AFRICA POPULATION INSTITUTE (API)

BUSINESS ADMINISTRATION & MANAGEMENT TERM FOUR STUDENT'S MODULES (BAM)

Contents

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Course Name	: Business Finance

Course Description
The Course describes the meaning of Business Finance, main techniques of the financial industry, the desirability of budgeting, understanding credit policy, management of stock, analysis of financial economics, public finance, insurance, debt consolidation, wealth management, capital investment decisions, and financial markets.

Course Objectives

- To equip students with a better understanding of major and fundamental theories behind business finance.
- To enable students adopt investment analysis techniques and detect financial problems.
- To help students appreciate the importance of having/acquiring insurance and credit policies in business.

Course content
Introduction

- Definition of Finance
- General areas of finance i.e business finance, personal finance and public finance
- Main techniques and sectors of the financial industry
- The desirability of budgeting
- Capital Vs Cash budgets

Credit Policy

- Definition of a credit policy
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- Purpose of stock control
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- Definition of Financial economics
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- Description of public finance
- Overview of public finance
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- Definition of debt consolidation
- Different alternatives for debt consolidation
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- What are pensions
- Retirement plan
- Employment-based pensions (retirement plans)
- Funded Vs unfunded benefit plans
- Criticisms for benefit plans
- Defined contribution plans
- Contrasting types of retirements plans

Other related topics; Wealth management, capital investment decisions,, working capital management, financial risk management, economic functions of banks, Financial markets

Mode of delivery Face to face lectures

Assessment
Coursework 40%
Exams 60%
Total mark 100%

Introduction Business Finance

Finance is the study of how investors allocate their assets over time under conditions of certainty and uncertainty. A key point in finance, which affects decisions, is the time value of money, which states that a dollar today is worth more than a dollar tomorrow. Finance measures the risks vs. profits and gives an indication of whether the investment is good or not. Finance can be broken into three different sub categories: public finance, corporate finance and personal finance.

Areas of finance

Personal finance

Questions in personal finance revolve around

- How can people protect themselves against unforeseen personal events, as well as those in the external economy?
- How can family assets best be transferred across generations (bequests and inheritance)?
- How does tax policy (tax subsidies or penalties) affect personal financial decisions?
- How does credit affect an individual's financial standing?
- How can one plan for a secure financial future in an environment of economic instability?

Personal financial decisions may involve paying for education, financing durable goods such as real estate and cars, buying insurance, e.g. health and property insurance, investing and saving for retirement.

Personal financial decisions may also involve paying for a loan, or debt obligations. The six key areas of personal financial planning, as suggested by the Financial Planning Standards Board, are:[1]

1. **Financial position:** is concerned with understanding the personal resources available by examining net worth and household cash flow. Net worth is a person's balance sheet, calculated by adding up all assets under that person's control, minus all liabilities of the household, at one point in time. Household cash flow totals up all the expected sources of income within a year, minus all expected expenses within the same year. From this analysis, the financial planner can determine to what degree and in what time the personal goals can be accomplished.
2. **Adequate protection:** the analysis of how to protect a household from unforeseen risks. These risks can be divided into liability, property, death, disability, health and long term care. Some of these risks may be self-insurable, while most will require the purchase of an insurance contract. Determining how much insurance to get, at the most cost effective terms requires knowledge of the market for personal insurance. Business owners, professionals, athletes and entertainers require specialized insurance professionals to adequately protect themselves. Since insurance also enjoys some tax benefits, utilizing insurance investment products may be a critical piece of the overall investment planning.
3. **Tax planning:** typically the income tax is the single largest expense in a household. Managing taxes is not a question of if you will pay taxes, but when and how much. Government gives many incentives in the form of tax deductions and credits, which can be used to reduce the lifetime tax burden. Most modern governments use a progressive tax. Typically, as one's income grows, a higher marginal rate of tax must be paid.[*citation needed*] Understanding how to take advantage of the myriad tax breaks when planning one's personal finances can make a significant impact.
4. **Investment and accumulation goals:** planning how to accumulate enough money for large purchases, and life events is what most people consider to be financial planning. Major reasons to accumulate assets include, purchasing a house or car, starting a business, paying for education expenses, and saving for retirement.

Achieving these goals requires projecting what they will cost, and when you need to withdraw funds. A major risk to the household in achieving their accumulation goal is the rate of price increases over time, or inflation. Using net present value calculators, the financial planner will suggest a combination of asset earmarking and regular savings to be invested in a variety of investments. In order to overcome the rate of inflation, the investment portfolio has to get a higher rate of return, which typically will subject the portfolio to a number of risks. Managing these portfolio risks is most often accomplished using asset allocation, which seeks to diversify investment risk and opportunity. This asset allocation will prescribe a percentage allocation to be invested in stocks, bonds, cash and alternative investments. The allocation should also take into consideration the personal risk profile of every investor, since risk attitudes vary from person to person.

