

CHAPTER ONE: AN OVERVIEW OF INTERNATIONAL MARKETING

1. Introduction

A firm selling abroad its merchandise often faced with cultural, economic, and legal systems that are quite different from those in its home country. Thus a firm must understand and adapt to a new and unfamiliar environment. A firm moves beyond domestic markets into international trade for several reasons.

The first is simply the **existence of foreign markets**. There is a strong demand for a wide variety of consumer products in the developed nations of the world. And within the developing as well as the developed nations of the world, there is a demand for business products such as machine tools, construction, equipment and computers. Second, as **domestic markets become saturated**, producers even those with no previous international experience, look to foreign markets. Third, some countries **possess unique natural or human resources** that give them a comparative advantage when it comes to producing particular products. Another factor in international expansion is the **possession of a technological advantage**.

All organizations in this world, large and small, have been so deeply involved in and affected by international business. A global economic boom, unprecedented in modern economic history, has been under way as the drive for efficiency, productivity, and open, unregulated markets sweeps the world. Powerful economic, technological, industrial, political, and demographic forces are converging to build the foundation of a new global economic order on which the structure of a one world economic and market system will be built.

Whether or not an Ethiopian company wants to participate directly in international business, it cannot escape the effects of the ever-increasing number of foreign firms exporting, importing and manufacturing abroad. Nor can it ignore the number of foreign based firms operating in Ethiopia markets, the growth of regional trade areas, the rapid growth of world markets, and the increasing number of competitors for global markets.

An organization whose products are marketed in two or more countries is engaged in international marketing.

The fundamentals of marketing apply to international marketing **in the same way** they apply to domestic marketing.

1.1. Definition of International Marketing

Understanding international marketing is easier if you have good Knowledge of the concept of marketing. As per the definition of American Marketing Association, “marketing is the process of planning and executing the conception, pricing, promotion and distribution of ideas, goods, and services to create exchanges that satisfy individual and organizational objectives”.

This definition can extend to define international marketing.

Thus “international marketing is **the multinational process of planning and executing** the conception, pricing, promotion and distribution of ideas, goods, and services to create exchanges that satisfy individual and organizational objectives.” International marketing is the performance of business activities that direct the flow of companies’ goods and services to consumers and users in more than one nation for a profit. International Marketing is the marketing carried on cross national boundaries. It is a marketing techniques involved between countries. To understand in a better way let’s read definitions of International Marketing given by different authors.

- “International Marketing has been defined by Franklin R. Root as “those activities performed by a business enterprise to promote, direct, support and control the penetrations and development of a foreign national market from a production base located either outside or inside that market.”
- Walsh defines international marketing as; “the marketing of goods and services across national frontiers, and the marketing operations of an organization that sells or produces within a given country when; that organization is a part of an enterprise which also operates in other countries and, there is some degree of influence on or control of the organizations marketing activities from outside the country in which it sells or produces.”
- “International Marketing is the performance of business activities designed to plan, price, promote, and direct the flow of a company’s goods and services to consumers or users in more than one nation for a profit” ***Philip R. Cateora and John h. Graham. 2002***

An organization whose products are marketed in two or more countries is engaged in international marketing. The **fundamentals of marketing** apply to international marketing in the same way they apply to domestic marketing. Marketing program should be built around a good product that is properly priced, promoted, and distributed to a market that has been carefully selected. International markets create attractive opportunities, but the competition is intense. Success goes to the firms that understand and adapt to the environmental factors that influence international marketing.

