illegal markets in foreign exchange exist in many developing countries in response to private or business demand for foreign exchange. These illegal markets are known as black markets. The illegal markets exist openly in some countries (e.g. Venezuela and Brazil) where interference of government is very little. However, in some other countries, foreign exchange laws are enforced strictly and lawbreakers when caught receive harsh sentences (e.g. China before 1985).

Often, governments set an official exchange rate that widely deviates from the one established by the free market. If the government wishes to purchases foreign exchange at the official rate, but private citizens wish to pay the market-determined rate, there would be steady supply of foreign exchange to the black market. Thus it can be inferred that government policy creates a black market. The demand arises due to legal restrictions on buying foreign exchange, and the supply exists because official exchanges that are mandated by governments offer less than the free market rate. Ironically, governments defend the need for restrictions on foreign exchange based on conserving scarce foreign exchange that flows to the government as traders may instead to black market.

The black market when legalized by the government is referred to as parallel market. It operates as an alternative to the official exchange rate. In countries facing economic hardship, the parallel markets allow continuation of normal economic activities through a steady supply of foreign exchange.

5.4 International Capital Markets

5.4.1 International Monetary Markets

International money markets are markets where foreign monies are invested or financed. MNEs make use of international money markets for financing global operations at a lower cost than is possible in domestic markets. The MNEs borrow currencies having lower interest rates and are expected to depreciate against their own currency. However, they incur the risk that the borrowed currencies may appreciate, which increases their cost of financing. On the other hand, investors may substantially achieve higher returns in foreign markets than in their domestic markets when they invest in currencies that appreciate against their home country. If the currencies depreciate, however, the effective yield on foreign investments would be lower than the domestic yield, and may be even negative. Investors make attempts to capitalize on potentially high effective yields on foreign market securities, while reducing the exchange rate risk by diversifying investments across currencies.

Often transactions in the international money markets take place through Eurocurrency market. The Eurocurrency market comprises commercial banks that offer large loans in foreign currencies and accept large deposits. The banks offering Eurocurrency services are either local banks or subsidiaries foreign banks in a host country. The growth of the Eurocurrency market is attributed to growing international trade and capital flows as well as cross-border differences in interest rates. In this market, Eurodollar deposits are transacted intensively.

Eurodollars are US dollar deposits in non-US banks. Eurodollar deposits are not subject to reserve requirements and hence banks can lend out 100 percent of deposits. Loan transactions and deposits on Eurodollars are usually US$ 1 million or more per transaction.

Two popular Eurodollar deposits are Eurodollar fixed-rate certificate of deposits (CDs) and Eurodollar floating-rate certificate of deposits. The fixed-rate Eurodollar CDs are adversely affected by the rising market interest rates but they receive guaranteed interest. This problem is neutralized by the floating-rate Eurodollar CDs that offer the rate that can be adjusted periodically to the London Interbank Offer Rate (LIBOR) – the rate charged on interbank loans.

5.4.2 International Bond Markets

International bond markets are the markets where corporate bonds or government bonds are issued, bought, or sold in foreign countries. The growth of these markets is attributed to some unique features that are offered by international bonds which are not offered by domestic bonds. The development of the international bond market is attributed to tax law differentials across countries. In 1984, the elimination of withholding tax on US-placed bonds caused a large increase in the foreign demand for US-placed bonds.

Example

As per a news reported in Business Standard dated 25th July 2019, Government of India is planning to raise $ 10 billion debt from international market through yen or euro-denominated debt over a long period. The reason for such an offering is that interest rate in yen is low. The report also mentioned that there is a possibility of offering dollar denominate debt as well to improve its liquidity.

Source: ICFAI Research Center

Bonds placed in international bond markets are typically underwritten by an association of investment banking firms. Many underwriters in the Eurobond market, which is a market where bonds issued in one foreign currency are issued in the country using that currency, are US bank subsidiaries that have focused their growth on non-US countries since they were banned historically by the Glass-Steagall Act from underwriting corporate bonds in the US.

5.4.3 International Stock Markets

International stock or equity markets are markets where company stocks are listed and traded on foreign stock exchanges. Firms in need of finance make use of foreign stock exchanges as additional sources of funds. Foreign stock markets are used by investors for enhancing the performance of their portfolio. This source of financing allows MNEs to attract more funds without flooding their home stock market thus circumventing the decline in share price. Many MNEs also issue stock in foreign markets for circumventing regulations as regulatory provisions differ among markets. Firms believe that by issuing stock in foreign markets, they can achieve worldwide recognition among consumers. Further, listing stock on a foreign stock exchange enhances the liquidity of the stock but also increases the perceived financial standing of the firm when the exchange approves the listing application. It also protects firms against hostile takeovers as it disperses ownership and makes it difficult for other firms to gain a controlling interest.

The Euroequity market is a market where US dollar-denominated stocks are issued on non-US exchanges. This market has grown and developed since the 1980s. the stock issued in the Euroequity market are designed specifically for distribution among foreign markets. They are underwritten by an association of investment banks and purchased chiefly by institutional investors in several countries.

The firms" ability to place new shares in foreign markets partially depends on the perceived liquidity of the stock in that market. To enhance liquidity and make newly issued stocks attractive, a secondary market should be established in foreign markets.

5.4.4 International Loan Markets

International loan markets comprise large commercial banks and lending institutions that offer loans to foreign companies. Loan markets are not restricted only to foreign currency transactions, unlike international money markets that have dealings only with foreign money. As regulations across the US, Europe, and Japan have standardized, the markets for loans and other services become globalized. Thus some financial institutions make attempts to achieve greater economies of scale on the services offered by them. Even financial institutions that do not plan global expansion experience increased foreign competition in their home markets.

International lending is perceived as a means of diversification by banks from all countries. International lending also allows banks to develop relationships with foreign firms, which create a demand for other services offered by the bank. In addition, a major portion of international lending is to support international acquisitions. Investment banks and commercial banks serve as advisers as well as financial intermediaries by providing loans or by placing stocks and bonds. A common form of participation has been to offer direct loans to finance acquisitions, especially for leveraged buyouts (LBOs) by management or other investor groups. Since LBOs mostly are financed through debt, they result in a large demand for loanable funds. Most of the LBOs are supported by debt from an international syndicate of banks. In this way, each bank limits its exposure to a particular borrower. As the firms engaged in LBOs are from diversified industries, a problem in any industry does not lead to a lending crisis. In addition, the debt of each individual firm is relatively small so that many borrowers do not access to sufficient bargaining power for rescheduling their debt payments. For this reason, international bank financing of LBOs is considered to be less risky than offering loans to government of developing countries.

Lending to developing countries requires credit checking. International commercial banks and other lending institutions carry out credit checking based on an analysis by credit rating agencies such as Moody's and Standard and Poor's. The focus of analysis is on political risks and overall pressures on the balance of payments and macroeconomic conditions.

Activity 5.2 ABC Automobiles Ltd., a Japanese automaker is one the leading players in the Japanese auto market. The company planned to expand its operations in Germany, China and India. The company borrowed funds from several banks in Japan but the funds were insufficient to finance its expansion plans. Thus the company borrowed money from US banks in Tokyo. In this context, identify and define the international capital market. Also discuss other international capital markets.

5.5 Asian Financial Crisis

The Asian financial crisis depicts how a crisis should take place in international financial markets and how the crisis relates international financial markets, financial institutions, and the governments. The Asian financial crisis had first afflicted Thailand in June 1997, which then quickly spread to the Philippines, Indonesia, Malaysia, South Korea, and other Southeast and East Asian countries. Initially, the crisis took the form of a financial meltdown, with stock markets, currencies, and property prices dropping across the region. Economic aftershocks ensued. The crisis was soon to have its affect on markets and economies across the world from Europe to Latin America. The nations of East and Southeast Asia familiarized with high single or double digit growth rates shifted to sluggish and negative growth. These poor economic conditions prevailed in most of these nations until early 1999.

