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INTERNATIONAL MANAGEMENT

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INTERNATIONAL MANAGEMENT

International business is the practice of transacting business in more than one country or in other words International trade is the exchange of goods and services across international boundaries or territories. In most countries, it represents a significant share of GDP. While international trade has been present throughout much of history, its economic, social, and political importance has been on the rise in recent centuries. Industrialization, advanced transportation, globalization, multinational corporations, and outsourcing are all having a major impact. Increasing international trade is basic to globalization. International trade is also a branch of economics, which, together with international finance, forms the larger branch of international economics.

Several different models have been proposed to predict patterns of trade and to analyze the effects of trade policies such as tariffs:

- **Ricardian model**

The Ricardian model focuses on comparative advantage and is perhaps the most important concept in international trade theory. In a Ricardian model, countries specialize in producing what they produce best. Unlike other models, the Ricardian framework predicts that countries will fully specialize instead of producing a broad array of goods. Also, the Ricardian model does not directly consider factor endowments, such as the relative amounts of labor and capital within a country.

- **Heckscher-Ohlin model**

The Heckscher-Ohlin model was produced as an alternative to the Ricardian model of basic comparative advantage. Despite its greater complexity it did not prove much more accurate in its predictions. However from a theoretical point of view it did provide an elegant solution by incorporating the neoclassical price mechanism into international trade theory.

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

- **Specific Factors**

In this model, labour mobility between industries is possible while capital is immobile between industries in the short run. The specific factors name refers to the given that in the short run specific factors of production, such as physical capital, are not easily transferable between industries. The theory suggests that if there is an increase in the price of a good, the owners of the factor of production specific to that good will profit in real terms. Additionally, owners of opposing specific factors of production (labour and capital) are likely to have opposing agendas when lobbying for controls over immigration of labour. Conversely, both owners of capital and labour profit in real terms from an

increase in the capital endowment. This model is ideal for particular industries. This model is ideal for understanding income distribution but awkward for discussing the pattern of trade.

- **Gravity model**

The Gravity model of trade presents a more empirical analysis of trading patterns rather than the more theoretical models discussed above. The gravity model, in its basic form, predicts trade based on the distance between countries and the interaction of the countries' economic sizes. The model mimics the Newtonian law of gravity which also considers distance and physical size between two objects. The model has been proven to be empirically strong through econometric analysis. Other factors such as income level, diplomatic relationships between countries, and trade policies are also included in expanded versions of the model.

Regulation of international trade

Traditionally trade was regulated through bilateral treaties between two nations. For centuries under the belief in Mercantilism most nations had high tariffs and many restrictions on international trade. In the 19th century, especially in Britain, a belief in free trade became paramount and this view has dominated thinking among western nations for most of the time since then which led to the general decline of Great Britain. In the years since the Second World War, controversial multilateral treaties like the GATT and World Trade Organization have attempted to create a globally regulated trade structure. These trade agreements have often resulted in protest and discontent with claims of unfair trade that is not mutually beneficial.

Free trade is usually most strongly supported by the most economically powerful entities with nations that stand to benefit from exploitation of cheap labor, though they often engage in selective protectionism for those industries which are strategically important such as the protective tariffs applied to agriculture by the United States and Europe. The Netherlands and the United Kingdom were both strong advocates of free trade when they were economically dominant, today the United States, the United Kingdom, Australia and Japan are its greatest proponents. However, many other countries such as India, China and Russia are increasingly becoming advocates of free trade as they become more economically powerful themselves. As tariff levels fall there is also an increasing willingness to negotiate non tariff measures, including foreign direct investment, procurement and trade facilitation. The latter looks at the transaction cost associated with meeting trade and customs procedures.

Traditionally agricultural interests are usually in favor of free trade while manufacturing sectors often support protectionism. This has changed somewhat in recent years, however. In fact, agricultural lobbies, particularly in the United States, Europe and Japan, are chiefly responsible for particular rules in the major international trade treaties which allow for more protectionist measures in agriculture than for most other goods and services.

During recessions there is often strong domestic pressure to increase tariffs to protect domestic industries. This occurred around the world during the Great depression leading to a collapse in world trade that many believe seriously deepened the depression.
The regulation of international trade is done through the World Trade Organization at the global level, and through several other regional arrangements such as MERCOSUR in South America, NAFTA between the United States, Canada and Mexico, and the European Union between 27 independent states. The 2005 Buenos Aires talks on the planned establishment of the Free Trade Area of the Americas (FTAA) failed largely due to opposition from the populations of Latin American nations. Similar agreements such as the MAI (Multilateral Agreement on Investment) have also failed in recent years.

Risks in international trade

The risks that exist in international trade can be divided into two major groups:

- Economic risks
    - Risk of insolvency of the buyer,
    - Risk of protracted default - the failure of the buyer to pay the amount due within six months after the due date
    - Risk of non-acceptance
    - Surrendering economic sovereignty

- Political risks
- Risk of cancellation or non-renewal of export or import licenses
- War risks
- Risk of expropriation or confiscation of the importer's company
- Risk of the imposition of an import ban after the shipment of the goods
- Transfer risk, imposition of exchange controls by the importer's country or foreign currency shortages
- Surrendering political sovereignty

Cost, Insurance and Freight

(CIF) is a common term in a sales contract that may be encountered in international trading when ocean transport is used.

When a price is quoted CIF, it means that the selling price includes the cost of the goods, the freight or transport costs and also the cost of marine insurance. CIF is an international commerce term (Incoterm).