1.2. International marketing VS Domestic marketing

Some basic distinctions between domestic and international markets are as enumerated below.

i) Domestic market

1. One language, one nation, one culture
2. Market is much more homogeneous
3. Single currency
4. No problems of exchange controls, tariffs
5. Relatively stable business

6. Minimum government interference in business decision
7. Data in marketing research available, easily collected, and accurate etc.

ii) International Markets

1. Many languages, many nations, many cultures
2. Markets are diverse and fragmented
3. Multiple currencies
4. Exchange controls and tariffs normal obstacles
5. Multiple and unstable business environments
6. Due to national economic plans government influence usual in business decisions
7. Marketing research very difficult, costly and cannot give desired accuracy, etc.
8. Domestic and International Enterprises: Characteristics and Practices Environment

1.3. Reason for entering International Market /Internationalization

Few companies operate in an isolated and fewer can effectively avoid international involvement. Local firms manufacturing for local consumers are dependent on equipment, parts, and/or raw materials originating abroad. They sell to clients and final consumers who have exposure to international products. Companies most often cannot avoid involvement in international marketing; increasingly companies cannot afford to avoid involvement in international marketing. Avoiding international marketing could mean losing market share to competitors and missing numerous opportunities created by changes in the international environment. Companies drive to internationalization by many reasons. They categorized in business environment and firm specific drives.

1.3.1. Business Environment Drivers

These are elements in the business environment which influence company to internationalize its business

- **Saturated home market:** If the home market for an organization's products or service is saturated or competition is so intense that it can no longer gain any significant market share improvement, it might consider extending its market activity to overseas markets.
- **Competition:** There are two cases in this instance: 1st competition may be less intense in overseas markets than in the domestic market; 2nd an organization is faced by particularly virulent international competition in its domestic market place. In this case it is difficult to compete from a domestic base against international competitors. So you have to move internationally to compete on a more equal footing with the opponent organization.
- **Regional Economic and Political Integration:** In addition to cultural similarities language and religion, economic and political integration play an important part in facilitating international trade. Regional agreements such as the North American Free Trade Agreement (NAFTA) and the politically and economically integrated European Union are best examples. It lowers or eliminates barriers between member countries and promoting trade within the perimeter of each common market.

- **Technology:** Technology has created opportunities for firms involved in international business.
- **Improvement in transportation and telecommunication infrastructure**
- **Economic Growth:** Economic growth constitutes a very important driver of internationalization. Economic growth increase buying power and create markets of high potential for international brands. Economic growth has also opened markets that have been previously closed that have limited international competition.
- **Transition to a market Economy:** The transition of countries to a market economy has lead to rapid economies development and has created important new markets for international brands. Another important outcome of the transition to a market economy has been the deregulation and privatization of former government monopolies. Opportunities exist for product manufactures to purchase or partner with local companies operating at loss, producing low quality goods and to turn them around in to successful enterprises selling global brands to local consumers.
- **Converging consumer needs:** Exposure to global brands in one's home country and while traveling abroad, to media advertising these brands has created demand for many global products. Consumers worldwide are loyal to international brands. Uniform consumer segments are emerging worldwide. During their international travels, consumers purchase brands and services available in their own home country, which they are familiar with. Most often, these offerings are successful international products and services. Alternatively consumers who have traveled abroad bring with them product experiences and demand brands that may not be available in the home country market. This will generate pull demand, where by consumers request the product from the retailers who subsequently convey the information up the distribution chain to wholesalers, who would then order the product.

1.3.2. Firms Specific Drivers

- **Product life cycle differences:** A main drive behind international expansion is a firms attempt to prolong the product life cycle. Products that are in late maturity or even in the decline stage can change their position on the global product life-cycle stage by going in to markets **where the product is in high demand**. To illustrate this point, the cigarette industry is in either the late maturity stage or in the decline stage in many industrialized countries. By entering emerging markets where cigarettes are in the growth stage and consumers have increasing purchase power, such as China, central and Eastern Europe, the cigarette industry is in fact prolonging its products life cycle.
- **High new product development costs:** Companies often spend long period of time and significant amount of money to develop new products. So to fully recover the product developments cost and make a profit companies, going international is not a choice it is a pre-condition for survival.
- **Standardization:** During the maturity stage of the PLC, the core product is likely to achieve a standard in a particular industry.