5.5.1 The Financial Perspective

According to the financial perspective, the Asian financial crisis resulted primarily due to weakness of the financial sector and market failure. Two factors stand-out for contributing to the financial sector weakness and market failure from the financial perspective. The first is the maintenance of the pegged exchange rates that were viewed as implicit guarantees of exchange that constrained monetary remedies. The second is excessive private sector short-term and dollar-denominated borrowing.

Additionally, the financial perspective emphasizes the effects of contagion on the crisis. Contagion fueled the crisis through the wake-up effect and the dynamics of competitive devaluation. The former explains the tendency of most of the foreign investors to treat all Asian countries as one and pull out investments from a country regardless of its market and economic fundamentals and the latter pertains to the pressure faced by Asian countries for devaluing their currency to match devaluation by neighboring countries.

5.5.2 The Political/Institutional Perspective

According to political/institutional-based explanations, the causes of Asian crisis extend beyond weaknesses in the financial sector and market failure. The political and institutional perspectives point to irresponsible domestic governance, corruption in the public and private sectors, crony capitalism, weak national and political institutions, misguided and poorly enforced regulatory environment, and other political and institutional-related factors as the principal forces behind the crisis.

The crisis highlighted key weaknesses in the institutions and political/economic systems of several Asian countries. The prevalent practice of crony capitalism in countries such as Malaysia, Thailand, and Indonesia led to an overextension of credit to undeserving companies with close ties to the military and political leadership. Due to conflicting business interests, politicians and government bureaucrats have been very ineffective in responding to the crisis.

The IMF noted three political and institutional-related considerations as forces contributing to the Asian financial crisis:

- In financial systems, lax enforcement of providential rules and inadequate supervision, weak management and poor control of risks, and government direct lending practices resulted in sharp deterioration of loan portfolios of banks.
- Lack of transparency and problems of data availability hindered market participants from maintaining a realistic view of economic fundamentals, and also added to uncertainty.
- Political uncertainties and governance problems aggravated the crisis of confidence, the downward pressure on currencies and stock markets, and the reluctance of foreign creditors to roll over short-term loans.

5.5.3 The Managerial Perspective

The third group of explanations advocates that micro-management was at the heart of the crisis. The booming economy of the 1990s encouraged many industrial companies in East and Southeast Asia to pursue risky over diversification. These companies relied on short-term debt financing to fund their expansion. For instance, the "chaebols" or the five largest conglomerates of South Korea (i.e. Samsung, Hyundai Motor, Lucky Goldstar, SK, and Kia contributed heavily to the GDP of South Korea .

Over diversification and extended leveraging led to the creation of a vicious cycle for many companies. Firms pursued risky ventures to service their expensive, short-term debt and earn large returns on their investment. When these risky projects failed, the firms borrowed more to keep their operations afloat. These companies maintained this practice until the banks were willing to extend their credit. When the financial crisis hit, the banks refused to extend their credit and this forced many firms into bankruptcy.

The problems for these firms were compounded by contracting export markets, falling commodity prices, and other external pressures. Instead of addressing these external pressures by cutting costs, improving productivity, and focusing on the bottom line, majority of the firms opted for growth and diversification into unrelated businesses. This strategy proved costly when the financial crisis hit and dried up the funds. In contrast, firms focusing on their core competencies – cutting costs, enhanced productivity, and focused on profitability were able to weather the storm.

Financial institutions and banks extended their credit to undeserving companies. When those companies could not repay, banks rolled over their loans and extended their credit. The financial perspective views the process as a market failure while the political/institutional perspective blames to overextended credit. The managerial perspective attributes such credit overextension to lack of sophistication in management and absence of administrative apparatus for conducting proper analysis and oversight.

Check Your Progress - 1

1. A ______________is an agreement between a buyer and seller for the delivery of certain amount of one currency at a specified rate in exchange for some other currency.
   a. International stock market transaction
   b. Foreign exchange transaction
   c. Domestic exchange transaction
   d. None of the above

2. ________________those that give units of the currency of that country per unit of a foreign currency.
   a. Indirect quotes
   b. Direct quotes
   c. Bid
   d. Offer
3. ________________ are stated as number of units of a foreign currency per unit of the home currency.
   a. Direct quotes
   b. Offer
   c. Bid
   d. Indirect quotes
4. A ______________ is the exchange rate for a transaction that requires almost immediate delivery of foreign exchange.
   a. Forward rate
   b. Spot rate
   c. Swap rate
   d. None of the above
5. A ______________is the exchange rate for a transaction that requires delivery of foreign exchange at specified future date.
   a. Swap rate
   b. Spot rate
   c. Forward rate
   d. indirect quote
6. The ____________ is the exchange rate between two infrequently traded currencies, calculated through a widely traded third currency.
   a. Forward rate
   b. Cross rate
   c. Spot rate
   d. None of the above
7. _________________include spot transactions between banks and bank notes transactions for individuals.
   a. Spot transactions
   b. Swap transactions
   c. Forward transactions
   d. None of the above

8. A _____occurs between a bank and a customer calling for delivery at a fixed future rate, of a specified amount of foreign exchange at the fixed forward exchange rate. swap
    a. Transactions forward
    b. Transactions spot
    c. Transactions
    d. None of the above
9. A ______ is an agreement to buy and sell foreign exchange at prespecified exchange rates where the buying and selling are separated in time.
    a. Swap
    b. Forward
    c. Spot
    d. Black market
10. The illegal markets in foreign exchange markets are known as ______.
    a. Parallel market
    b. Black market
    c. Primary market
    d. Secondary market
11. The black market when legalized by the government is referred to as _.
    a. Black market
    b. Parallel market
    c. Primary market
    d. Secondary market
12. ________________________comprise large commercial banks and lending institutions that offer loans to foreign companies.
    a. International stock markets
    b. International loan markets
    c. International money markets
    d. International bond markets
13. ________________________are markets where foreign monies are invested or financed.
    a. International bond markets
    b. International loan markets
    c. International money markets
    d. International stock markets

14. Often transactions in the ___take place through Eurocurrency market.
    a. International stock markets
    b. International money markets
    c. International bond markets
    d. None of the above
15. The ____________ are adversely affected by the rising market interest rates but they receive guaranteed interest.
    a. Eurodollar fixed-rate CDs
    b. Eurodollar floating-rate CDs
    c. international money markets
    d. None of the above
16. The ____________ offer the rate that can be adjusted periodically to the London Interbank Offer Rate.
    a. Eurocurrency market
    b. Eurodollar floating-rate CDs
    c. international stock markets
    d. Eurodollar fixed-rate CDs
17. ________________________are the markets where corporate bonds or government bonds are issued, bought, or sold in foreign countries.
    a. International stock markets
    b. International bond markets
    c. International money markets
    d. International loan markets
18. ________________________are markets where company stocks are listed and traded on foreign stock exchanges.
    a. International stock markets
    b. International loan markets
    c. International bond markets
    d. International money markets
19. The ____________ is a market where US dollar-denominated stocks are issued on non-US exchanges.
    a. Eurocurrency market
    b. Euroequity market
    c. Eurodollar market
    d. None of the above

20. The causes of Asian financial crisis can be understood from which of the following perspectives?
    i. Economic perspective
    ii. Managerial perspective
    iii. Political/institutional perspective
    iv. Social perspective
    v. Financial perspective
    a. i, ii, and v
    b. ii, iii, and iv
    c. i, iii, and iv
    d. ii, iii, and v
21. According to which perspective, the Asian financial crisis resulted primarily due to weakness of the financial sector and market failure?
    a. Managerial perspective
    b. Economic perspective
    c. Political perspective
    d. Financial perspective
22. The _____emphasizes the effects of contagion on the Asian financial crisis.
    a. Financial perspective
    b. Market perspective
    c. Institutional perspective
    d. Managerial perspective
23. The _____________ perspectives point to irresponsible domestic governance, corruption in the public and private sectors, crony capitalism, weak national and political institutions, and misguided and poorly enforced regulatory environment as causes for the Asian financial crisis.
    a. Managerial perspective
    b. Political/institutional perspective
    c. Financial perspective
    d. None of the above
24. The _____________ attributes such credit overextension to lack of sophistication in management and absence of administrative apparatus for conducting proper analysis and oversight as causes for the Asian financial crisis.
    a. Financial perspective
    b. Political/institutional perspective
    c. Managerial perspective
    d. Economic perspective

5.6 Summary

- A foreign exchange transaction is an agreement between a buyer and seller for the delivery of certain amount of one currency at a specified rate in exchange for some other currency.
- The foreign exchange market includes individuals, banks, corporations, and brokers who buy or sell currencies.
- International money markets are markets where foreign monies are invested or financed.
- International bond markets are the markets where corporate bonds or government bonds are issued, bought, or sold in foreign countries.
- International stock or equity markets are markets where company stocks are listed and traded on foreign stock exchanges.
- International loan markets comprise large commercial banks and lending institutions that offer loans to foreign companies.
- The Asian financial crisis depicts how a crisis should take place in international financial markets and how the crisis relates international financial markets, financial institutions, and the governments.