CIF is identical in most particulars with Cost and Freight (CFR), and the same comments apply, including its applicability only to conventional maritime transport. In addition to the CFR responsibilities, the seller under CIF must obtain in transferable form a marine insurance policy to cover the risks of transit with insurers of repute. The policy must cover the CIF price plus 10 per cent and where possible be in the currency of the contract. Note that only very basic cover is required equivalent to the Institute C clauses, and buyers should normally insist on an all risk type of policy such as that under the Institute A clauses. The seller's responsibility for the goods ends when the goods have been delivered on board the shipping vessel. In the guidelines for CIF published in Incoterm 2000 the term carrier does not appear and it clearly states the seller must deliver the

goods on board the vessel at the port of shipment which makes CIF the incorrect term to use where the seller wishes their responsibility to end when they deliver the goods into the hands of a carrier prior to the goods passing the ship's rail at the port of loading. In the great majority of transactions the more correct term is CIP. This term is only appropriate for conventional maritime transport, or international container movements.

CIF ASWP indicates that the exporter is responsible for insuring on behalf of the buyer until goods arrive and are unloaded at the port of destination. The opposite of this is FOB (Freight on Board), which means the buyer is responsible for payment to the seller when the good is loaded onto the ship at the port of origination. ASWP indicates Any Safe World Port.

Apart from the above poor English it should be carefully noted that CIF ASWP is not an Incoterm of the International Chamber of Commerce. ASWP (any safe world port) may be added as a separate article in a Purchase Contract but should not be confused with an Incoterm.

Currency

A currency is a unit of exchange, facilitating the transfer of goods and services. It is one form of money, where money is anything that serves as a medium of exchange, a store of value, and a standard of value. A currency zone is a country or region in which a specific currency is the dominant medium of exchange. To facilitate trade between currency zones, there are exchanges rates i.e. prices at which currencies and the goods and services of individual currency zones can be exchanged against each other. Currencies can be classified as either floating currencies or fixed currencies based on their exchange rate regime. In common usage, currency sometimes refers to only paper money, as in coins and currency, but this is misleading. Coins and paper money are both forms of currency.
In most cases, each country has monopoly control over the supply and production of its own currency. Member countries of the European Union's Economic and Monetary Union are a notable exception to this rule, as they have ceded control of monetary policy to the European Central Bank.

In cases where a country does have control of its own currency, that control is exercised either by a central bank or by a Ministry of Finance. In either case, the institution that has control of monetary policy is referred to as the monetary authority. Monetary authorities have varying degrees of autonomy from the governments that create them. In the United States, the Federal Reserve System operates without direct interference from the legislative or executive branches. It is important to note that a monetary authority is created and supported by its sponsoring government, so independence can be reduced or revoked by the legislative or executive authority that creates it. However, in practical terms, the revocation of authority is not likely. In almost all Western countries, the monetary authority is largely independent from the government.

Several countries can use the same name, each for their own currency (e.g. Canadian dollars and U.S. dollars), several countries can use the same currency (e.g. the euro), or a country can declare the currency of another country to be legal tender. For example,

Panama and El Salvador have declared U.S. currency to be legal tender, and from 1791-1857, Spanish silver coins were legal tender in the United States. At various times countries have either restamped foreign coins, or used currency board issuing one note of currency for each note of a foreign government held, as Ecuador currently does.

Each currency typically has one fractional currency, often valued at $^{1}/_{100}$ of the main currency: 100 cents = 1 dollar, 100 centimes = 1 franc, 100 pence = 1 pound. Units of $^{1}/_{10}$ or $^{1}/_{1000}$ are also common, but some currencies do not have any smaller units. Mauritania and Madagascar are the only remaining countries that do not use the decimal system; instead, the Mauritanian ouguiya is divided into 5 khoums, while the Malagasy ariary is divided into 5 iraimbilanja. However, due to inflation, both fractional units have in practice fallen into disuse.

The origin of currency is the creation of a circulating medium of exchange based on a unit of account which quickly becomes a store of value. Currency evolved from two basic innovations: the use of counters to assure that shipments arrived with the same goods that were shipped, and later with the use of silver ingots to represent stored value in the form of grain. Both of these developments had occurred by 2000 BC. Originally money was a form of receipting grain stored in temple granaries in ancient Egypt and Mesopotamia.

This first stage of currency, where metals were used to represent stored value, and symbols to represent commodities, formed the basis of trade in the Fertile Crescent for over 1500 years. However, the collapse of the Near Eastern trading system pointed to a flaw, in an era where there was no place that was safe to store value, the value of a circulating medium could only be as sound as the forces that defended that store. Trade could only reach as far as the credibility of that military. By the late Bronze Age, however, a series of international treaties had established safe passage for merchants around the Eastern Mediterranean, spreading from Minoan Crete and Mycenae in the North West to Elam and Bahrain in the South East. Although it is not known what functioned as a currency to facilitate these exchanges, it is thought that ox hide shaped ingots of copper, produced in Cyprus may have functioned as a currency.

In Africa many forms of value store have been used including beads, ingots, ivory, various forms of weapons, livestock, the manilla currency, ochre and other earth oxides, and so on. The manilla rings of West Africa were one of the currencies used from the 15th century onwards to buy and sell slaves. African currency is still notable for its variety, and in many places various forms of barter still apply.

Coinage

These factors led to the shift of the store of value being the metal itself: at first silver, then both silver and gold. Metals were mined, weighed, and stamped into coins. This was to assure the individual taking the coin that he was getting a certain known weight of precious metal. Coins could be counterfeited, but they also created a new unit of account, which helped lead to banking. Archimedes' principle was that the next link in currency occurred, coins could now be easily tested for their fine weight of metal, and thus the

value of a coin could be determined, even if it had been shaved, debased or otherwise tampered with.

In most major economies using coinage, copper, silver and gold formed three tiers of coins. Gold coins were used for large purchases, payment of the military and backing of state activities. Silver coins were used for large, but common, transactions, and as a unit of account for taxes, dues, contracts and fealty, while copper coins represented the coinage of common transaction. This system had been used in ancient India since the time of the Mahajanapadas. In Europe, this system worked through the medieval period because there was virtually no new gold, silver or copper introduced through mining or conquest. Thus the overall ratios of the three coinages remained roughly equivalent.