5. **Retirement planning** is the process of understanding how much it costs to live at retirement, and coming up with a plan to distribute assets to meet any income shortfall. Methods for retirement plan include taking advantage of government allowed structures to manage tax liability including: individual (IRA) structures, or employer sponsored retirement plans.
6. **Estate planning** involves planning for the disposition of one's assets after death. Typically, there is a tax due to the state or federal government at your death. Avoiding these taxes means that more of your assets will be distributed to your heirs. You can leave your assets to family, friends or charitable groups.

Corporate finance

Managerial or corporate finance is the task of providing the funds for a corporation's activities (for small business, this is referred to as SME finance). Corporate finance generally involves balancing risk and profitability, while attempting to maximize an entity's wealth and the value of its stock, and generically entails three interrelated decisions. In the first, "the investment decision", management must decide which "projects" (if any) to undertake. The discipline of capital budgeting is devoted to this question, and may employ standard business valuation techniques or even extend to real options valuation; see Financial modeling. The second, "the financing decision" relates to how these investments are to be funded: capital here is provided by shareholders, in the form of equity (privately or via an initial public offering), creditors, often in the form of bonds, and the firm's operations (cash flow). Short-term funding or working capital is mostly provided by banks extending a line of credit. The balance between these elements forms the company's capital structure. The third, "the dividend decision", requires management to determine whether any unappropriated profit is to be retained for future investment / operational requirements, or instead to be distributed to shareholders, and if so in what form. Short term financial management is often termed "working capital management", and relates to cash-, inventory- and debtors management. These areas often overlap with the firm's accounting function, however, financial accounting is more concerned with the reporting of historical financial information, while these financial decisions are directed toward the future of the firm.

Another business decision concerning finance is investment, or fund management. An investment is an acquisition of an asset in the hope that it will maintain or increase its value. In investment management– in choosing a portfolio– one has to decide *what*, *how much* and *when* to invest. To do this, a company must:

- Identify relevant objectives and constraints: institution or individual goals, time horizon, risk aversion and tax considerations;
- Identify the appropriate strategy: active *v*. passive– hedging strategy
- Measure the portfolio performance

Financial management is duplicate with the financial function of the Accounting profession. However, financial accounting is more concerned with the reporting of historical financial information, while the financial decision is directed toward the future of the firm.

Financial risk management, an element of corporate finance, is the practice of creating and protecting economic value in a firm by using financial instruments to manage exposure to risk, particularly credit risk and market risk. (Other risk types include Foreign exchange, Shape, Volatility, Sector, Liquidity, Inflation risks, etc.) It focuses on when and how to hedge using financial instruments; in this sense it overlaps with financial engineering. Similar to general risk management, financial risk management requires identifying its sources, measuring it (see: Risk measure: Well known risk measures), and formulating plans to address these, and can be qualitative and quantitative. In the banking sector worldwide, the Basel Accords are generally adopted by internationally active banks for tracking, reporting and exposing operational, credit and market risks.

Financial services

An entity whose income exceeds its expenditure can lend or invest the excess income. On the other hand, an entity whose income is less than its expenditure can raise capital by borrowing or selling equity claims, decreasing its expenses, or increasing its income. The lender can find a borrower, a financial intermediary such as a bank, or buy notes or bonds in the bond market. The lender receives interest, the borrower pays a higher interest than the lender receives, and the financial intermediary earns the difference for arranging the loan.

A bank aggregates the activities of many borrowers and lenders. A bank accepts deposits from lenders, on which it pays interest. The bank then lends these deposits to borrowers. Banks allow borrowers and lenders, of different sizes, to coordinate their activity.

Finance is used by individuals (personal finance), by governments (public finance), by businesses (corporate finance) and by a wide variety of other organizations, including schools and non-profit organizations. In general, the goals of each of the above activities are achieved through the use of appropriate financial instruments and methodologies, with consideration to their institutional setting.

Finance is one of the most important aspects of business management and includes decisions related to the use and acquisition of funds for the enterprise.

In corporate finance, a company's capital structure is the total mix of financing methods it uses to raise funds. One method is *debt financing*, which includes bank loans and bond sales. Another method is *equity financing* - the sale of stock by a company to investors, the original shareholders of a share. Ownership of a share gives the shareholder certain contractual rights and powers, which typically include the right to receive declared dividends and to vote the proxy on important matters (e.g., board elections). The owners of both bonds and stock, may be *institutional investors* - financial institutions such as investment banks and pension funds — or private individuals, called *private investors* or *retail investors*.