5.7 Glossary

Eurobond market: Eurobond market is a market where bonds issued in one foreign currency are issued in the country using that currency.

Eurocurrency market: The Eurocurrency market comprises commercial banks that offer large loans in foreign currencies and accept large deposits.

Eurodollars: Eurodollars are US dollar deposits in non-US banks.

Euroequity market: The Euroequity market is a market where US dollar-denominated stocks are issued on non-US exchanges.

Foreign exchange transaction: A foreign exchange transaction is an agreement between a buyer and seller for the delivery of certain amount of one currency at a specified rate in exchange for some other currency.

Foreign exchange rate quotation: A foreign exchange rate quotation is the expression of willingness to buy or sell at a set rate.

International bond markets: International bond markets are the markets where corporate bonds or government bonds are issued, bought, or sold in foreign countries.

International loan markets: International loan markets comprise large commercial banks and lending institutions that offer loans to foreign companies.

International money markets: International money markets are markets where foreign monies are invested or financed.

International stock: International stock or equity markets are markets where company stocks are listed and traded on foreign stock exchanges.

5.8 Self-Assessment Test

1. Define a foreign exchange transaction. List the participants in the foreign exchange market. Also state the functions of the foreign exchange market.
2. Describe different foreign exchange rate quotations.
3. Briefly describe the various transaction forms.
4. Define black market and parallel market.
5. Briefly explain the various international capital markets.
6. The causes of Asian financial crisis fall into three broad perspectives – financial, political/institutional, and managerial. Explain these perspectives in detail.

5.9 Suggested Readings/Reference Material

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3. Brett Steenbarger. Why diversity matters in the world of Finance. 2020. https://www.forbes.com/sites/brettsteenbarger/2020/06/15/why-diversity-matters-in-the-world-of-finance/?sh=36dba0637913

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5.10 Answers to Check Your Progress Questions

1. (b) Foreign exchange transaction

A foreign exchange transaction is an agreement between a buyer and seller for the delivery of certain amount of one currency at a specified rate in exchange for some other currency.

2. (b) Direct quotes

Direct quotes are those that give units of the currency of that country per unit of a foreign currency.

3. (d) Indirect quotes

Indirect quotes are stated as as number of units of a foreign currency per unit of the home currency.

4. (b) Spot rate

A spot rate is the exchange rate for a transaction that requires almost immediate delivery of foreign exchange.

5. (c) Forward rate

A forward rate is the exchange rate for a transaction that requires delivery of foreign exchange at specified future date.

6. (b) Cross rate

The cross rate is the exchange rate between two infrequently traded currencies, calculated through a widely traded third currency.

7. (a) Spot transaction

Spot transactions include spot transactions between banks and bank notes transactions for individuals.

8. (b) Forward transaction

A forward transaction occurs between a bank and a customer calling for delivery at a fixed future rate, of a specified amount of foreign exchange at the fixed forward exchange rate.

9. (a) Swap

A swap is an agreement to buy and sell foreign exchange at prespecified exchange rates where the buying and selling are separated in time.

10. (b) Black market

The illegal markets in foreign exchange markets are known as black markets.

11. (b) Parallel market

The black market when legalized by the government is referred to as parallel market.

12. (b) International loan markets

International loan markets comprise large commercial banks and lending institutions that offer loans to foreign companies.

13. (c) International money markets

International money markets are markets where foreign monies are invested or financed.

14. (b) International money markets

Often transactions in the international money markets take place through Eurocurrency market.

15. (a) Eurodollar fixed-rate CDs

The fixed-rate Eurodollar CDs are adversely affected by the rising market interest rates but they receive guaranteed interest.

16. (b) Eurodollar floating-rate CDs

The floating-rate Eurodollar CDs offer the rate that can be adjusted periodically to the London Interbank Offer Rate.

17. (b) International bond markets

International bond markets are the markets where corporate bonds or government bonds are issued, bought, or sold in foreign countries.

18. (a) International stock markets

International stock or equity markets are markets where company stocks are listed and traded on foreign stock exchanges.

19. (b) Euroequity market

The Euroequity market is a market where US dollar-denominated stocks are issued on non-US exchanges.

20. (d) ii, iii, and v

The causes of Asian financial crisis can be understood from financial, political/institutional, and managerial perspectives.

21. (d) Financial perspective

According to the financial perspective, the Asian financial crisis resulted primarily due to weakness of the financial sector and market failure.

22. (a) Financial perspective

The financial perspective emphasizes the effects of contagion on the Asian financial crisis.

23. (b) Political/institutional perspective

The political/institutional perspectives point to irresponsible domestic governance, corruption in the public and private sectors, crony capitalism, weak national and political institutions, and misguided and poorly enforced regulatory environment as causes for the Asian financial crisis.

24. (c) Managerial perspective

The managerial perspective attributes such credit overextension to lack of sophistication in management and absence of administrative apparatus for conducting proper analysis and oversight as causes for the Asian financial crisis.

Unit 6

International Economic Integration and Institutions

Structure

There are differences in the world community. But we have a common interest in a strong multilateral system.

- Joschka Fischer (Former Vice Chancellor of Germany)

6.1 Introduction

The previous unit discussed different concepts in international foreign exchange rate markets. It then explained the different international capital markets. It finally discussed the three perspectives that highlight the causes for the Asian financial crisis.

The International economic relations are governed by a variety of institutions and treaties which have boosted economic integration and erased barriers to free trade, service, and investment among nations. International economic integration is propelled by three levels of cooperation – global, regional, or commodity. Global-level cooperation occurs through international economic agreements or organizations (e.g. WTO). Regional-level cooperation takes place through common markets or unions (e.g. NAFTA), and commodity-level cooperation takes place through multilateral commodity cartels or agreements (e.g. OPEC).

With the increasingly integrated environments, multinational enterprises have also realigned their international strategies as they are a critical force in steering international economic integration.

This unit will discuss the different forms of economic integration. It then goes into explaining the three fundamental institutions affecting cooperation among nations at the global level – the World Trade Organization, the International Monetary Fund, and the World Bank. It then discusses different regional agreements and international commodity agreements. It finally discusses the strategic responses of multinational enterprises to regional economic integration.

6.2 Objectives

By the end of this unit, students should be able to:

- Describe the different forms of economic integration.
- State the different institutions affecting global-level cooperation.
- Discuss different regional agreements and international commodity agreements.
- Explain the strategic responses of multinational enterprises to regional economic integration.

6.3 International Economic Integration

Economic integration concerns removal of trade barriers or impediments between at least two participating nations and establishing and coordinating between them. Economic integration helps steer the world toward globalization. The following forms of economic integration are implemented often:

Free trade area involves country combination, where the member nations remove trade barriers among themselves while retaining their freedom related to policy making vis-à-vis non-member countries. Examples of free trade area include Latin American Free Trade Agreement and North American Free Trade Agreement.