- Competitors respond to consumer needs by offering products whose components are interchangeable and which converge towards the brand experiencing the greatest consumer franchise (demand).
- **Economies of scale:** During the maturity stage, firms also increasingly compete on price. Typically, they attempt to lower the product manufacturing cost by achieving economies of scale in production.
- **Cheap Labor:** Firms at maturity also move manufacturing operations and facilities abroad, to developing countries, in attempt to take advantage of significantly lower labor costs.
- **Experience transfers:** International firms benefit from lessons they learn in the different parts of the world.
- **Comparative advantage in product, skill or technology:** The organization may discover, when analyzing overseas market opportunities, that it has a comparative advantage against local competition in the foreign market. This advantage might be in product, skill or technology.
- **Excess Capacity:** Where an organization is operating successfully in its domestic market place but it is operating at below optimal capacity levels, there is excess capacity available for production. In these instances, it may be wise to consider international operations where the product or service can be coasted at marginal cost, thereby giving a potential price advantage for overseas marketing operations.

1.4. Stages of International Involvement

Once a company has decided to go international, it has to decide the degree of marketing involvement and commitment it is prepared to make. These decisions should reflect considerable analysis of market potential and company capabilities a process not always followed. Many companies begin tentatively in international marketing, growing as they gain experience and gradually changing strategy and tactics as they become more committed. Others enter international marketing after much research and with fully developed long-range plans, prepared to make investments to acquire a market position. Anyways, below we shall try to describe the six international marketing stages a company may encounter in marketing across national boundaries.

1. **No Direct Foreign Marketing:** A company in this stage does not actively cultivate customers outside national boundaries; however, this company's products may reach foreign markets. Sales may be made to trading companies as well as foreign customers who come directly to the firm. Or products may reach foreign markets via domestic wholesalers or distributors who sell abroad without explicit encouragement or even knowledge of the producer. Often an unsolicited order from a foreign buyer is what piques the interest of a company to seek additional international sales.

2. ***Infrequent Foreign Marketing:*** Temporary surpluses caused by variations in production levels or demand may result in infrequent marketing overseas. The surpluses are characterized by their temporary nature; therefore, sales to foreign markets are made as goods are available, with little or no intention of maintaining continuous market representation. **As domestic demand increases and absorbs surpluses, foreign sales activity is withdrawn.** In this stage, there is little or no change in company organization or product lines. However, few companies today fit this model because customers around the world increasingly seek long-term commercial relationships.
3. ***Regular Foreign Marketing:*** At this level, the firm has permanent productive capacity devoted to the production of goods to be marketed in foreign markets. A firm may employ foreign or domestic overseas middlemen or it may have its own sales force or sales subsidiaries in important foreign markets. The primary focus of operations and production is to service domestic market needs. However, as overseas demand grows, production is allocated for foreign markets, and products may be adapted to meet the needs of individual foreign markets. Profit expectations from foreign markets move from being seen as a bonus to regular domestic profits to a position in which the company becomes dependent on foreign sales and profits to meet its goals.
4. ***International Marketing:*** Companies in this stage are fully committed and involved in international marketing activities. Such companies seek markets all over the world and sell products that are a result of planned production for markets in various countries. This generally entails not only the marketing but also the production of goods outside the home market. At this point a company becomes an international firm.
5. ***Multinational Marketing:*** Now, in this stage, the number of countries in which the company is doing business gets bigger than that in earlier stage. And so, instead of producing different goods for different countries, company tries to identify different regions for which it can deliver same product. So, same product for countries lying in one region but different from product offered in countries of another region. E.g. a company may decide to offer same product to India, Sri Lanka and Pakistan if it thinks the taste of people of these countries is same but at the same time offering different product for American countries.
6. ***Global Marketing:*** At the global marketing level, the most profound change is the orientation of the company toward markets and associated planning activities. At this stage, companies treat the world, including their home market, as one market. Market segmentation decisions are no longer focused on national borders. Instead, market segments are defined by income levels, usage patterns, or other factors that often span countries and regions.

Often this transition from international marketing to global marketing is catalyzed by a company's crossing the threshold of more than half its sales revenues coming from abroad. The best people in the company begin to seek international assignments and the entire operation organizational structure, sources of finance, production, marketing, and so forth begins to take on a global perspective.