In China, the need for credit and for circulating medium led to the introduction of paper money, commonly known today as banknotes. In Europe paper money was first introduced in Sweden in 1661. Sweden was rich in copper; thus, because of copper's low value, extraordinarily big coins often weighing several kilograms had to be made. Because the coin was so big, it was probably more convenient to carry a note stating your possession of such a coin than to carry the coin itself.

Paper money was, in one sense, a return to the oldest form of currency; it represented a store of value backed by the credibility of the issuing authority. Drafts, letters of credit and checks issued privately had been in intermittent use for centuries, however, it was with the rise of global trade that paper money would find a permanent place in currency.
The advantages of paper currency were numerous, it reduced transport of gold and silver, and thus lowered the risks; it made loaning gold or silver at interest easier, since the specie gold or silver never left the possession of the lender until someone else redeemed the note, and it allowed for a division of currency into credit and specie backed forms. It enabled the sale of stock in joint stock companies, and the redemption of those shares in paper.

However, these advantages held within them disadvantages. First, since a note has no intrinsic value, there was nothing to stop issuing authorities from printing more of it than they had specie to back it with. Second, because it created money that did not exist, it increased inflationary pressures. The result is that paper money would often lead to an inflationary bubble, which could collapse if people began demanding hard money, causing the demand for paper notes to fall to zero. The printing of paper money was also associated with wars, and financing of wars, and therefore regarded as part of maintaining a standing army.

For these reasons, paper currency was held in suspicion and hostility in Europe and America. It was also addictive, since the speculative profits of trade and capital creation were quite large. Major nations established mints to print money and mint coins, and branches of their treasury to collect taxes and hold gold and silver stock.

With the creation of central banks, currency underwent several significant changes. During both the coinage and credit money eras the number of entities which had the

ability to coin or print money was quite large. One could, literally, have a license to print money, many nobles had the right of coinage. Royal colonial companies, such as the Massachusetts Bay Company or the British East India Company could issue notes of credit, money backed by the promise to pay later or exchangeable for payments owed to the company itself. This led to continual instability of the value of money. The exposure of coins to debasement and shaving, however, presented the same problem in another form, with each pair of hands a coin passed through, its value grew less.

The solution which evolved beginning in the late 18th century and through the 19th century was the creation of a central monetary authority which had a virtual monopoly on issuing currency, and whose notes had to be accepted for all debts public and private. The creation of a truly national currency, backed by the government's store of precious metals, and enforced by their military and governmental control over an area was, in its time, extremely controversial. Advocates of the old system of Free Banking repealed central banking laws, or slowed down the adoption of restrictions on local currency. At this time both silver and gold were considered legal tender, and accepted by governments for taxes. However, the instability in the ratio between the two grew over the course of the 19th century, with the increase both in supply of these metals, particularly silver, and of trade. This is called bimetallism and the attempt to create a bimetallic standard where both gold and silver backed currency remained in circulation occupied the efforts of inflationist. Governments at this point could use currency as an instrument of policy, printing paper currency such as the United States Greenback, to pay for military expenditures. They could also set the terms at which they would redeem notes for specie, by limiting the amount of purchase, or the minimum amount that could be redeemed.
By 1900, most of the industrializing nations were on some form of gold standard, with paper notes and silver coins constituting the circulating medium.

A banknote more commonly known as a bill in the United States and Canada is a type of currency, and commonly used as legal tender in many jurisdictions. With coins, banknotes make up the cash form of all modern money.
Modern currencies

To find out which currency is used in a particular country, check list of circulating currencies.

Nowadays, the International Organization for Standardization has introduced a system a three letter system of codes (ISO 4217) to define currency as opposed to simple names or currency signs, in order to remove the confusion that there are dozens of currencies called the dollar and many called the franc. Even the pound is used in nearly a dozen different countries, all, of course, with wildly differing values. In general, the three letter code uses the ISO 3166-1 country code for the first two letters and the first letter of the name of the currency D for dollar, for instance) as the third letter.

The International Monetary Fund uses a variant system when referring to national currencies.

From the earliest times token coins were issued by companies in remote parts of the world to overcome the shortage of circulating currency.

Several large companies issue points to their customers, to be redeemed for products and services produced by that company. Often, a network of companies will join to share in the offering and redemption of points. While these can hardly be considered stable currency systems, they present many of the same features as "legitimate" currency: they are a store of value, issued in discrete units; they are controlled by a central issuing authority; and they have varying rates of exchange with other forms of currency. For example, frequent flyer miles can be bought using U.S. dollars.

- Casino token: Chips are used in wagering for various reasons - mostly to make it easier to recognize or count the amount of a wager by eye, or (as in roulette or craps) to distinguish wagers belonging to different players that by necessity must be played near each other.
- Alternative currency: A currency such as the Liberty Dollar that is intended to replace or compete with a national currency.
- Digital gold currency: Privately issued digital currency backed by gold
- Frequent flyer miles: A type of private currency, different versions of which are issued by most major airlines to encourage customer loyalty.
- Subway tokens, issued by city transit authorities, can be considered a highly specialized form of currency.
- Scrip: A type of private currency where a certain value is captured, and used to purchase goods from a company. Examples of scrip include gift certificates, gift cards, and Disney Dollars, Canadian Tire Money and more recently Microsoft Points on the Xbox Live Marketplace. However, scrip is not considered a currency in itself, but merely a store of value, denominated in another currency.
- Coupons: Is a form of currency that is recognized by businesses, not to purchase a product or service, but to deduct from the total cost, promote benefits, rebates or discounts. Coupons are primarily used as a marketing tool.