Customs union is identical to free trade area except that member nations must pursue and conduct common external commercial relations like common tariff policies on imports from non-member nations. Examples of this form include the Caribbean Community and Common Market (CARICOM) and the Central American Common Market (CACM).

Common market is a particular customs union that permits free trade of products and services only but with free mobility of production factors across national member borders. Example of this form is the Southern Common Market Treaty (MERCOSUR).

Economic union is a particular common market that unifies fiscal and monetary policies. The participants bring in a central authority for exercising control over these matters so that member nations become an enlarged entity.

Political union requires participating nations to become one nation in a political and economic sense. This union involves establishing a common parliament and other political institutions.

The above forms reflect economic integration between or among nations in a region. Global economic integration also takes place through multilateral cooperation in which nations who participate are bound by rules, responsibilities, or principles which are stipulated in commonly agreed agreements. Multilateral agreements promote worldwide economic exchanges. They may be designed for governing general trade, investment, service, capital flows, financial market stability, or specific areas of trade.

Economic integration generates economic gains for participating nations. Production efficiency can be enhanced by increased specialization according to the law of comparative advantage. The increased market size increases economies of scale which in turn elevates the level of production. Further, the collective bargaining power of the member nations increases against non-member nations. This power lead to better terms of trade that is higher price on products exported to non-participating countries and lower prices on imports from non-participating countries. However, these gains are not guaranteed nor will each member country benefit equally from integration. Free mobility of production factors may create pressures on inflation rates, employment levels, income distribution, or trade balance for nations that are in different economic stages or have a varying dependence on the goods and services of other nations.

Activity 6.1

In December 1995, an agreement came into effect between Turkey and European Union wherein goods could travel between two entities without any restriction. Identify the form of economic integration. Also discuss other forms of economic integration.

Answer:

6.4 Cooperation among Nations at the Global-Level

The three fundamental institutions affecting cooperation among nations at the global level are the World Trade Organization, the International Monetary Fund, and the World Bank. While the WTO serves as the institutional foundation of the international trade system, the IMF and the World Bank serve as institutional foundation of the international monetary and financial system.

6.4.1 The World Trade Organization (WTO)

Background and Structure

The World Trade Organization came into being on January 1, 1995 as a multilateral trade organization that aimed at international liberalization of trade.

It came as a successor to the General Agreement on Tariffs and Trade (GATT). GATT was set up after the first round of tariff negotiations at the Geneva conference held in 1947 on the proposed International Trade Organization (ITO). After periodic rounds of multilateral negotiations on tariff cuts and non-tariff reductions, GATT was evolved.

Prior to the Kennedy Round, early negotiations primarily dealt with reducing tariffs. By the end of the Tokyo round in 1979, the need to confront increasing usage of non-tariff barriers, especially by developed countries, led to the adoption of number of codes that dealt with specific practices. The scope of GATT was broadened in the Uruguay round where it reintroduced the idea of a comprehensive international trade organization for coordinating international economic activities.

The Uruguay Round agreement took effect in 1995 and specified several liberalization measures that had an effect on the threats and opportunities of international companies. First, members agreed to slash export subsidies by 36 percent and domestic agricultural price supports by 20 percent. These subsidy reductions benefited major exporters in Canada, Australia, Thailand, New Zealand, and the US. Second, the Uruguay Round set up several principles concerning trade in services. Third, the Uruguay Round agreement strengthened the protection of intellectual property rights which includes trademarks, patents, copyrights, brand names, and expertise.

As a successor to GATT, the main objective of the WTO is to establish trade policy rules that raise living standards and help expand international trade. The WTO pursues these objectives by administering trade agreements, settling trade disputes, acting as a forum for trade negotiations, cooperating with international organizations, and assisting developing countries on trade policy issues through training programs and technical assistance.

The WTO has 153 members as of July 2008. The Ministerial Conference is the top-level decision-making body of the WTO, which meets at least once in two years. The General Council is the highest-level decision-making body of the WTO where member nations are represented as heads or ambassadors of delegations. The General Council also meets as the Dispute Settlement Body and the Trade Policy Review Body. The Goods Council, Trade-Related Aspects of Intellectual Property Council, and Services Council report to the General Council. In addition, several specialized working groups or committees deal with individual agreements and other crucial areas such as the development membership applications, environment, trade and investment, regional trade agreements, trade and competition policy, and transparency in government procurement. Electronic commerce is also studied by many councils and committees.

Functions

The dominant function of the WTO is reduction of import duties. Other functions include elimination of discrimination. The main principles designed for eliminating discrimination are the most-favored-nation treatment and the national treatment. The most-favored-nation (MFN) treatment means that "any advantage, favor, or privilege granted to one country must be extended to all other member countries." For instance, if Canada reduced its import tariffs on German cars to 20 percent, it should cut its tariffs on imported cars from all other member nations to 20 percent. The national treatment means that "once they have cleared customs, foreign goods in a member country should be treated the same as domestic goods."

There are some exceptions to the MFN principle. First, the WTO permits members to establish regional or bilateral custom unions or free trade areas. Second, the WTO permits members to lower tariffs to developing countries without lowering them to developed countries. The third exception is the escape clauses allowed by the WTO. Escape clauses are "special allowances permitted by the WTO to safeguard infant industries or nourish economic growth for newly admitted developing countries." The purpose of escape clauses is to help the developing countries members safeguard their economies.

Another WTO function is to combat forms of protection and trade barriers. The WTO eliminates quantitative restrictions to maintain agricultural products or to balance foreign exchange reserve by a member government. Quantitative restrictions on industrial products can be levied by imposing an anti-dumping duty. Dumping is "sale of imported goods either at prices below what a company charges in its home market or at prices below cost." Other forms of protection include customs valuation, subsidies, import deposit without interest, excise duties, and countervailing duty. The non-tariff barriers were effectively combated in the Uruguay Round. The Trade Policy Review of the WTO monitors the trade policies of its members regularly.

Example

Insitesonindia.com dared 1st January 2022 has reported, "India has imposed anti-dumping duty on five Chinese products, including certain aluminium goods and some chemicals, for five years through quantitative restrictions to guard local manufacturers from cheap imports from the neighbouring country". This action of India comes under one of the functions of WTO, i.e., Combat forms of protection and trade barriers.

Source: ICFAI Research Center

Another significant function of the WTO is to provide a forum for dealing with various emerging issues that concern the world trade system such as the environment, regional agreements, economic development, intellectual property, government procurement, unfair trade practices, and special sectors such as agriculture, financial services, telecommunications, and maritime services. From such forum discussions, many new rules have been derived. For instance, the Trade-Related Intellectual Property Agreement (TRIP) brings new discipline for protecting copyrights, patents, trade secrets, and similar components of intellectual property.

Finally, the WTO functions as a united dispute settlement system for members through its Dispute Settlement Body which consists of representatives from every WTO member. The DSB has the solitary authority for establishing dispute settlement panels for cases, for adopting panel reports, for monitoring implementation of its rulings and for authorizing suspension of rights if its rulings are not acted upon by the members in a timely fashion.

The WTO and GATT are viewed as „club of rich nations" by some developing countries. While being beneficial for the world trade in total, benefits largely on the bargaining power a member nation or group of member nations. Developing countries often believe that they are victims of unfair trade practices and policies adopted by rich nations. Developing countries have asked affluent nations to honor commitments to remove unfair treatments and open more markets.

6.4.2 The International Monetary Fund (IMF)

The IMF and the World Bank are together referred to as the Bretton Woods Institutions, as they were established at Bretton Woods, New Hampshire, in July 1944. The overall objectives of the IMF include expansion of international trade, reduce disequilibrium in balance of payments of member countries, and promote international monetary cooperation. For accomplishing these objectives, IMF seeks to maintain orderly exchange arrangements, promote exchange stability, avoid competitive exchange depreciation, and provide confidence to member states. IMF was established for rendering temporary assistance to member countries trying to defend their currencies against random, seasonal, or cyclical fluctuations. It also assists countries having structural trade problems if they take ample steps for correcting their problems.