7. **Transnational Marketing:** It produces, markets, invests and operates, across the world. It is an integrated global enterprise which links global resources with global markets at profit. There is no pure transnational companies satisfy many of the characteristics of a global corporation.

1.5. Strategic Orientation/International Marketing Concepts

The stages of international marketing involvement described above do not necessarily concede with managers' thinking and strategic orientation. Often companies are led in to international and even global market by burgeoning consumers or customer demands, and strategic thinking. Management's orientation toward the internationalization of the firms operations affects each of the functional areas of the firm, and as such, has a direct impact on the marketing functions within the firm. Management's philosophy on international involvement affects decisions such as the firm's response to global threats and opportunities and related resource allocation. Companies' philosophies on international involvement can be described, based on the EPRG framework, as ethnocentric, polycentric, regio-centric and geocentric.

- I. **Ethnocentric Orientation:** is a strong orientation toward the home country. Firms with an ethnocentric orientation are guided by a domestic market extension concept. Firms with ethnocentric orientation consider that domestic strategies, techniques, and personnel are superior to foreign ones, and therefore provide the most effective framework for the company's overseas involvement; consequently, international operations and customers are considered secondary to domestic operations and customers.

Ethnocentric firms are likely to be highly centralized, and consider that the purpose of their international operation is to identify markets that could absorb surplus domestic production; alternatively, international operations could represent a cash cow that generates revenue and necessitates only minimal attention and investment.

- II. **Polycentric Orientation:** It is the opposite of ethnocentricity, is a strong orientation to the host country. The attitude places emphasize on difference between markets that are caused by variations within such as income, culture, laws and politics. The assumption is that each market is a unique and consequently difficult for outsiders to understand. Thus such companies assume each market is unique and needs to be addressed in individually. Consequently, the company is fully decentralized and engages in minimal coordination with

head quarters. Thus managers from the host country should be employed and allowed to have great deal of discretion in market decision. In the process of developing individual strategies for each market the company does not coordinate activities across the different countries and cannot benefit from economies of scale that such coordination will allow. Further more numerous functions are duplicated, and ultimate final product costs are higher to the end consumer.

- III. **Regio-centric Orientation:** Companies adapting a regio-centric orientation view world regions as distinct markets that share economic, political and/or cultural traits such that they would be viable candidates for a region wide marketing approach. A regio-centric orientation is now possible due to the success of regional economic and political integration that allows for implementing a uniform marketing strategy in the entire region.
- IV. **Geocentric Orientation:** Firms in which top management adapts a geocentric orientation perceive the entire world-without national and regional distinctions-as a potential market with identifiable, homogenous segments, regardless of geographic location or nationality. Coordinated management policies are designed to reflect the full integration among worldwide operation.

The objective of a geocentric company is most often to achieve a position as a low-cost manufacturer and markets of its product line, such a firm achieves a strategic competitive advantage by developing manufacturing process that add more value per unit cost to the final product than its rivals. This Company thinks globally and acts locally. This company adopts global strategy but allows value addition to the customer of a domestic country. The assets of a transnational company are distributed throughout the world.

1.6. Challenges and Opportunities in international marketing

1.6.1. Challenges in international marketing

- 1) **Political and legal differences:** The political and legal environment of foreign markets is different from that of the domestic. The complexity generally increases based on the operations in a number of countries.
- 2) **Cultural differences:** the cultural difference is one of the most difficult problems in international marketing. Many domestic markets are also free from cultural diversity.
- 3) **Economic differences:** Economic environment vary from country to country based on national income, spending pattern, rate of savings, debt position, business cycles etc.
- 4) **Differences in the currency unit:** Currency variation from nation to nation cause problems of currency convertibility, besides the problems of exchange rate fluctuations. The monetary system and regulations may also vary.