Public finance

Public finance describes finance as related to sovereign states and sub-national entities (states/provinces, counties, municipalities, etc.) and related public entities (e.g. school districts) or agencies. It is concerned with:

- Identification of required expenditure of a public sector entity
- Source(s) of that entity's revenue
- The budgeting process
- Debt issuance (municipal bonds) for public works projects

Central banks, such as the Federal Reserve System banks in the United States and Bank of England in the United Kingdom, are strong players in public finance, acting as lenders of last resort as well as strong influences on monetary and credit conditions in the economy.[2]

Capital

Capital, in the financial sense, is the money that gives the business the power to buy goods to be used in the production of other goods or the offering of a service. (The capital has two types of resources Equity and Debt)

The deployment of capital is decided by the budget. This may include the objective of business, targets set, and results in financial terms, e.g., the target set for sale, resulting cost, growth, required investment to achieve the planned sales, and financing source for the investment.

A budget may be long term or short term. Long term budgets have a time horizon of 5–10 years giving a vision to the company; short term is an annual budget which is drawn to control and operate in that particular year.

Budgets will include proposed fixed asset requirements and how these expenditures will be financed. Capital budgets are often adjusted annually and should be part of a longer-term Capital Improvements Plan.

A cash budget is also required. The working capital requirements of a business are monitored at all times to ensure that there are sufficient funds available to meet short-term expenses.

The cash budget is basically a detailed plan that shows all expected sources and uses of cash. The cash budget has the following six main sections:

1. **Beginning Cash Balance** - contains the last period's closing cash balance.
2. **Cash collections** - includes all expected cash receipts (all sources of cash for the period considered, mainly sales)
3. **Cash disbursements** - lists all planned cash outflows for the period, excluding interest payments on short-term loans, which appear in the financing section. All expenses that do not affect cash flow are excluded from this list (e.g. depreciation, amortization, etc.)
4. **Cash excess or deficiency** - a function of the cash needs and cash available. Cash needs are determined by the total cash disbursements plus the minimum cash balance required by company policy. If total cash available is less than cash needs, a deficiency exists.
5. **Financing** - discloses the planned borrowings and repayments, including interest.
6. **Ending Cash balance** - simply reveals the planned ending cash balance.

Theories of Finance

Financial economics

Financial economics is the branch of economics studying the interrelation of financial variables, such as prices, interest rates and shares, as opposed to those concerning the real economy. Financial economics concentrates on influences of real economic variables on financial ones, in contrast to pure finance. It centres on decision making under uncertainty in the context of the financial markets, and the resultant economic and financial models. It essentially explores how rational investors would apply decision theory to the problem of investment. Here, the twin assumptions of rationality and market efficiency lead to modern portfolio theory (the CAPM), and to the Black Scholes theory for option valuation; it further studies phenomena and models where these assumptions do not hold, or are extended. "Financial economics", at least formally, also considers investment under "certainty" (Fisher separation theorem, "theory of investment value", Modigliani-Miller theorem) and hence also contributes to corporate finance theory. Financial Econometrics is the branch of Financial Economics that uses econometric techniques to parameterize the relationships suggested.

Although closely related, the disciplines of economics and finance are distinctive. The “economy” is a social institution that organizes a society’s production, distribution, and consumption of goods and services,” all of which must be financed.

Economists make a number of abstract assumptions for purposes of their analyses and predictions. They generally regard financial markets that function for the financial system as an efficient mechanism. Instead, financial markets are subject to human error and emotion.[3] New research discloses the mischaracterization of investment safety and measures of financial products and markets so complex that their effects, especially under conditions of uncertainty, are impossible to predict. The study of finance is subsumed under economics as financial economics, but the scope, speed, power relations and practices of the financial system can uplift or cripple whole economies and the well-being of households, businesses and governing bodies within them—sometimes in a single day.

Financial mathematics

Financial mathematics is a field of applied mathematics, concerned with financial markets. The subject has a close relationship with the discipline of financial economics, which is concerned with much of the underlying theory. Generally, mathematical finance will derive, and extend, the mathematical or numerical models suggested by financial economics. In terms of practice, mathematical finance also overlaps heavily with the field of computational finance (also known as *financial engineering*). Arguably, these are largely synonymous, although the latter focuses on application, while the former focuses on modeling and derivation (*see: Quantitative analyst*). The field is largely focused on the modelling of derivatives, although other important subfields include insurance mathematics and quantitative portfolio problems. See Outline of finance: Mathematical tools; Outline of finance: Derivatives pricing.