The IMF is headed by Board of Governors, consisting representatives from all member countries. The IMF requires all members to collaborate with the Fund in promoting a stable system of exchange rates for facilitating the exchange of goods, capital, and services, and for providing conditions essential for economic and financial stability. Members should avoid manipulating exchange rates in order to prevent effective balance of payments adjustments or as an effort to gain unfair competitive advantage.

The world community has been increasingly using the IMF as a vital forum for multilateral surveillance and coordination of monetary and fiscal policies.

IMF has begun to develop greater flexibility for responding purposefully and quickly to change economic conditions constantly.

The IMF created the Special Drawing Right (SDR) for carrying out tasks of monitoring the international monetary system and supplementing foreign exchange reserves. SDR serves as unit account for the IMF and other regional and international organizations, and is also the base against which countries peg the exchange rate of their currencies. SDRs are not circulated internationally. Individual countries hold SDRs in the IMF in the form of deposits. Members settle transactions among themselves by transferring SDRs.

Example

Business Standard dated 1st September 2021 has reported, "The International Monetary Fund (IMF) has sharply increased its allocation of Special Drawing Rights (SDR) to India, in line with the country's existing quota in the fund". The total SDR holdings of India now stands at SDR 13.66 billion which is equivalent to around USD 19.41 billion as on August 23, 2021, as per the RBI and the increased SDR will reflect in the foreign exchange reserves data. In the given case, SDR serves as a unit account for the IMF and members settle transactions among themselves by transferring SDRs.

Source: ICFAI Research Center

6.4.3 The World Bank Group

The World Bank refers to International Bank for Reconstruction and Development (IBRD). It has three affiliates – the International Development Association, the International Finance Corporation (IFC), and the Multilateral Investment Guarantee Agency (MIGA). Together with its affiliates, World Bank is known as the World Bank Group. The common objective of these institutions is to help raise living standards in developing countries by channeling financial resources to them from developed countries.

The World Bank was set up in 1945 and is owned by 160 countries. The subscription of its member countries funds the capital of the World Bank. Its lending operations are financed chiefly through its borrowings in the world capital markets. A significant contribution to World Bank's capital resources also comes from its flow of repayments on its loans and its retained earnings. The loans offered by the World Bank are repayable over 15 to 20 years with a grace period of five years. Loans are geared toward developing countries that are in advanced stages of social and economic growth. The interest rates on these loans are calculated based on the cost of borrowing, which makes the interest rate lower than market interest rates.

The World Bank's charter lists basic rules governing its operations. It should lend only for productive purposes and should stimulate economic growth in the developing countries which are recipients of the loan. It must pay due regard to prospects of repayment. Each loan is made to a government or should be guaranteed by the concerned government. The use of loans cannot be restricted to purchases in any member country particularly.

The IDA was established in 1960. It concentrates on developing the least developed nations. The terms of IDA credits, which are usually made to governments, are grace period of ten years, 35- or 40- year maturities, and no interest. The IFC was set up in 1956 with the stated aim to assist the economic development of developing countries by promoting growth in the private sector of the economies and serving to mobilize domestic and foreign capital for this purpose. The MIGA was established in 1988. It specializes in encouraging equity investment and other direct investment flows to the developing countries by mitigating the non-commercial investment barriers.

Example

In March 2020, Somalia became a member-nation of the Multilateral Investment Guarantee Agency (MIGA). MIGA's Executive Vice President Hiroshi Matano stated (CNBC Africa, March 31, 2020) that it has started looking opportunities for expanding and increasing foreign direct investments in the fields of agri-business, energy, information and communications technology sectors, and small and medium-sized finance sectors for Somalia. This would help Somalia achieve higher trade flows, economic growth and sustainable development in the long run.

Source: ICFAI Research Center

Since the late 1990s, the cooperation between the WTO, IMF, and the World Bank has increased significantly. This includes information sharing, participation in meetings, contacts at the staff level, and the creation of a High Level Working Group on Coherence that manages the process and prepares an annual joint statement on Coherence. In 1998, the WTO Secretariat collaborated with the IMF and the World Bank staff for assisting developing countries in stimulating their foreign trade and their participation in the multilateral trading system.

Activity 6.2

An Asian country took US$ 4 billion loan from an affiliate of theWorld Bank. The country did not have to pay an interest to the World Ban and had to repay the loan in a 10 year period. Identify the affiliate of the World Bank. Also discuss other affiliates of the World Bank.

Answer:

6.4.4 Other International Economic Organizations

Some of the other International Economic Organizations are:

The Organization for Economic Cooperation and Development (OECD)

In December 1960, the Organization for Economic Cooperation and Development (OECD) was established. It includes the US, Canada, Japan, Australia, New Zealand, and Mexico. It stated mission is to aid in achieving the highest possible growth in the economies of member countries as well as non-member states. Its emphasis is on employment expansion, financial stability, economic development, improvement of living standards, and extension of world trade on a non-discriminatory and multilateral basis. The highest authority in the OECD is the council. The OECD does not have specific provisions on liberalization of goods, capital, and invisible transactions. After the formation of the European Union, the aim of OECD is to coordinate the economic policies of all developed countries.

The United Nations Conference on Trade and Development (UNCTAD)

UNCTAD is a forum that examines economic problems that plague developing countries. It also formulates, negotiates, and implements measures for improving the development process of developing countries. This forum is essential for achieving the demand for "a new international economic order" that involves more trade and capital concessions on the part of developed countries. Developing countries hope to solve three problems through UNCTAD:

- The share of developed countries in world trade is decreasing and the terms of trade with developed countries are deteriorating.
- Developed countries markets are not adequately open for manufacturing products of developing countries.
- The aid given to developing countries is inadequate and they have huge foreign debts.

6.5 Cooperation among Nations at the Regional-Level

After World War II, multilateral trade liberalization has been paralleled by an integration process through regional agreements. From 1947 to 1994, 109 agreements have been reported to the GATT.

Example

Business Standard dated 16th January 2022 has reported, "India's extension of USD 400 million to Sri Lanka under the SAARC currency swap arrangement and deferral of A.C.U. settlement of USD 515.2 million by two months, are key assistance in the current Sri Lankan foreign currency shortage situation, according to analysts".

Contd….

Further Sri Lanka has urged more Indian investments in ports, infrastructure, energy, power and manufacturing sectors, days after New Delhi announced a USD 900 million loan to Colombo. There, the **international economic cooperation** at regional level is noticed in the given case.

Source: ICFAI Research Center

India's support to Sri Lanka in the form of economic assistance is under SAARC framework that is the South Asian Association for the Regional Cooperation and is at regional level as the name itself suggests.

6.5.1 Postwar Regional Integration

Postwar regional integration is characterized by three features. First, it has been primarily centered in Western Europe. The creation of the European Economic Community (EEC) in 1958 after signing of the treat in 1957 and the European Free Trade Association in 1960 initiated a process that aimed to enlarge the scope of regional integration among European countries with other countries. A significant feature of trade policies of non-European countries is integration through preferential trade agreements.

Second, many developing countries particularly in Asia and Latin America have renewed their interest in regional integration since the beginning of the Uruguay round. Regional integration can broaden the openness and internationalization of developing economies while avoiding overdependence on world markets. Moreover, continued economic reforms suggest that the overall policy environment have become conducive to objectives of regional integration.

Third, the level of economic integration varies among different agreements. Most of the regional integration agreements involve free trade areas, and the number of customs union agreements is small. It is useful to distinguish between reciprocal arrangements and non-reciprocal arrangements among free trade agreements. In a reciprocal agreement, each member agrees to reduce or eliminate trade barriers. In a non-reciprocal agreement, some developed countries may reduce barriers to trade.

The North American Free Trade Agreement (NAFTA)

On December 17, 1992, the leaders of Canada, Mexico, and the US signed the North American Free Trade Agreement (NAFTA), creating a tri-national market area. NAFTA is the first free trade agreement between industrial countries and a developing nation (Mexico). The agreement enhances the ability of North American producers for competing globally.