- 5) **Differences in the language:** An international marketer often encounters problems arising out of the differences in the language. Even when the same language is used in different countries, the same words or terms may have different meanings.
- 6) **Differences in the marketing infrastructure:** The availability and nature of the marketing facilities available in different countries may vary widely. For example an advertising medium very effective in one market may not be available or may be underdeveloped in another market.
- 7) **Trade restrictions:** Trade restriction, particularly import controls, is a very important problem which an international marketer faces. Every country has its own customs duties and also rules and regulations relating to demand and supply of foreign exchange.
- 8) **High costs of distance:** When the markets are far away by distance, the transportation cost becomes high and the time required for effective delivery tends to become longer.
- 9) **Differences in trade practices:** Trade practices and customs may differ between markets. The export procedures and policies also vary from country to country. This directly reflects international business operations.
- 10) **Risks and uncertainties:** Long distance, dangers of sea transport, changing exchange rates etc create a number of risks and uncertainties leading to heavy losses or damages.

1.6.2. Opportunities in international marketing

Challenges lead to new opportunities! Discover what opportunities await in the global market.

- **Exporting and Importing Opportunities:** International business developed centuries ago. What began as trading overseas has developed into a global highway. Exporting and importing businesses encounter many challenges but [successful international transactions](#) lead to a promising, lucrative profit.
- **Licensing Opportunities:** Licensing can be a lucrative, door-opening opportunity for many businesses. Licensing is often associated with characters and shows but can extend to your company's production process and much more. Consider what sets your business apart from the rest and how you maximize your potential through licensing.
- **Franchising Opportunities:** Franchising is the ultimate international business opportunity. Not only does this open the door to more profits, it gives your company the chance to grow its brand in several cities or countries at the same time. Identify where your business can fill a city or country's need and find out [how to franchise your small business](#).

1.7. Theories of International Trade and Balance of Payment

1.7.1. International Trade Theories

Although our primary concern is **international marketing** rather than international trade, a brief survey of international trade will prove useful. Trading between groups has been going on since the beginning of recorded history. Much early trade was economically motivated and conducted through barter or commercial transactions. However, a large part of the exchange of goods historically occurred through military conquest: "To the victor belong the spoils." The predominant pattern of international trade is the voluntary exchange of goods and services. In domestic marketing, much emphasis is placed on the analysis of buyer behavior and motivation. For the international marketer, knowledge of the basic causes and nature of international trade is important. It is easier for a firm to work with the underlying economic forces than against them. To work with them, however, the firm must understand them.

Essentially, international trade theory seeks the answers to a few basic questions: Why do nations trade? What goods do they trade? Nations trade for economic, political, and cultural reasons, but the principal economic basis for international trade is difference in price; that is, a nation can buy some goods more cheaply from other nations than it can make them itself. In a sense, the nation faces the same "make or buy" decision, as does the firm. Just as most firms do not go for complete vertical integration but buy many materials and supplies from outside firms, so most nations decide against complete self-sufficiency (or autarky) in favor of buying cheaper goods from other countries.

In the 1600 and 1700 centuries, **mercantilism stressed** that countries should simultaneously encourage exports and discourages imports. Although mercantilism is an old theory it echoes in modern politics and trade policies of many countries. The neoclassical economist Adam Smith, who developed the theory of absolute advantage, was the first to explain why **unrestricted free trade is beneficial to a country**. Smith argued that '**the invisible hand**' of the market mechanism, rather than government policy, should determine what a country imports and what it exports. Two theories have been developed from Adam Smith's absolute advantage theory. The first is the English neoclassical economist David Ricardo's comparative advantage. Two Swedish economists, Eli Hecksher and Bertil Ohlin, develop the second theory. The Heckscher-Ohlin theory is preferred on theoretical grounds, but in real-world international trade pattern it turned out not to be easily transferred, referred to as the Leontief paradox. Another theory trying to explain the failure of the Hecksher-Ohlin theory of international trade was the product life cycle theory developed by Raymond Vernon.

1. Mercantilism

According to Wild, 2000, the trade theory that states that nations should accumulate financial wealth, usually in the form of gold, by encouraging exports and discouraging

imports is called mercantilism. According to this theory other measures of countries' well being, such as living standards or human development, are irrelevant. Mainly Great Britain, France, the Netherlands, Portugal and Spain used mercantilism during the 1500s to the late 1700s.