Experimental finance

Experimental finance aims to establish different market settings and environments to observe experimentally and provide a lens through which science can analyze agents' behavior and the resulting characteristics of trading flows, information diffusion and aggregation, price setting mechanisms, and returns processes. Researchers in experimental finance can study to what extent existing financial economics theory makes valid predictions, and attempt to discover new principles on which such theory can be extended. Research may proceed by conducting trading simulations or by establishing and studying the behaviour of people in artificial competitive market-like settings.

Behavioral finance

Behavioral Finance studies how the psychology of investors or managers affects financial decisions and markets. Behavioral finance has grown over the last few decades to become central to finance.

Behavioral finance includes such topics as:

1. Empirical studies that demonstrate significant deviations from classical theories.
2. Models of how psychology affects trading and prices
3. Forecasting based on these methods.
4. Studies of experimental asset markets and use of models to forecast experiments.

A strand of behavioral finance has been dubbed Quantitative Behavioral Finance, which uses mathematical and statistical methodology to understand behavioral biases in conjunction with valuation. Some of this endeavor has been led by Gunduz Caginalp (Professor of Mathematics and Editor of Journal of Behavioral Finance during 2001-2004) and collaborators including Vernon Smith (2002 Nobel Laureate in Economics), David Porter, Don Balenovich, Vladimira Ilieva, Ahmet Duran). Studies by Jeff Madura, Ray Sturm and others have demonstrated significant behavioral effects in stocks and exchange traded funds. Among other topics, quantitative behavioral finance studies behavioral effects together with the non-classical assumption of the finiteness of assets.

Intangible asset finance

Intangible asset finance is the area of finance that deals with intangible assets such as patents, trademarks, goodwill, reputation, etc.

Professional qualifications

There are several related professional qualifications, that can lead to the field:

- **Generalist Finance qualifications:**
    - Degrees: Masters degree in Finance (MSF), Master of Financial Economics, Master of Finance & Control (MFC), Master Financial Manager (MFM), Master of Financial Administration (MFA)
    - Certifications: Chartered Financial Analyst (CFA), Certified Treasury Professional (CTP), Certified Valuation Analyst (CVA), Certified International Investment Analyst (CIIA), Financial Risk Manager (FRM), Association of Corporate Treasurers (ACT), Certified Market Analyst (CMA/FAD) Dual Designation, Corporate Finance Qualification (CF), Chartered Alternative Investment Analyst (CAIA)
- **Quantitative Finance qualifications:** Master of Financial Engineering (MSFE), Master of Quantitative Finance (MQF), Master of Computational Finance (MCF), Master of Financial Mathematics (MFM), Certificate in Quantitative Finance (CQF).
- **Accountancy qualifications**:
    - Qualified accountant: Chartered Accountant (ACA - UK certification / CA - certification in Commonwealth countries), Chartered Certified Accountant (ACCA, UK certification), Certified Public Accountant (CPA, US certification), ACMA/FCMA (Associate/Fellow Chartered Management Accountant) from Chartered Institute of Management Accountant(CIMA), UK.
    - Non-statutory qualifications: Chartered Cost Accountant CCA Designation from AAFM
- **Business qualifications:** Master of Business Administration (MBA), Master of Management (MM), Master of Commerce (M.Comm), Master of Science in Management (MSM), Doctor of Business Administration (DBA)

STOCK

The **capital stock** (or simply **stock**) of a business entity represents the original capital paid into or invested in the business by its founders. It serves as a security for the creditors of a business since it cannot be withdrawn to the detriment of the creditors. Stock is different from the property and the assets of a business which may fluctuate in quantity and value.

Shares

The stock of a business is divided into multiple shares, the total of which must be stated at the time of business formation. Given the total amount of money invested in the business, a share has a certain declared face value, commonly known as the par value of a share. The par value is the *de minimis* (minimum) amount of money that a business may issue and sell shares for in many jurisdictions and it is the value represented as capital in the accounting of the business. In other jurisdictions, however, shares may not have an associated par value at all. Such stock is often called non-par stock. Shares represent a fraction of ownership in a business. A business may declare different types (*classes*) of shares, each having distinctive ownership rules, privileges, or share values.

Ownership of shares is documented by issuance of a stock certificate. A stock certificate is a legal document that specifies the amount of shares owned by the shareholder, and other specifics of the shares, such as the par value, if any, or the class of the shares.