In economics, a local currency is a currency not backed by a national government, and intended to trade only in a small area. Advocates such as Jane Jacobs argue that this enables an economically depressed region to pull itself up, by giving the people living there a medium of exchange that they can use to exchange services and locally produced goods. In a broader sense, this is the original purpose of all money. Opponents of this concept argue that local currency creates a barrier which can interfere with economies of scale and comparative advantage, and that in some cases they can serve as a means of tax evasion.

Local currencies can also come into being when there is economic turmoil involving the national currency. An example of this is the Argentine economic crisis of 2002 in which IOUs issued by local governments quickly took on some of the characteristics of local currencies

Balance of trade

The balance of trade or net exports, sometimes symbolized as *NX* is the difference between the monetary value of exports and imports in an economy over a certain period of time. A positive balance of trade is known as a trade surplus and consists of exporting more than is imported, a negative balance of trade is known as a trade deficit or, informally, a trade gap. The balance of trade is sometimes divided into a goods and a services balance, especially in the United Kingdom the terms visible and invisible balance are used.

The balance of trade forms part of the current account, which also includes other transactions such as income from the international investment position as well as international aid. If the current account is in surplus, the country's net international asset position increases correspondingly. Equally, a deficit decreases the net international asset position.

The trade balance is identical to the difference between a country's output and its domestic demand the difference between what goods a country produces and how many goods it buys from abroad; this does not include money re spent on foreign stocks, nor does it factor the concept of importing goods to produce for the domestic market.
Measuring the balance of payments can be problematic because of problems with recording and collecting data. As an illustration of this problem, when official data for the entire world's countries are added up, exports exceed imports by a few percent; it appears the world is running a positive balance of trade with itself. This cannot be true, because all transactions involve an equal credit or debit in the account of each nation. The discrepancy is widely believed to be explained by transactions intended to launder money or evade taxes, smuggling and other visibility problems. However, especially for developed countries, accuracy is likely to be good.

Factors that can affect the balance of trade figures include:

- Prices of goods manufactured at home influenced by the responsiveness of supply
- Exchange rates
- Trade agreements or barriers
- Other tax, tariff and trade measures
- Business cycle at home or abroad.

The balance of trade is likely to differ across the business cycle. In export led growth such as oil and early industrial goods, the balance of trade will improve during an economic expansion. However, with domestic demand led growth as in the United States and Australia Modern economists are split on the economic impact of the trade deficit with some viewing it as a loss in a fixed volume of trade and more radical Neoliberal voices who claim it is a sign of economic strength.

The traditional view opposes long run trade deficits and outsourcing for the sake of labor arbitrage to obtain cheap labor as an example of absolute advantage which does not

produce mutual gain, and not an example of comparative advantage which does.Neoliberal economists claim that trade deficits are beneficial, noting the correlation between increasing trade deficits and increasing GDP and employment. An expanding economy means increased demand for domestic and foreign products. This rising demand promotes domestic investment as both foreign and domestic businesses seek to capitalize on the growth in demand. As the rate of growth accelerates foreign credit sources have greater incentives to invest in a growing nation's capital. The greater net inflows from abroad, the greater the trade deficit. Thus, GDP growth can be correlated with a trade deficit. However, these economists seem to ignore the fact the excessive borrowing may artificially inflate GDP.

Strong GDP growth economies such as the United Kingdom, Australia, Hong Kong and the United States run consistent trade deficits.

On the other hand, GDP growth may be due to excess borrowing to fund consumption and not an expansion of the base of an economy. Developed nations such as Canada, Japan, and Germany typically run trade surpluses. China also has a trade surplus. A higher savings rate generally corresponds with a trade surplus. In 2006, the United States has its lowest savings rate since 1933. Correspondingly, the United States has high trade deficits. The general decline of Great Britain is another example of the deleterious effects of long term trade deficits.

Large imbalances may sometimes be a sign of underlying economic problems or rigidities. An example would be a situation where exchange rates have been fixed or pegged for political reasons at levels impeding a correction of a trade imbalance.
The trade deficit must be financed by foreign income or transfers, or by a capital account surplus. This includes inward foreign investment and capital purchases stocks, bonds. An increase in net foreign liabilities tends to lead to an increase in the net outflow of income on international investments.

Those in favor of the trade deficit point to this financing as the source of the benefit. Instead of buying goods back, buyers in the receiving country send the money back in the form of capital. A firm in America sends dollars for Chinese toys, and the Chinese receivers use the money to buy stock in an American firm. Although this is a form of financing, it is not a debt on any party in America.

Such payments to foreigners have intergenerational effects, by shifting consumption over time; some generations may gain at the expense of others. However, a trade deficit may lead to higher consumption in the future if, for example, it is used to finance profitable domestic investment, which generates returns in excess of that paid on the net foreign liabilities a situation that might arise if a country experiences an unexpected gain in productivity. Similarly, a surplus on the current account implies an increase in the net international investment position and the shifting of consumption to future rather than current generations.

However, trade imbalances are not always indicative of the smooth operation of the market given differences in international productivity and intertemporal consumption preferences. Trade deficits have often been associated with a loss of international competitiveness, or unsustainable booms in domestic demand. Similarly, trade surpluses have been associated with policies that inefficiently bias a country's economic activity towards external demand, resulting in lower living standards. An example of an economy which has had a positive balance of payments was is Japan in the 1990s. The positive balance was partly the result of protectionist measures that brought excessive profits to Japanese exporters.