Mercantilist countries practiced the so-called zero-sum game, which meant that world wealth was limited and that countries only could increase their share at expense of their neighbors. The economic development was prevented when the mercantilist countries paid the colonies little for export and charged them high price for import. The main problem with mercantilism is that all countries engaged in export but was restricted from import, prevention from development of international trade.

2. Absolute Advantage

The Scottish economist Adam Smith developed the trade theory of absolute advantage in 1776. A country that has an absolute advantage produces greater output of a good or service than other countries using the same amount of resources. Smith stated that tariffs and quotas should not restrict international trade; it should be allowed to flow according to market forces. Contrary to mercantilism Smith argued that a country should concentrate on production of goods in which it holds an absolute advantage. No country would then need to produce all the goods it consumed.

The theory of absolute advantage destroys the mercantilist idea that international trade is a zero-sum game. According to the absolute advantage theory, international trade is a positive-sum game, because there are gains for both countries to an exchange. Unlike mercantilism this theory measures the nation's wealth by the living standards of its people and not by gold and silver. There is a potential problem with absolute advantage.

If there is one country that does not have an absolute advantage in the production of any product, **will there still be benefit to trade, and will trade even occur?** The answer may be found in the extension of absolute advantage, the theory of comparative advantage.

3. Comparative Advantage

The most basic concept in the whole of international trade theory is the principle of comparative advantage, first introduced by David Ricardo in 1817. It remains a major influence on much international trade policy and is therefore important in understanding the modern global economy. The principle of comparative advantage states that a country should specialize in producing and exporting those products in which it has a comparative, or relative cost advantage compared with other countries and should import those goods in which it has a comparative disadvantage. Out of such specialization, it is argued, will accrue greater benefit for all.

In this theory there are several assumptions that limit the real-world application. The assumption that countries are driven only by the maximization of production and consumption and not by issues out of concern for workers or consumers is a mistake.

This theory States that, the principle of comparative costs is based on the differences in production costs of similar commodities in different countries. Production costs differ in countries because of geographical division of labor and specialization in production. In this way, each country specializes in the production of that commodity in which its comparative cost of production is the least. Therefore, when a country enters in to trade with some other country, it will export those commodities in which its comparative production costs are less, and will import those commodities in which its comparative production costs are high. It follows that each country will specialize in the production of those commodities in which it has greater comparative advantage.

In sum, his theory of comparative advantage states that even if a country is able to produce all its goods at lower cost than another country can, trade still benefits both countries, based on comparative, not absolute costs. In other words, countries should concentrate efforts on producing goods that have a comparative advantage over other countries, and then export those goods in exchange for goods that command advantage in their native countries.

To illustrate this point, let us assume the following information about the United State and Italy. Labor costs per unit (in Hours)

Country	Hand calculator	Bottle of wine
United States	6	8
Italy	30	15

Although these figures show that the production cost of both hand calculators and wine is lower in the United States than in Italy, **according to the theory of comparative advantage**, the United States is better off specializing in hand calculators and exchanging them for Italian wine. This way, it can obtain from Italy a bottle of wine for only six hours of labor instead of eight hours that would be required at home. Italy would also gain from the exchange by **concentrating on producing wine and exchanging** it for hand calculators at the cost of 15 instead of 30 hours of labor. The key to this concept is in the word “comparative” -which implies that each and every country has both definite ‘advantage’ in producing some goods and definite ‘disadvantage’ in producing other goods.

4. Factor Endowment Theory

In the early 1900s an international trade theory called factor proportions theory emerged by two Swedish economists, Eli Heckscher and Bertil Ohlin. This theory is also called the Heckscher-Ohlin theory. The Heckscher-Ohlin theory stresses that countries should

produce and export goods that require resources (factors) that are abundant and import goods that require resources in short supply.

5. Product Life Cycle Theory

Raymond Vernon developed the international product life cycle theory in the 1960s. The international product life cycle theory stresses that a company will begin to export its product and later take on foreign direct investment as the product moves through its life cycle. Eventually a country's export becomes its import. Although the model is developed around the U.S, it can be generalized and applied to any of the developed and innovative markets of the world.