Types of stock

Stock typically takes the form of shares of either common stock or preferred stock. As a unit of ownership, common stock typically carries voting rights that can be exercised in corporate decisions. Preferred stock differs from common stock in that it typically does not carry voting rights but is legally entitled to receive a certain level of dividend payments before any dividends can be issued to other shareholders.[4][5] Convertible preferred stock is preferred stock that includes an option for the holder to convert the preferred shares into a fixed number of common shares, usually anytime after a predetermined date. Shares of such stock are called "convertible preferred shares" (or "convertible preference shares" in the UK)

New equity issues may have specific legal clauses attached that differentiate them from previous issues of the issuer. Some shares of common stock may be issued without the typical voting rights, for instance, or some shares may have special rights unique to them and issued only to certain parties. Often, new issues that have not been registered with a securities governing body may be restricted from resale for certain periods of time.

Preferred stock may be hybrid by having the qualities of bonds of fixed returns and common stock voting rights. They also have preference in the payment of dividends over common stock and also have been given preference at the time of liquidation over common stock. They have other features of accumulation in dividend.

Stock derivatives

A stock derivative is any financial instrument which has a value that is dependent on the price of the underlying stock. Futures and options are the main types of derivatives on stocks. The underlying security may be a stock index or an individual firm's stock, e.g. single-stock futures.

Stock futures are contracts where the buyer is long, i.e., takes on the obligation to buy on the contract maturity date, and the seller is short, i.e., takes on the obligation to sell. Stock index futures are generally not delivered in the usual manner, but by cash settlement.

A stock option is a class of option. Specifically, a call option is the right (*not* obligation) to buy stock in the future at a fixed price and a put option is the right (*not* obligation) to sell stock in the future at a fixed price. Thus, the value of a stock option changes in reaction to the underlying stock of which it is a derivative. The most popular method of valuing stock options is the Black Scholes model.[6] Apart from call options granted to employees, most stock options are transferable.

Means of financing

Financing a company through the sale of stock in a company is known as equity financing. Alternatively, debt financing (for example issuing bonds) can be done to avoid giving up shares of ownership of the company. Unofficial financing known as trade financing usually provides the major part of a company's working capital (day-to-day operational needs).

Trading

In general, the shares of a company may be transferred from shareholders to other parties by sale or other mechanisms, unless prohibited. Most jurisdictions have established laws and regulations governing such transfers, particularly if the issuer is a publicly-traded entity.

The desire of stockholders to trade their shares has led to the establishment of stock exchanges, organizations which provide marketplaces for trading shares and other derivatives and financial products. Today, stock traders are usually represented by a stock broker who buys and sells shares of a wide range of companies on such exchanges. A company may list its shares on an exchange by meeting and maintaining the listing requirements of a particular stock exchange. In the United States, through the intermarket trading system, stocks listed on one exchange can often also be traded on other participating exchanges, including electronic communication networks (ECNs), such as Archipelago or Instinet.[16]

Many large non-U.S companies choose to list on a U.S. exchange as well as an exchange in their home country in order to broaden their investor base. These companies must maintain a block of shares at a bank in the US, typically a certain percentage of their capital. On this basis, the holding bank establishes American depositary shares and issues an American depositary receipt (ADR) for each share a trader acquires. Likewise, many large U.S. companies list their shares at foreign exchanges to raise capital abroad.

Small companies that do not qualify and cannot meet the listing requirements of the major exchanges may be traded over-the-counter (OTC) by an off-exchange mechanism in which trading occurs directly between parties. The major OTC markets in the United States are the electronic quotation systems OTC Bulletin Board (OTCBB) and OTC Markets Group where individual retail investors are also represented by a brokerage firm and the quotation service's requirements for a company to be listed are minimal. Shares of companies in bankruptcy proceeding are usually listed by these quotation services after the stock is delisted from an exchange.

Buying

There are various methods of buying and financing stocks, the most common being through a stock broker. Whether they are a full service or discount broker, they arrange the transfer of stock from a seller to a buyer. Most trades are actually done through brokers listed with a stock exchange.

There are many different stock brokers from which to choose, such as full service brokers or discount brokers. The full service brokers usually charge more per trade, but give investment advice or more personal service; the discount brokers offer little or no investment advice but charge less for trades. Another type of broker would be a bank or credit union that may have a deal set up with either a full service or discount broker.

There are other ways of buying stock besides through a broker. One way is directly from the company itself. If at least one share is owned, most companies will allow the purchase of shares directly from the company through their investor relations departments. However, the initial share of stock in the company will have to be obtained through a regular stock broker. Another way to buy stock in companies is through Direct Public Offerings which are usually sold by the company itself. A direct public offering is an initial public offering in which the stock is purchased directly from the company, usually without the aid of brokers.