Foreign exchange reserves

Foreign exchange reserves also called Forex reserves in a strict sense are only the foreign currency deposits held by central banks and monetary authorities. However, the term foreign exchange reserves in popular usage commonly includes foreign exchange and gold, SDRs and IMF reserve position as this total figure is more readily available, however it is accurately deemed as official reserves or international reserves. These are assets of the central banks which are held in different reserve currencies such as the dollar, euro and yen, and which are used to back its liabilities, e.g. the local currency issued, and the various bank reserves deposited with the central bank, by the government or financial institutions

Reserves were formerly held only in gold, as official gold reserves. But under the Bretton Woods system, the United States pegged the dollar to gold, and allowed convertibility of dollars to gold. This effectively made dollars appear as good as gold. The U.S. later abandoned the gold standard, but the dollar has remained relatively stable as a fiat currency, and it is still the most significant reserve currency. Central banks now typically hold large amounts of multiple currencies in reserve.

In a non fixed exchange rate system, reserves allow a central bank to purchase the issued currency, exchanging its assets to reduce its liability. The purpose of reserves is to allow central banks an additional means to stabilize the issued currency from excessive volatility, and protect the monetary system from shock, such as from currency traders engaged in flipping. Large reserves are often seen as strength, as it indicates the backing a currency has. Low or falling reserves may be indicative of an imminent bank run on the currency or default, such as in a currency crisis.

Central banks sometimes claim that holding large reserves is a security measure. This is true to the extent that a central bank can prop up its own currency by spending reserves. This practice is essentially large scale manipulation of the global currency market. Central banks have sometimes attempted this in the years since the 1971 collapse of the Bretton Woods system. A few times, multiple central banks have cooperated to attempt to manipulate exchange rates. It is unclear just how effective the practice is. But often, very large reserves are not a hedge against inflation but rather a direct consequence of the opposite policy, the bank has purchased large amounts of foreign currency in order to keep its own currency relatively cheap.

Costs and benefits

On one hand, if a country desires to have a government influenced exchange rate, then holding bigger reserves gives the country a bigger ability to manipulate the currency market. On the other hand, holding reserves does induce opportunity cost. The quasi fiscal costs of holding reserves are the gap between the low yield assets that returns managers typically hold, and the average cost of government debt in the country. In addition, many governments have suffered huge losses on the management of the reserves portfolio all of which is ultimately fiscal. When there is a currency crisis and all reserves vanish, this is ultimately a fiscal cost. Even when there is no currency crisis, there can be a fiscal cost.

Exchange rate

In finance, the exchange rate also known as the foreign exchange rate, Forex rate or FX rate between two currencies specifies how much one currency is worth in terms of the other. For example an exchange rate of 123 Japanese yen (JPY, ¥) to the United States dollar (USD, $) means that JPY 123 is worth the same as USD 1. The foreign exchange market is one of the largest markets in the world. By some estimates, about 2 trillion USD worth of currency changes hands every day.

The spot exchange rate refers to the current exchange rate. The forward exchange rate refers to an exchange rate that is quoted and traded today but for delivery and payment on a specific future date.

An exchange rate quotation is given by stating the number of units of a price currency that can be bought in terms of 1 unit currency also called base currency. For example, in a quotation that says the EUR/USD exchange rate is 1.3 (USD per EUR), the price currency is USD and the unit currency is EUR.

Quotes using a country's home currency as the price currency (0.50593 = $1 in the UK) are known as direct quotation or price quotation from that country's perspective and are used by most countries.

Quotes using a country's home currency as the unit currency (e.g. $1.97656 = £1 in the UK) are known as indirect quotation or quantity quotation and are used in British newspapers and are also common in Australia, New Zealand and Canada.

- Direct quotation: 1 foreign currency unit = x home currency units
- Indirect quotation: 1 home currency unit = x foreign currency units

Note that, using direct quotation, if the home currency is strengthening (i.e. appreciating, or becoming more valuable) then the exchange rate number decreases. Conversely if the foreign currency is strengthening, the exchange rate number increases and the home currency is depreciating.

When looking at a currency pair such as EUR/USD, many times the first component (EUR in this case) will be called the base currency. The second is called the counter currency. For example: EUR/USD = 1.33866, means EUR is the base and USD the counter, so 1 EUR = 1.33866 USD.

Currency pair is given with four decimal places except au JPY with two decimal places (EUR/USD: 1.33866 - EUR/JPY: 165.293). In other words, quotes are given with 5 digits. Where rates are below 1, quotes frequently include 5 decimal places.
If a currency is free floating, its exchange rate is allowed to vary against that of other currencies and is determined by the market forces of supply and demand. Exchange rates for such currencies are likely to change almost constantly as quoted on financial markets, mainly by banks, around the world. A movable or adjustable peg system is a system of fixed exchange rates, but with a provision for the devaluation of a currency. For example, between 1994 and 2005, the Chinese yuan renminbi (CNY, ¥) was pegged to the United States dollar at ¥8.2768 to $1. The Chinese were not the only country to do this, from the end of World War II until 1970, Western European countries all maintained fixed exchange rates with the US dollar based on the Bretton Woods system.

- The nominal exchange rate is the rate at which an organization can trade the currency of one country for the currency of another.
- The real exchange rate (RER) is an important concept in economics, though it is quite difficult to grasp concretely. It is defined by the model: $RER = e\ (P^*/P)$, where e is the exchange rate, as the number of home currency units per foreign currency unit, where P is the price level of the home country, and where P^* is the foreign price level.

Unfortunately, this compact and simple model for RER calculations is only a theoretical ideal. In practical usage, there are many foreign currencies and price level values to take into consideration. Correspondingly, the model calculations become increasingly more complex. Furthermore, the model is based on purchasing power parity (PPP), which implies a constant RER. The empirical determination of a constant RER value could never be realized due to limitations on data collection. PPP would imply that the RER is the rate at which an organization can trade goods and services of one economy for those of another. For example, if the price of good increases 10% in the UK, and the Japanese currency simultaneously appreciates 10% against the UK currency, then the price of the good remains constant for someone in Japan. The people in the UK, however, would still have to deal with the 10% increase in domestic prices. It is also worth mentioning that government enacted tariffs can affect the actual rate of exchange, helping to reduce price pressures. PPP was seen to have worked only in the long term when prices eventually correct towards parity. More recent approaches in modeling the RER employ a set of macroeconomic variables, such as relative productivity and the real interest rate differential.