NAFTA came into effect on January 1, 1994 uniting the US with its largest (Canada) and third largest (Mexico) trading partners. On the basis of the earlier US-Canada Free Trade Agreement, NAFTA dismantled trade barriers for industrial goods and included agreements on agriculture, investments, services, and intellectual property rights.

NAFTA also includes side agreements on import surges, labor adjustments, and environmental protection. The side agreement on import surges creates an early warning mechanism for identifying sectors where sudden, explosive trade growth may significantly harm the domestic industry. The side agreement on labor adjustments came due to concerns of America workers that US jobs would be exported to Mexico due to cheap labor, weak child labor laws, etc. The side agreement on environmental protection ensures the rights of the US for safeguarding the environment.

With the integration of the Mexican, Canadian, and the US markets, many companies have changed their plans and business strategies for serving the North American market efficiently.

6.5.2 Europe: The European Union

The postwar efforts for the formation of the European Union have been a long process, beginning with the formation of EEC in 1957. On January 1, 1995, the European Community (EC) was formed comprising the Netherlands, Belgium, France, Luxembourg, Ireland, the UK, Denmark, Italy, Germany, Portugal, Greece, Spain, Finland, Sweden, and Austria. These member states constitute the economic level of the European economic integration. The outer tier of trade and economic liberalization around the EC is composed of countries in eastern and central Europe as well as the Mediterranean countries with which the EC had included reciprocal trade agreements.

The Treaty of European Union, signed in February 1992, was enforced in November 1993. The most basic step in strengthening political and economic ties among member states of the EC occurred with this treaty. This treaty promotes economic and trade expansion in a common market as well as embraces the formation of a monetary union, common citizenship, establishment of a common foreign and security policy, and the development of cooperation on social affairs and justice. The treaty's significance was marked by the adoption of European Union (EU). The Maastricht Treaty includes several high-impacting provisions such as:

It creates a common European currency called the European currency unit (ECU). The ECU is a popular unit for international payment, security investment, bond issuance, commercial loans, bank deposits, and traveler's check.

Every citizen in an EU member state is eligible to obtain a European passport, which allows them to move freely from one country to another within the EU.

- It includes provisions on cooperation in fields of domestic affairs and justice.
- It empowers the EU to play an active role in trans-European transport and environmental protection.
- It increases the European Parliament's power to enact legislation.
- It removes restrictions on capital movements between member states. It sets a European Central Bank that is responsible for monetary policy.

6.5.3 Asia Pacific

In November 1994, the Asia-Pacific Economic Cooperation Forum (APEC) was founded. Its member states comprise New Zealand, Mexico, Canada, Australia, the US, Chile, China, Japan, Hong Kong, South Korea, Papua New Guinea, Chinese Taipei (Taiwan), Indonesia, Singapore, Malaysia, the Philippines, Thailand, and Brunei. APEC is cross-regional spanning Asia, North, and South America, and the Pacific.

Asia is distinctive in many ways. First, many countries have accelerated their trade liberalization in the region at the sub-national level by authorizing special investment areas and export processing zones within each country.

Second, many neighbors which are geographically proximate in Asia have reached less formal trade agreements. For instance, members of South Asian Association for Regional Cooperation (SAARC) – Bhutan, Pakistan, Sri Lanka, Maldives, and India have concluded a trade agreement in April 1993.

Finally, numerous sub-regional economic zones have emerged. These zones are also called transnational export processing zones, natural economic territories, or growth triangles.

Example

The regional economic integration of ASEAN led to the signing of SIJORI pact by three regions – an acronym for Singapore, Johor (Malaysia), and Riau (Indonesia). A published article by Xu Xiadong in the Journal of Maritime Studies and National Integration (2019) had stated that due to this pact Singapore obtained the rights of drawing fresh water from Johor River in Johor. Advanced infrastructure, financial resources and management expertise flowed from Singapore to Riau and Johor. Singapore and Malaysia helped Riau establish a regional centre of industry for Indonesia. Workforce mobility improved from Johor and Riau to Singapore.

Source: ICFAI Research Center

6.5.4 ASEAN

On August 8, 1967, the Association of South East Asian Nations (ASEAN) was established by Malaysia, the Philippines, Indonesia, Thailand, Singapore, and Brunei. ASEAN adheres to the principles of the United Nations Charter, which stipulated the Association to be open to participation by all stated in the Southeast Asian region subscribing to its aims, purposes, and principles. ASEAN aims to promote peace, stability, and economic growth in the region. In January 1992, the AFTA agreement was signed by six member nations including Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand. Vietnam joined in 1995 followed by Laos and Myanmar in 1997 and by Cambodia in 1999. The AFTA is a trade bloc agreement that aimed to support local manufacturing in all the ASEAN countries. The primary goal of AFTA is to increase ASEAN"s competitive edge as a production base in the world market b elimination tariff and non-tariff barriers within ASEAN countries. In order to become a free trade zone, ASEAN countries have cut tariffs on several products such as chemicals, ceramics, cement, pharmaceuticals, etc. Another major goal of AFTA is to attract foreign direct investment to ASEAN. As of 2011, the member states of ASEAN included Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. The member countries of ASEAN are diverse in terms of geographical, economic, political, and cultural backgrounds.

6.5.5 SAARC

Founded in December 1985, South Asian Association for Regional Cooperation (SAARC) is an association of South Asian nations. Its members include Bangladesh, Bhutan, India, Pakistan, Maldives, Sri Lanka, Nepal, and Afghanistan are dedicated to social, economic, technological, and cultural development. The areas of cooperation include Agriculture; education, culture, and sports; environment and meteorology; tourism; transport; communication; rural development; health, population, and child welfare; and science and technology.

6.5.6 Latin America

In 1960, the Latin American Free Trade Association (LAFTA) was formed in Latin America by Argentina, Brazil, Bolivia, Colombia, Chile, Ecuador, Mexico, Peru, Paraguay, Uruguay, and Venezuela. In the same year, the Central American Common Market (CACM) was formed by Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. Both the agreements failed to achieve their objectives of due to different economic policies and economic conditions.

In 1973, the Caribbean Community and Common Market (CARICOM) were started by the Caribbean region. The objectives of this treaty is to achieve economies of scale in the regional production of transportation, services, health, education, and to pool financial resources for investment in a regional development bank. This treaty also targets coordination of development planning and economic policies.

In 1980, LAFTA was superseded by Montevideo Treaty, which set up the Latin America Integration Association (LAIA) with the stated goal to increase bilateral trade among member countries.

Example

The economic and business magazine Atalayar dated 5th November 2021 has published an article on the increased trade between Argentina and Brazil. "Argentina has achieved its highest level of exports to Brazil in the month of October 2021 worth US$1.218 billion". The article also mentions the good prospects of increased trade between the member countries of the **economic** regional forum comprising Argentina, Brazil, Bolivia, Colombia, Chile, Ecuador, Mexico, Peru, Paraguay, Uruguay, and Venezuela.

Contd….

Here, LAIA is the trade agreement that represents the trade between Brazil and Argentina in the given case.

Latin America Integration Association (LAIA) was formed to increase bilateral trade among member countries of Latin America comprising Argentina, Brazil, Bolivia, Colombia, Chile, Ecuador, Mexico, Peru, Paraguay, Uruguay, and Venezuela. The trade between Argentina and Brazil falls under LAIA.

Source: ICFAI Research Center

In 1991, the Southern Common Market Treaty (MERCO-SUR) was formed by Argentina, Brazil, Paraguay, and Uruguay, which formed a common market for free circulation of labor, capital, goods, and services. The member countries also aimed to coordinate macroeconomic policy and harmonize legislation for strengthening the integration process. Since January 1, 1995, members of the MERCOSUR have used common external tariff rates and common tariff structures.

Other members of the LAFTA, including Colombia, Peru, Bolivia, Ecuador, and Venezuela formed the Andean Free Trade Area in 1992 with a common external tariff. On January 1, 1993, the Central American Common Market (CACM) established a customs union and reactivated its objectives.