The product life cycle theory was developed during the 1960s and focused on the U.S since most innovations came from that market. This was an applicable theory at that time since the U.S dominated the world trade. Today, the U.S is no longer the only innovator of products in the world. Today companies design new products and modify them much quicker than before. Companies are forced to introduce the products in many different markets at the same time to gain cost benefits before its sales declines. The theory does not explain trade patterns of today.

Generally, mercantilism proposed that a country should try to export more than it imports, in order to receive gold. The main criticism of mercantilism is that countries are restricted from import, a prevention of international trade. Adam Smith developed the theory of absolute advantage that stressed that a country should produce goods or services if it uses a lesser amount of resources than other countries. David Ricardo stated in his theory of comparative advantage that a country should specialize in producing and exporting products in which it has a comparative advantage and it should import goods in which it has a comparative disadvantage. Hecksher-Ohlin's theory of factor endowments stressed that a country should produce and export goods that require resources (factors) that are abundant in the home country. Leontief tested the Hecksher-Ohlin theory in the U.S. and found that it was not applicable in the U.S. Raymond Vernon's product life cycle theory stresses that a company will begin to export its product and later take on foreign direct investment as the product moves through its life cycle. Eventually a country's export becomes its import.

According to this concept, many products go through a trade cycle wherein one nation is initially an exporter, then loses its export markets, and finally may become an importer of the product. Empirical studies have demonstrated the validity of the model for some kinds of manufactured goods.

1.8. Concepts of Foreign Exchange and Balance of Payment

1.8.1. Balance of Payments

When countries trade, financial transactions among businesses or consumers of different nations occur

Products and services are exported and imported, monetary gifts are exchanged, investments are made, cash payments are made and cash receipts received, and vacation and foreign travel occur. In short, over a period of time, there is a constant flow of money into and out of a country. The system of accounts that records a nation's international financial transactions is called its balance of payments.

A nation's balance-of-payments statement records all financial transactions between its residents and those of the rest of the world during a given period of time usually one year. Because the balance-of-payments record is maintained on a double-entry bookkeeping system, it must always be in balance. As on an individual company's financial statement, the assets and liabilities or the credits and debits must offset each other. And like a company's statement, the fact that they balance does not mean a nation is in particularly good or poor financial condition. A balance of payments is a record of condition, not a determinant of condition. Each of the nation's financial transactions with other countries is reflected in its balance of payments.

A nation's balance-of-payments statement presents an overall view of its international economic position and is an important economic measure used by treasuries, central banks, and other government agencies whose responsibility is to maintain external and internal economic stability. A balance of payments represents the difference between receipts from foreign countries on one side and payments to them on the other.

1.8.2. Exchange Rate

An exchange rate is the value of a nation's currency in terms of the currency of another nation or economic zone.

A business man operating in the international environment is faced with a two price system i.e., the price of the product and the price of the currency. With the collapse of the Bretton woods system of fixed but infrequently adjusted exchange rates in the early seventies. The generalized floating exchange rates in the second quarter of 1973, most countries are exposed to enhanced exchange rate risks because of frequent adjustment in normal and real exchange rate.

This phenomenon of generalized floating exchange rate has great implications for developing countries, owing to their dependence on developed countries for trade. Therefore any adjustment in the exchange rate of developed countries would mean implications on trade and balance of payments and thereby an influence on the price levels existing in the developing countries economy.

There is a complex web of international payments that links countries. Payment for goods and services is normally made through the banking system. The exporter's bank balance is credited and the exporter's bank settles with the importer's bank. However, what the exporter gets in his own currency is not a fixed return. Exchange rates vary, determined largely by short-term rates of interest.

This means that the exporter may have to ‘sell forward’, that is to be put in funds by the bank which will cover itself in the discount market and receive payment when it falls due. An appreciation of a currency makes exports more expensive to overseas buyers (and imports cheaper to domestic consumers). Depreciation has the opposite effect; the value of exports will increase while the volume of imports may fall and imports become dearer for domestic consumers. The adoption of the euro by a majority of the EU countries has eliminated that risk within the group of countries embracing the European Monetary Union (EMU).