Interest rate parity (IRP) states that an appreciation or depreciation of one currency against another currency might be neutralized by a change in the interest rate differential. If US interest rates exceed Japanese interest rates then the US dollar should depreciate against the Japanese yen by an amount that prevents arbitrage. The future exchange rate is reflected into the forward exchange rate stated today. The forward exchange rate of the dollar is said to be at a discount because it buys fewer Japanese yen in the forward rate than it does in the spot rate. The yen is said to be at a premium.

IRP showed no proof of working after 1990s. Contrary to the theory, currencies with high interest rates characteristically appreciated rather than depreciated on the reward of the containment of inflation and a higher yielding currency.

This model holds that a foreign exchange rate must be at its equilibrium level the rate which produces a stable current account balance. A nation with a trade deficit will experience reduction in its foreign exchange reserves which ultimately lowers/depreciates the value of its currency. The cheaper currency renders the nation's goods, exports more affordable in the global market place while making imports more expensive. After an intermediate period, imports are forced down and exports rise, thus stabilizing the trade balance and the currency towards equilibrium.

Like PPP, the balance of payments model focuses largely on tradable goods and services, ignoring the increasing role of global capital flows. In other words, money is not only chasing goods and services, but to a larger extent, financial assets such as stocks and bonds. Their flows go into the capital account item of the balance of payments, thus, balancing the deficit in the current account. The increase in capital flows has given rise to the asset market model.

Asset market model: The explosion in trading of financial assets i.e stocks and bonds has reshaped the way analysts and traders look at currencies. Economic variables such as economic growth, inflation and productivity are no longer the only drivers of currency movements. The proportion of foreign exchange transactions stemming from cross border trading of financial assets has dwarfed the extent of currency transactions generated from trading in goods and services.

The asset market approach views currencies as asset prices traded in an efficient financial market. Consequently, currencies are increasingly demonstrating a strong correlation with other markets, particularly equities.

Like the stock exchange, money can be made or lost on the foreign exchange market by investors and speculators buying and selling at the right times. Currencies can be traded at spot and foreign exchange options markets. The spot market represents current exchange rates, whereas options are derivatives of exchange rates.

Fluctuations in exchange rates: A market based exchange rate will change whenever the values of either of the two component currencies change. A currency will tend to become more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than available supply, this does not mean people no longer want money, it just means they prefer holding their wealth in some other form, possibly another currency.

Increased demand for a currency is due to either an increased transaction demand for money, or an increased speculative demand for money. The transaction demand for money is highly correlated to the country's level of business activity, gross domestic product (GDP), and employment levels. The more people there are out of work, the less

the public as a whole will spend on goods and services. Central banks typically have little difficulty adjusting the available money supply to accommodate changes in the demand for money due to business transactions.
The speculative demand for money is much harder for a central bank to accommodate but they try to do this by adjusting interest rates. An investor may choose to buy a currency if the return that is the interest rate is high enough. The higher the country's interest rates, the greater the demand for that currency. It has been argued that currency speculation can undermine real economic growth, in particular since large currency speculators may deliberately create downward pressure on a currency in order to force that central bank to sell their currency to keep it stable, once this happens, the speculator can buy the currency back from the bank at a lower price, close out their position, and thereby take a profit.

In choosing what type of asset to hold, people are also concerned that the asset will retain its value in the future. Most people will not be interested in a currency if they think it will devalue. A currency will tend to lose value, relative to other currencies, if the country's level of inflation is relatively higher, if the country's level of output is expected to decline, or if a country is troubled by political uncertainty.

Foreign exchange markets: The foreign exchange markets are usually highly liquid as the world's main international banks provide a market around the clock. The Bank for international ssettlements reported that global foreign exchange market turnover daily averages in April was $650 billion in 1998 at constant exchange rates and increased to $1.9 trillion in. The biggest foreign exchange trading centre is London, followed by New York and Tokyo.

Absolute advantage

A country has an absolute advantage economically over another, in a particular good, when it can produce that good at a lower cost. Using the same input of resources a country with an absolute advantage will have greater output. Assuming this one good is the only item in the market, beneficial trade is impossible. An absolute advantage is one where trade is not mutually beneficial, as opposed to a comparative advantage where trade is mutually beneficial. Comparative advantage principles did not hold where the factors of production are internationally mobile.
Limitations to the theory may exist if there are multiple kinds of utility. The very fact that people want food and shelter already indicates that multiple utilities are present in human desire. The moment the model expands from one good to multiple goods, the absolute may turn to a comparative advantage. However, pure labor arbitrage, where one county exploits the cheap labor of another, would be a case of absolute advantage that is not mutually beneficial.
The two concepts have applications outside international trade, though this is where they are most commonly used. Suppose that two cast aways on a desert island gather both fruit and grain, which they then share equally between them. Suppose that Cast away A. can gather more fruit per hour than Castaway B, and therefore has an absolute advantage in this good. Nonetheless, it may well make sense for A to leave some fruit gathering to B.

This is because it is possible that B gathers fruit slightly slower than A, but gathers grain extremely slowly.
One needs to look at comparative advantage rather than absolute advantage, to discover how A and B can each best allocate their effort. If A's initial advantage over B in grain gathering is greater than his or her advantage in fruit gathering, then fruit effort should be transferred from A to B, to the point where A's comparative advantages in the two goods are equal. Thus it may be rational for fruit to flow from B to A, despite A's absolute advantage.