6.5.7 Africa and the Middle East

In 1975, the Economic Community of West African States (ECOWAS) was established with members comprising Burkina Faso, Benin, Mali, Niger, Mauritania, Cote d‟lvoire, Senegal, Liberia, Guinea, Cape Verde, Sierra Leone, Ghana, Gambia, Nigeria, Togo, and Guinea-Bissau. In 1981, ECOWAS eliminated duties on unprocessed agricultural products and handicrafts. In 1990, it implemented free trade for all unprocessed products. Other activities include steps to avoid the use of hard currencies in intra-member trade through a regional payments-clearing system, progressive liberalization of industrial products, and cooperation on industrial and agricultural investment projects.

Example

The nationonline.net dated 22nd December 2021 has reported that “two western African states Nigeria, Ghana have decided to get the trade dispute settlement amongst themselves under the regional forum of western African countries for the implementation of trade and other economic related activities and both have signed joint statement” in this regard. This was necessitated in order to engage and effectively find a lasting solution to the recurring dispute between Nigerian traders and their Ghanaian counterparts. In the given case, ECOWAS is the regional forum under which western African countries can settle their disputes and implement free trade.

Source: ICFAI Research Center

In 1966, in former French Africa, the Central African Economic and Customs Union (UDEAC) was established comprising Gabon, Chad, Congo, the Equatorial Guinea, the Central African Republic, and Cameroon. The EDEAC offers a framework for free capital movement throughout the area, harmonization of fiscal incentives, and coordination of industrial development. In 1990, a common external tariff was introduced by four member countries – Cameroon, Gabon, the Central African Republic, and Congo.

In 1967, the East African Economic Community (EAEC) was formed in former British East Africa by Tanzania, Uganda, and Kenya. In 1979, the EAEC was dissolved and three members joined with other states (Angola, Burundi, Comoros, Djibouti, Ethiopia, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Rwanda, Somalia, Sudan, Swaziland, Zambia, and Zimbabwe) for establishing the Preferential Trade Area for eastern and south African states in 1981. Its goal includes establishing a common market and promoting trade and economic cooperation among its members.

In 1981, Kuwait, Oman, Bahrain, Qatar, Saudi Arabia, and the UAE established the Gulf Cooperation Council (GCC) in the Middle East. A free trade area that covered agricultural and industrial products was set. In 1989, the Arab Maghreb Union was set up by Algeria, Morocco, Mauritania, and Tunisia, for laying the foundation for a Maghreb Economic Area.

6.6 Cooperation among Nations at the Commodity-Level

The emergence of several international commodity agreements is a natural development in the international economic relations. Countries may also cooperate for controlling the pricing, sale, and production of goods that are traded internationally. A commodity cartel is “a group of producing countries that wish to protect themselves from the wild fluctuations that often occur in the prices of certain commodities traded internationally (e.g. coffee, rubber, cocoa, or crude oil).” Cartel members may seek stable and higher prices for their goods. A commodity cartel can increase the prices of their goods in international markets by limiting overall output and assigning production quotas to individual countries. The two important commodity cartels that influence the world economy are OPEC and the Multifiber Arrangement.

6.6.1 Organization of Petroleum Exporting Countries (OPEC)

The Organization of Petroleum Exporting Countries (OPEC) is the most notable and critical commodity. It is not a commercial entity, but an intergovernmental organization. It has 13 members, including Iraq, Iran, Kuwait, Saudi Arabia, Algeria, Venezuela, Ecuador, Indonesia, Libya, Gabon, Nigeria, Qatar, and the United Arab Emirates. OPEC is the strongest collective force that impacts oil prices in the international oil market. OPEC controls the price in world markets by assigning its members production quotas that limit the overall amount of crude oil that would be supplied internationally.

OPEC became a catalyst for action by developing countries to make sure export earnings that are remunerative from their topical products and raw materials. For instance, The Intergovernmental Council of Copper Exporting Countries and The International Bauxite Association were formed in the 1970s by major developing countries that produced these commodities.

6.6.2 The Multifiber Arrangement (MFA)

The Multifiber Arrangement (MFA) originally signed in 1972 is an agreement between exporting and importing countries for controlling exports of apparel and textiles from developing countries to developed countries. The MFA took advantage of a GATT rule exemption that allowed individual importing countries to establish quota and other restrictions on apparel and textile exports on a country-by-country basis. Nearly two-thirds of the apparel and textile products traded internationally were covered by the MFA.

The MFA had been renewed several times due to the lack of a better solution between developing and developed over the trade involving apparel and textile trade. For instance, the US and China negotiated yearly over the quota of Chinese exported garments and textiles. The process was lengthy due to conflicts over issues on which both the parties do not compromise. The MFA governed the world trade in textiles and garments till 2004. In 2004, at the GATT Uruguay round it was decided that the textile trade would be brought under the WTO. Hence the MFA expired on January 1, 2005. Thus, the MFA ended on Jan. 1, 1995, and was replaced by the Agreement on Textiles and Clothing under the World Trade Organization (WTO)

6.6.3 Other international Commodity Arrangements

Other multilateral commodity arrangements include The International Sugar Agreement, The International Tin Agreement, The International Cocoa Agreement, The Wheat Trade Convention, the International Coffee Agreement, and the International National Rubber Agreement.

6.7 Strategic Responses of Multinational Enterprises

International economic integration has a profound effect on the operations of multinational enterprises. The activities of an MNE are triggered by economic integration, which then increases foreign direct investment in the integrated region. In response to regional economic integration, some strategies can be identified. The defensive export substituting investment is a strategy by which MNEs protect their existing market share gained through exports by switching to direct production inside the region. For instance, Dow Chemicals and Du Pont had increased investments in their export-oriented operations in Canada in reaction to NAFTA.

Another strategy adopted by MNEs is the offensive export substituting strategy in which MNEs prefer to ensure market penetration by making direct investments in the region before the region is officially integrated. This strategy helps an MNE gain an early position in the market.

The third strategy is the rationalized foreign direct investment strategy in which MNEs increase their investment and heighten resource commitment to the integrated region to gain greater economic efficiency through market expansion and scale economies.

Finally, the reorganization investment is a strategy by which MNEs realign their value-added activities and organizational structures in order to reflect a regional market. Firms realign investment capital among trading bloc members once the protective barriers are removed. Under this strategy, MNEs increase their cross-border investment activities within the region.

In response to economic integration, MNEs, including those from developing economies such as Brazil, South Korea, Singapore, and Taiwan have been employing cross-border strategic alliances actively. These alliances allow then to enter new markets more rapidly than mergers or acquisitions.

Check Your Progress - 1

1. _________________concerns removal of trade barriers or impediments between at least two participating nations and establishing and coordinating between them.
   a. Economic integration
   b. Dumping
   c. Anti-dumping
   d. None of the above
2. Free trade area involves country combination, where the member nations remove trade barriers among themselves while retaining their freedom related to policy making vis-à-vis non-member countries.
   a. Free trade area
   b. Political union
   c. Customs union
   d. Common market
3. Customs union is identical to free trade area except that member nations must pursue and conduct common external commercial relations like common tariff policies on imports from non-member nations.
   a. Common market
   b. Economic union
   c. World Trade Organization
   d. Customs union

4. Common market is a particular customs union that permits free trade of products and services only but with free mobility of production factors across national member borders.
    a. Political union
    b. ASEAN
    c. Common market
    d. Multifiber Arrangement
5. Economic union is a particular common market that unifies fiscal and monetary policies.
    a. European union
    b. Political union
    c. Economic union
    d. None of the above
6. Political union involves establishing a common parliament and other political institutions.
    a. Political union
    b. Free trade area
    c. NAFTA
    d. LAFTA
7. ________________came as a successor to the General Agreement on Tariffs and Trade (GATT).
    a. World Bank
    b. World trade organization
    c. SAARC
    d. IMF
8. The ____________ means that any advantage, favor, or privilege granted to one country must be extended to all other member countries.
    a. Regional treatment
    b. National treatment
    c. Most-favored nation treatment
    d. International treatment
9. The ____________means that once they have cleared customs, foreign goods in a member country should be treated the same as domestic goods.
    a. National treatment
    b. Most-favored nation treatment
    c. Regional treatment
    d. None of the above