When it comes to financing a purchase of stocks there are two ways: purchasing stock with money that is currently in the buyer's ownership, or by buying stock on margin. Buying stock on margin means buying stock with money borrowed against the value of stocks in the same account. These stocks, or collateral, guarantee that the buyer can repay the loan; otherwise, the stockbroker has the right to sell the stock (collateral) to repay the borrowed money. He can sell if the share price drops below the margin requirement, at least 50% of the value of the stocks in the account. Buying on margin works the same way as borrowing money to buy a car or a house, using a car or house as collateral. Moreover, borrowing is not free; the broker usually charges 8–10% interest.

Selling

Selling stock is procedurally similar to buying stock. Generally, the investor wants to buy low and sell high, if not in that order (short selling); although a number of reasons may induce an investor to sell at a loss, e.g., to avoid further loss.

As with buying a stock, there is a transaction fee for the broker's efforts in arranging the transfer of stock from a seller to a buyer. This fee can be high or low depending on which type of brokerage, full service or discount, handles the transaction.

After the transaction has been made, the seller is then entitled to all of the money. An important part of selling is keeping track of the earnings. Importantly, on selling the stock, in jurisdictions that have them, capital gains taxes will have to be paid on the additional proceeds, if any, that are in excess of the cost basis.

Stock price fluctuations

The price of a stock fluctuates fundamentally due to the theory of supply and demand. Like all commodities in the market, the price of a stock is sensitive to demand. However, there are many factors that influence the demand for a particular stock. The fields of fundamental analysis and technical analysis attempt to understand market conditions that lead to price changes, or even predict future price levels. A recent study shows that customer satisfaction, as measured by the American Customer Satisfaction Index (ACSI), is significantly correlated to the market value of a stock.[17] Stock price may be influenced by analyst's business forecast for the company and outlooks for the company's general market segment. Stocks can also fluctuate greatly due to pump and dump scams.

Share price determination

At any given moment, an equity's price is strictly a result of supply and demand. The supply, commonly referred to as the *float*, is the number of shares offered for sale at any one moment. The demand is the number of shares investors wish to buy at exactly that same time. The price of the stock moves in order to achieve and maintain equilibrium. The product of this instantaneous price and the float at any one time is the market capitalization of the entity offering the equity at that point in time.

When prospective buyers outnumber sellers, the price rises. Eventually, sellers attracted to the high selling price enter the market and/or buyers leave, achieving equilibrium between buyers and sellers. When sellers outnumber buyers, the price falls. Eventually buyers enter and/or sellers leave, again achieving equilibrium.

Thus, the value of a share of a company at any given moment is determined by all investors voting with their money. If more investors want a stock and are willing to pay more, the price will go up. If more investors are selling a stock and there aren't enough buyers, the price will go down.

- Note: "For Nasdaq-listed stocks, the price quote includes information on the bid and ask prices for the stock."[18]

Of course, that does not explain how people decide the maximum price at which they are willing to buy or the minimum at which they are willing to sell. In professional investment circles the efficient market hypothesis (EMH) continues to be popular, although this theory is widely discredited in academic and professional circles. Briefly, EMH says that investing is overall (weighted by the standard deviation) rational; that the price of a stock at any given moment represents a rational evaluation of the known information that might bear on the future value of the company; and that share prices of equities are priced *efficiently*, which is to say that they represent accurately the expected value of the stock, as best it can be known at a given moment. In other words, prices are the result of discounting expected future cash flows.

The EMH model, if true, has at least two interesting consequences. First, because financial risk is presumed to require at least a small premium on expected value, the return on equity can be expected to be slightly greater than that available from non-equity investments: if not, the same rational calculations would lead equity investors to shift to these safer non-equity investments that could be expected to give the same or better return at lower risk. Second, because the price of a share at every given moment is an "efficient" reflection of expected value, then—relative to the curve of expected return—prices will tend to follow a random walk, determined by the emergence of information (randomly) over time. Professional equity investors therefore immerse themselves in the flow of fundamental information, seeking to gain an advantage over their competitors (mainly other professional investors) by more intelligently interpreting the emerging flow of information (news).

The EMH model does not seem to give a complete description of the process of equity price determination. For example, stock markets are more volatile than EMH would imply. In recent years it has come to be accepted that the share markets are not perfectly efficient, perhaps especially in emerging markets or other markets that are not dominated by well-informed professional investors.

Another theory of share price determination comes from the field of Behavioral Finance. According to Behavioral Finance, humans often make irrational decisions—particularly, related to the buying and selling of securities—based upon fears and misperceptions of outcomes. The irrational trading of securities can often create securities prices which vary from rational, fundamental price valuations. For instance, during the technology bubble of the late 1990s (which was followed by the dot-com bust of 2000–2002), technology companies were often bid beyond any rational fundamental value because of what is commonly known as the "greater fool theory". The "greater fool theory" holds that, because the predominant method of realizing returns in equity is from the sale to another investor, one should select securities that they believe that someone else will value at a higher level at some point in the future, without regard to the basis for that other party's willingness to pay a higher price. Thus, even a rational investor may bank on others' irrationality.