Comparative advantage

In economics, the theory of comparative advantage explains why it can be beneficial for the two parties, countries, regions, individuals and so on to trade if one has a lower relative cost of producing some good. What matters is not the absolute cost of production but the opportunity cost which measures how much production of one good is reduced to produce one more unit of the other good. Comparative advantage is critical to understanding modern international trade theory.

Under absolute advantage, one country can produce more output per unit of productive input than another. With comparative advantage, if one country has an absolute advantage in every type of output, the other might benefit from specializing in and exporting those products, if any exist. Comparative advantage was first described by Robert Torrens in 1815 in an essay on the Corn Laws. He concluded that it was to England's advantage to trade various goods with Poland in return for grain, even though it might be possible to produce that grain more cheaply in England than Poland.

However, the theory is usually attributed to David Ricardo who created a systematic explanation. In Portugal it is possible to produce both wine and cloth with less work than it takes in England. However, the relative costs of producing those two goods are different in the two countries. In England it is very hard to produce wine, and only moderately difficult to produce cloth. In Portugal both are easy to produce. Therefore, while it is cheaper to produce cloth in Portugal than England, it is cheaper still for Portugal to produce excess wine, and trade that for English cloth. Conversely, England benefits from this trade because its cost for producing cloth has not changed but it can now get the cheaper Portuguese wine.

A country should specialize in products and services in which they have a comparative disadvantage. They should then trade with another country that has products in which that country has a comparative advantage. In this way both countries become better off.

For example, two men land alone in an isolated island. To survive they must undertake a few basic economic activities like water carrying, fishing, cooking and shelter construction and maintenance. The first man is young, strong, and educated and is faster, better, more productive at everything. He has an absolute advantage in all activities. The second man is old, weak, and uneducated. He has an absolute disadvantage in all economic activities. In some activities the difference between the two is great; in others it is small.

Is it in the interest of either of them to work in isolation? No, specialization and exchange trade can benefit both of them.
How should they divide the work? According to comparative, not absolute advantage: the young man must spend more time on the tasks in which he is much better and the old man must concentrate on the tasks in which he is only a little worse. Such an arrangement will increase total production and/or reduce total labour. It will make both of them richer.

Bilateral investment treaty: Bilateral Investment Treaty (BIT) is an agreement establishing the terms and conditions for private investment by nationals and companies of one state in the state of the other. This type of investment is called foreign direct investment (FDI). BITs are established through trade pacts.

Most BITs grant investments made by an investor of one contracting state in the territory of the other a number of guarantees, which typically include fair and equitable treatment, protection from expropriation, free transfer of means and full protection and security. The distinctive feature of many BITs is that they allow for an alternative dispute resolution mechanism, whereby an investor whose rights under the BIT have been violated could have recourse to international arbitration, often under the auspices of the ICSID International center for the resolution of investment disputes, rather than suing the host State in its own courts.

Free trade

Free trade is a market model in which trade in goods and services between or within countries flow unhindered by government imposed restrictions. Restrictions to trade include taxes and other legislation, such as tariff and non tariff trade barriers.

The theory is that any voluntary trade must benefit both parties; otherwise it would not be made. More precisely, for a trade to occur both parties must expect a benefit. Furthermore, the advantages of free trade according to classic economic theory are substantiated in analysis, according to which free trade achieves maximum economic efficiency and overall productivity gains.

Free Trade can be contrasted with protectionism, which is the economic policy of restraining trade between nations, through methods such as high tariffs on imported goods, restrictive quotas, a variety of restrictive government regulations designed to discourage imports, and anti dumping laws in an attempt to protect domestic industries in a particular nation from foreign take over or competition.

Governments often call managed international trade agreements free trade, and although this is not really free trade, such treaties may result in freer trade.

Free trade is a term in economics and government that includes:

- Trade of goods without taxes (including tariffs) or other trade barriers (quotas on imports or subsidies for producers)

- Trade in services without taxes or other trade barriers
- The absence of trade-distorting policies (such as taxes, subsidies, regulations or laws) that give some firms, households or factors of production an advantage over others
- Free access to markets
- Free access to market information
- Inability of firms to distort markets through government-imposed monopoly or oligopoly power
- The free movement of labor between and within countries
- The free movement of capital between and within countries

Few propositions command as much consensus among professional economists as that open world trade increases economic growth and raises living standards. Two simple ways to understand the benefits of free trade are in analyzing the impact of a tariff or import quota
A simple economic analysis using the law of supply and demand and the economic effects of a tax can be used to show the theoretical benefits of free trade.

Free trade: A free trade area is a designated group of countries that have agreed to eliminate tariffs, quotas and preferences on most if not all goods between them.

It can be considered the second stage of economic integration. Countries choose this kind of economic integration form, if their economical structures are complementary. If they are competitive, they will choose customs union.

Unlike a customs union, members of a free trade area do not have the same policies with respect to non members, meaning different quotas and customs. To avoid evasion through reexportation, the countries use the system of certification of origin most commonly called rules of origin, where there is a requirement for the minimum extent of local material inputs and local transformations adding value to the goods. Goods that don't cover these minimum requirements are not entitled for the special treatment envisioned in the free trade area provisions.

Cumulation is the relationship between different FTAs regarding the rules of origin sometimes different FTAs supplement each other, in other cases there is no cross cumulation between the FTAs.

The free trade area is a result of a free trade agreement which form the trade pact) between two or more countries. Free trade areas and agreements (FTAs) are cascadable to some degree. if some countries sign agreement to form free trade area and choose to negotiate together either as a trade bloc or as a forum of individual members of their FTA another free trade agreement with some external country or countries then the new FTA will consist of the old FTA plus the new country or countries.