1.9. Barriers of international trade

To encourage development of domestic industry (**infant industry**) and protect existing industry, governments may establish such barriers to trade as tariffs, quotas, boycotts, monetary barriers, non-tariff barriers, and market barriers. Barriers are imposed against import and against foreign business. While the inspiration for such barriers may be economic or political, they are encouraged by local industry. Whether or not the barriers are economically logical the fact is they exist.

Trade barriers can be broadly classified into **tariff** and **non-tariff** barriers.

1.9.1. Tariff barriers

A tariff is a duty or a tax which is imposed on a commodity when it crosses national borders. A tariff, simply defined, is a tax imposed by a government on goods entering at its border. Tariffs may be used as a revenue-generating tax or to discourage the importation of goods, or for both reasons. In general tariffs increase: inflationary pressures, special interests’ privileges, government control and political considerations in economic matters the number of tariffs (they beget other tariffs via reciprocity). And weaken: balance-of-payments positions, supply-and-demand patterns, international relations (they can start trade wars) .Tariff also restricts: manufactures’ supply sources, choices available to consumers and competition

In addition, tariffs are arbitrary, discriminatory, and require constant administration and supervision. They often are used as reprisals against protectionist moves of trading partners. Tariffs can be classified as **protective tariffs** and **revenue tariffs**. The purpose of protective tariff is to protect home industry, agriculture and labor against foreign competitors by trying to keep foreign goods out of the country. Example, Brazil has 50% import tax on imported “flyaway’ planes. **Protective tariffs** can be further classified according to length of time.

A **tariff surcharge** is a temporary action. To adjust the Japanese imports, President Reagan concentrated national interest to provide import relief. The tariff surcharge on motor vehicles jumped from 4.4% to 45% for one year and declined in subsequent years.

A **countervailing duty** is a permanent surcharge. Countervailing duties are imposed on certain imports when products are subsidized by foreign governments. These duties are thus assessed to offset a special advantage or discount allowed by an exporter's government.

The purpose of a **revenue tariff** is to generate tax revenues for the government. Compared to a protective tariff, a revenue tariff is relatively low. Example: when Japanese and other foreign cars are imported to U.S, there is a 3% duty. The U.S tax is a revenue tax; whereas the Japanese tax is more of a protective tariff. There are three kinds of tax rates applied in tariffs.

1. Specific duties are a fixed or specified amount of money per unit of weight, or other measure of quantity. It is a fixed sum of money charged upon each unit of the commodity imported.

2. Ad-valorem duties are duties 'according to value'. An ad-valorem duty is charged as a fixed percentage of the value of the imported article.

3. Combined rates or duties: Is a combination of the specific and ad-valorem duties on a single product. They are duties based on both the specific rate and the ad-valorem rate that are applied to an imported product.

1.9.2. Non-tariff barriers

Tariffs are at least straightforward and obvious. Non-tariff barriers are more elusive and non-transparent. Non-tariff barriers can be grouped into five major categories:

- 1) Government participation in trade:** The degree of government involvement in trade varies from passive to active. The types of participation include *administrative guidance, state trading and subsidies*.
- 2. Customs and entry procedures:** Customs and entry procedures can be employed as non-tariff barriers. These restrictions involve *classification, valuation, documentation, license, inspection and health and safety regulations*.
- 3. Product requirements:** For goods to enter a country, product requirements set by that country must be met. Requirements may apply to product standards and product specifications as well as to packaging, labeling and marking.
- 4. Quotas:** Quotas – A quota is a specific unit or dollar limit applied to a particular type of goods. Quotas put an absolute restriction on the quantity of a specific item that can be imported. They are specific provisions limiting the amount of foreign products imported in order to protect local firms and to conserve foreign currency. Quotas can be used for export control as well. There are three kinds of quotas: absolute, tariff and voluntary quotas.
- 5. Financial Control: Financial regulations can also function to restrict international trade. These restrictive monetary policies are designed to control capital flow so that currencies can be defended or imports controlled.**