Arbitrage trading

When companies raise capital by offering stock on more than one exchange, the potential exists for discrepancies in the valuation of shares on different exchanges. A keen investor with access to information about such discrepancies may invest in expectation of their eventual convergence, known as arbitrage trading. Electronic trading has resulted in extensive price transparency (efficient-market hypothesis) and these discrepancies, if they exist, are short-lived and quickly equilibrated.

Financial economics

Financial economics is the branch of economics concerned with "the allocation and deployment of economic resources, both spatially and across time, in an uncertain environment".[1] It is additionally characterised by its "concentration on monetary activities", in which "money of one type or another is likely to appear on *both sides* of a trade".[2] The questions within financial economics are typically framed in terms of "time, uncertainty, options, and information".[2]

- Time: money now is traded for money in the future.
- Uncertainty (or risk): The amount of money to be transferred in the future is uncertain.
- Options: one party to the transaction can make a decision at a later time that will affect subsequent transfers of money.
- Information: knowledge of the future can reduce, or possibly eliminate, the uncertainty associated with future monetary value (FMV).

Models in financial economics

Financial economics is primarily concerned with building models to derive testable or policy implications from acceptable assumptions. Some fundamental ideas in financial economics are portfolio theory, the Capital Asset Pricing Model. Portfolio theory studies how investors should balance risk and return when investing in many assets or securities. The Capital Asset Pricing Model describes how markets should set the prices of assets in relation to how risky they are. The Modigliani-Miller Theorem describes conditions under which corporate financing decisions are irrelevant for value, and acts as a benchmark for evaluating the effects of factors outside the model that do affect value.

A common assumption is that financial decision makers act rationally (see Homo economicus; efficient market hypothesis). However, recently, researchers in experimental economics and experimental finance have challenged this assumption empirically. They are also challenged, theoretically, by behavioral finance, a discipline primarily concerned with the limits to rationality of economic agents.

Other common assumptions include market prices following a random walk or asset returns being normally distributed. Empirical evidence suggests that these assumptions may not hold and that in practice, traders, analysts and particularly risk managers frequently modify the "standard models".

PUBLIC FINANCE

Public finance is the study of the role of the government in the economy.

The purview of public finance is considered to be threefold: governmental effects on (1) efficient allocation of resources, (2) distribution of income, and (3) macroeconomic stabilization.

Overview

The proper role of government provides a starting point for the analysis of public finance. In theory, under certain circumstances, private markets will allocate goods and services among individuals efficiently (in the sense that no waste occurs and that individual tastes are matching with the economy's productive abilities). If private markets were able to provide efficient outcomes and if the distribution of income were socially acceptable, then there would be little or no scope for government. In many cases, however, conditions for private market efficiency are violated. For example, if many people can enjoy the same good at the same time (non-rival, non-excludable consumption), then private markets may supply too little of that good. National defense is one example of non-rival consumption, or of a public good.

"Market failure" occurs when private markets do not allocate goods or services efficiently. The existence of market failure provides an efficiency-based rationale for collective or governmental provision of goods and services. Externalities, public goods, informational advantages, strong economies of scale, and network effects can cause market failures. Public provision via a government or a voluntary association, however, is subject to other inefficiencies, termed "government failure."

Under broad assumptions, government decisions about the efficient scope and level of activities can be efficiently separated from decisions about the design of taxation systems (Diamond-Mirlees separation). In this view, public sector programs should be designed to maximize social benefits minus costs (cost-benefit analysis), and then revenues needed to pay for those expenditures should be raised through a taxation system that creates the fewest efficiency losses caused by distortion of economic activity as possible. In practice, government budgeting or public budgeting is substantially more complicated and often results in inefficient practices.

Government can pay for spending by borrowing (for example, with government bonds), although borrowing is a method of distributing tax burdens through time rather than a replacement for taxes. A deficit is the difference between government spending and revenues. The accumulation of deficits over time is the total public debt. Deficit finance allows governments to smooth tax burdens over time, and gives governments an important fiscal policy tool. Deficits can also narrow the options of successor governments.

Public finance is closely connected to issues of income distribution and social equity. Governments can reallocate income through transfer payments or by designing tax systems that treat high-income and low-income households differently.

The Public Choice approach to public finance seeks to explain how self-interested voters, politicians, and bureaucrats actually operate, rather than how they should operate.

Public finance management

Collection of sufficient resources from the economy in an appropriate manner along with allocating and use of these resources efficiently and effectively constitute good financial management. Resource generation, resource allocation and expenditure management (resource utilization) are the essential components of a **public financial management** system.