Within an industrialized country there are usually few if any significant barriers to the easy exchange of goods and services between parts of that country. For example, there

are usually no trade tariffs or import quotas; there are usually no delays as goods pass from one part of the country to another other than those that distance imposes, there are usually no differences of taxation and regulation.

Between countries on the other hand, many of these barriers to the easy exchange of goods can and often do occur. It is commonplace for there to be import duties of one kind or another as goods enter a country and the levels of sales tax and regulation often vary by country.

The aim of a free trade area is to so reduce barriers to easy exchange that trade can grow as a result of specialization, division of labour, and most importantly via the theory and practice of comparative advantage. The theory of comparative advantage argues that in an unrestricted marketplace in equilibrium each source of production will tend to specialize in that activity where it has comparative rather than absolute advantage. The theory argues that the net result will be an increase in income and ultimately wealth and well being for everyone in the free trade area. However the theory refers only to aggregate wealth and says nothing about the distribution of wealth. In fact there may be significant losers, in particular among the recently protected industries with a comparative disadvantage. The proponent of free trade can, however, retort that the gains of the gainers exceed the losses of the losers.

A free trade zone (FTZ) or Export processing zone (EPZ) is one or more areas of a country where tariffs and quotas are eliminated and bureaucratic requirements are lowered in hopes of attracting new business and foreign investments. Free trade zones can be defined as labor intensive manufacturing centers that involve the import of raw materials or components and the export of factory products.

Most FTZs are located in developing countries. They are special zones where some normal trade barriers such as import or export tariffs do not apply, bureaucracy is typically minimized by outsourcing it to the FTZ operator and corporations setting up in the zone may be given tax breaks as an additional incentive. Usually, these zones are set up in underdeveloped parts of the host country, the rationale being that the zones will attract employers and thus reduce poverty and unemployment and stimulate the area's economy. These zones are often used by multinational corporations to set up factories to produce goods such as clothing or shoes.

International law

Can be described in three distinct legal disciplines:

- Public international law, which involves for instance the United Nations, maritime law, international criminal law and the Geneva conventions.
- Private international law or conflict of laws, which addresses the question of which legal jurisdiction cases may be heard in

- The law of supranational organizations which concerns at present regional agreements where the special distinguishing quality is that laws of nation states is held inapplicable when conflicting with a supranational legal system.
    - ❖ Public international law or international public law concerns the relationships between sovereign nations. It is developed mainly through multilateral conventions, though custom state practice with can play an important role. Its modern corpus started to be developed in the middle of the 19th Century. The two World Wars, the league of nations and other international organizations such as the international labor organization all contributed to accelerate this process and established much of the foundations of modern public international law. After the failure of the Treaty of Versailles and World War II, the League of Nations was replaced by the United Nations, founded under the UN charter. The UN has developed new standards, such as the Universal declaration of human Rights. Other international norms and laws have been established through international agreements, e.g. the Geneva Conventions on the conduct of war or armed conflict, as well as by other international organizations such as the ILO, the World Health Organization, the World Intellectual Property Organization, the International Telecommunication Union, UNESCO, the World Trade Organization, and the International Monetary Fund. Thus later law is of great importance in the realm of international relations.

    - ❖ Conflict of laws, or private international law in civil law jurisdictions, is less international than international law. It is distinguished from public international law because it governs conflicts between private persons, rather than states or other international bodies with standing. It concerns which jurisdiction a legal dispute between private parties should be heard in, therefore raising issues of international law. Today corporations are increasingly capable of shifting capital and labor supply chains across borders, as well as trading with overseas corporations. This increases the number of disputes of inter state nature outside a unified legal framework and raises issues of the enforceability of standard practices.

    - ❖ The European Union is the first and only example of a supra national legal framework, where sovereign nations have pooled their authority through a system of courts and political institutions. It constitutes a new legal order in international law for the mutual social and economic benefit of the member states.

International organization

An international organization, or more formally intergovernmental organization (IGO), is an organization, such as the European Community or World Trade Organization, with sovereign states or other IGOs as members.

Non-governmental organizations (NGOs) are private organizations that can also be international in scope. Generally and correctly used, however, the term international organization is reserved for intergovernmental organizations only.
Legally speaking, an international organization must be established by a treaty constituent instrument providing it with legal recognition. International organizations so established are subjects of international law, capable of entering into agreements among themselves or with states. Thus international organizations in a legal sense are distinguished from mere groupings of states, such as the G-8 and the G-77, neither of which have been founded by treaty, though in non legal contexts these are sometimes referred to as international organizations as well.

International organizations must also be distinguished from treaties, while all international organizations are founded on a treaty, many treaties (the North American Free Trade Agreement (NAFTA) or, in the 1947-1995 period, the General Agreement on Tariffs and Trade (GATT)) do not establish an international organization and rely purely on the parties for their administration.

International organizations differ in function, membership and membership criteria. Membership of some organizations (global organizations) is open to all the nations of the world. This category includes the United Nations and its specialized agencies and the World Trade Organization. Other organizations are only open to members from a particular region or continent of the world, like European Union, African Union, and ASEAN and so on.

Finally, some organizations base their membership on other criteria, cultural or historical links, the Commonwealth of Nations, La Francophonie, the Community of Portuguese Language Countries, the Latin Union, level of economic development or type of economy, Organization for Economic Co-operation and Development (OECD), Organization of Petroleum-Exporting Countries (OPEC), or religion , Organization of the Islamic Conference.

The Union of International Associations provides information on international organizations. The Bretton Woods Conference of 1944 recognized the need for a comparable international institution for trade, the later proposed International Trade Organization (ITO) to complement the IMF and the World Bank. Probably because Bretton Woods was attended only by representatives of finance ministries and not by representatives of trade ministries, an agreement covering trade was not negotiated there.

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