10. __________are special allowances permitted by the WTO to safeguard infant industries or nourish economic growth for newly admitted developing countries.
    a. Quotas
    b. Cartels
    c. Escape clauses
    d. Subsidies
11. ____________is sale of imported goods either at prices below what a company charges in its home market or at prices below cost.
    a. Anti-dumping
    b. Depreciation
    c. Dumping
    d. Revaluation
12. The IMF and the ______ are together referred to as the Bretton Woods Institutions.
    a. World Trade Organization
    b. World Bank
    c. ASEAN
    d. NAFTA
13. The _____ refers to International Bank for Reconstruction and Development (IBRD).
    a. International Monetary Fund
    b. Multifiber Agreement
    c. European Union
    d. World Bank
14. _______________is the first free trade agreement between industrial countries and a developing nation (Mexico).
    a. LAFTA
    b. NAFTA
    c. MERCOSUR
    d. European Union
15. A _______________ is a group of producing countries that wish to protect themselves from the wild fluctuations that often occur in the prices of certain commodities traded internationally (e.g. coffee, rubber, cocoa, or crude oil).
    a. Customs union
    b. Political union
    c. Free trade area
    d. Commodity cartel

16. The ____________ is the strongest collective force that impacts oil prices in the international oil market.
    a. ASEAN
    b. MFA
    c. OPEC
    d. SAARC
17. The ____________ originally signed in 1972 is an agreement between exporting and importing countries for controlling exports of apparel and textiles from developing countries to developed countries.
    a. OPEC
    b. Multifiber Arrangement
    c. NAFTA
    d. WTO

6.8 Summary

- Economic integration concerns removal of trade barriers or impediments between at least two participating nations and establishing and coordinating between them.
- Free trade area involves country combination, where the member nations remove trade barriers among themselves while retaining their freedom related to policy making vis-à-vis non-member countries.
- Customs union is identical to free trade area except that member nations must pursue and conduct common external commercial relations like common tariff policies on imports from non-member nations.
- Common market is a particular customs union that permits free trade of products and services only but with free mobility of production factors across national member borders.
- Economic union is a particular common market that unifies fiscal and monetary policies.
- Political union involves establishing a common parliament and other political institutions.
- The World Trade Organization came into being on January 1, 1995 as a multilateral trade organization that aimed at international liberalization of trade.
- The overall objectives of the International Monetary Fund include expansion of international trade, reduce disequilibrium in balance of payments of member countries, and promote international monetary cooperation.

- In December 1960, the Organization for Economic Cooperation and Development (OECD) was established. It stated mission is to aid in achieving the highest possible growth in the economies of member countries as well as non-member states.
- UNCTAD is a forum that examines economic problems that plague developing countries.
- NAFTA is the first free trade agreement between industrial countries and a developing nation (Mexico). The agreement enhances the ability of North American producers for competing globally.
- The Treaty of European Union, signed in February 1992, promotes economic and trade expansion in a common market as well as embraces the formation of a monetary union, common citizenship, establishment of a common foreign and security policy, and the development of cooperation on social affairs and justice.
- In November 1994, the Asia-Pacific Economic Cooperation Forum (APEC) was founded.
- The Association of South East Asian Nations aims to promote peace, stability, and economic growth in the region.
- In 1960, the Latin American Free Trade Association (LAFTA) was formed in Latin America by Argentina, Brazil, Bolivia, Colombia, Chile, Ecuador, Mexico, Peru, Paraguay, Uruguay, and Venezuela.
- The Economic Community of West African States (ECOWAS) eliminated duties on unprocessed agricultural products and handicrafts.
- In 1981, Kuwait, Oman, Bahrain, Qatar, Saudi Arabia, and the UAE established the Gulf Cooperation Council (GCC) in the Middle East. A free trade area that covered agricultural and industrial products was set.
- The Organization of Petroleum Exporting Countries (OPEC) is the strongest collective force that impacts oil prices in the international oil market.
- The Multifiber Arrangement (MFA) originally signed in 1972 is an agreement between exporting and importing countries for controlling exports of apparel and textiles from developing countries to developed countries.
- In response to regional economic integration, some strategies can be identified. defensive export substituting investment offensive export substituting strategy rationalized foreign direct investment strategy reorganization investment

6.9 Glossary

Commodity cartel: A commodity cartel is a group of producing countries that wish to protect themselves from the wild fluctuations that often occur in the prices of certain commodities traded internationally (e.g. coffee, rubber, cocoa, or crude oil).

Dumping: Dumping is sale of imported goods either at prices below what a company charges in its home market or at prices below cost.

Escape clauses: Escape clauses are special allowances permitted by the WTO to safeguard infant industries or nourish economic growth for newly admitted developing countries.

Most-favored-nation (MFN) treatment: The most-favored-nation (MFN) treatment means that any advantage, favor, or privilege granted to one country must be extended to all other member countries.

National treatment: The national treatment means that once they have cleared customs, foreign goods in a member country should be treated the same as domestic goods.

6.10 Self-Assessment Test

1. Define economic integration. Explain different forms of economic integration.
2. The three fundamental institutions affecting cooperation among nations at the global level are the World Trade Organization, the International Monetary Fund, and the World Bank. Explain the background and functions of these institutions in brief.
3. Explain different regional agreements followed worldwide that had resulted in elimination of various trade barriers.
4. Define a commodity cartel. Explain briefly the two important commodity cartels that influence the world economy.
5. Discuss the strategic responses of multinational enterprises to regional economic integration.

6.11 Suggested Readings/Reference Material

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6.12 Answers to Check Your Progress Questions

1. (a) Economic integration

Economic integration concerns removal of trade barriers or impediments between at least two participating nations and establishing and coordinating between them.

2. (a) Free trade area

Free trade area involves country combination, where the member nations remove trade barriers among themselves while retaining their freedom related to policy making vis-à-vis non-member countries.

3. (d) Customs union

Customs union is identical to free trade area except that member nations must pursue and conduct common external commercial relations like common tariff policies on imports from non-member nations.

4. (c) Common market

Common market is a particular customs union that permits free trade of products and services only but with free mobility of production factors across national member borders.

5. (c) Economic union

Economic union is a particular common market that unifies fiscal and monetary policies.

6. (a) Political union

Political union involves establishing a common parliament and other political institutions.

7. (b) WTO

WTO came as a successor to the General Agreement on Tariffs and Trade (GATT).

8. (c) Most-favored nation treatment

The most-favored-nation (MFN) treatment means that "any advantage, favor, or privilege granted to one country must be extended to all other member countries.

9. (a) National treatment

The national treatment means that "once they have cleared customs, foreign goods in a member country should be treated the same as domestic goods.

10. (c) Escape clauses

Escape clauses are special allowances permitted by the WTO to safeguard infant industries or nourish economic growth for newly admitted developing countries.

11. (c) Dumping

Dumping is "sale of imported goods either at prices below what a company charges in its home market or at prices below cost.

12. (b) World Bank

The IMF and the World Bank are together referred to as the Bretton Woods Institutions.

13. (d) World Bank

The World Bank refers to International Bank for Reconstruction and Development (IBRD).

14. (b) NAFTA

NAFTA is the first free trade agreement between industrial countries and a developing nation (Mexico).

15. (d) Commodity cartel

A commodity cartel is "a group of producing countries that wish to protect themselves from the wild fluctuations that often occur in the prices of certain commodities traded internationally (e.g. coffee, rubber, cocoa, or crude oil).

16. (c) OPEC

The Organization of Petroleum Exporting Countries (OPEC) is the strongest collective force that impacts oil prices in the international oil market.

17. (b) Multifiber Arrangement

The Multifiber Arrangement (MFA) originally signed in 1972 is an agreement between exporting and importing countries for controlling exports of apparel and

International Business

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