Public Finance Management (PFM) basically deals with all aspects of resource mobilization and expenditure management in government. Just as managing finances is a critical function of management in any organization, similarly public finance management is an essential part of the governance process. Public finance management includes resource mobilization, prioritization of programmes, the budgetary process, efficient management of resources and exercising controls. Rising aspirations of people are placing more demands on financial resources. At the same time, the emphasis of the citizenry is on value for money, thus making public finance management increasingly vital.

Government expenditures

Economists classify government expenditures into three main types. Government purchases of goods and services for current use are classed as government consumption. Government purchases of goods and services intended to create future benefits--- such as infrastructure investment or research spending--- are classed as government investment. Government expenditures that are not purchases of goods and services, and instead just represent transfers of money--- such as social security payments--- are called transfer payments.[2]

Government operations

Government operations are those activities involved in the running of a state or a functional equivalent of a state (for example, tribes, secessionist movements or revolutionary movements) for the purpose of producing value for the citizens. Government operations have the power to make, and the authority to enforce rules and laws within a civil, corporate, religious, academic, or other organization or group.[3] In its broadest sense, "to govern" means to rule over or supervise, whether over a state, a set group of people, or a collection of people.[4]

Income distribution

- Income distribution - Some forms of government expenditure are specifically intended to transfer income from some groups to others. For example, governments sometimes transfer income to people that have suffered a loss due to natural disaster. Likewise, public pension programs transfer wealth from the young to the old. Other forms of government expenditure which represent purchases of goods and services also have the effect of changing the income distribution. For example, engaging in a war may transfer wealth to certain sectors of society. Public education transfers wealth to families with children in these schools. Public road construction transfers wealth from people that do not use the roads to those people that do (and to those that build the roads).
- Income Security
- Employment insurance
- Health Care
- Public financing of campaigns

Government expenditures are financed in three ways:

- Government revenue
  - Taxes
  - Non-tax revenue (revenue from government-owned corporations, sovereign wealth funds, sales of assets, or Seigniorage)
- Government borrowing
- Printing of Money or Inflation
- Privatization

How a government chooses to finance its activities can have important effects on the distribution of income and wealth (income redistribution) and on the efficiency of markets (effect of taxes on market prices and efficiency). The issue of how taxes affect income distribution is closely related to tax incidence, which examines the distribution of tax burdens after market adjustments are taken into account. Public finance research also analyzes effects of the various types of taxes and types of borrowing as well as administrative concerns, such as tax enforcement.

Taxes

Taxation is the central part of modern public finance. Its significance arises not only from the fact that it is by far the most important of all revenues but also because of the gravity of the problems created by the present day heavy tax burden. The main objective of taxation is raising revenue. A high level of taxation is necessary in a welfare State to fulfill its obligations. Taxation is used as an instrument of attaining certain social objectives i.e. as a means of redistribution of wealth and thereby reducing inequalities. Taxation in a modern Government is thus needed not merely to raise the revenue required to meet its ever-growing expenditure on administration and social services but also to reduce the inequalities of income and wealth. Taxation is also needed to draw away money that would otherwise go into consumption and cause inflation to rise.[5]

A tax is a financial charge or other levy imposed on an individual or a legal entity by a state or a functional equivalent of a state (for example, tribes, secessionist movements or revolutionary movements). Taxes could also be imposed by a subnational entity. Taxes consist of direct tax or indirect tax, and may be paid in money or as *corvée* labor. A tax may be defined as a "pecuniary burden laid upon individuals or property to support the government [. . .] a payment exacted by legislative authority."[6] A tax "is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority" and is "any contribution imposed by government [. . .] whether under the name of toll, tribute, tallage, gabel, impost, duty, custom, excise, subsidy, aid, supply, or other name."[7]

- There are various types of taxes, broadly divided into two heads - direct (which is proportional) and indirect tax (which is differential in nature):
- Stamp duty, levied on documents
- Excise tax (tax levied on production for sale, or sale, of a certain good)
- Sales tax (tax on business transactions, especially the sale of goods and services)
  - Value added tax (VAT) is a type of sales tax
  - Services taxes on specific services

- Road tax; Vehicle excise duty (UK), Registration Fee (USA), Regco (Australia), Vehicle Licensing Fee (Brazil) etc.
- Gift tax
- Duties (taxes on importation, levied at customs)
- Corporate income tax on corporations (incorporated entities)
- Wealth tax
- Personal income tax (may be levied on individuals, families such as the Hindu joint family in India, unincorporated associations, etc.)

Debt

Foreign currency reserves and gold minus external debt based on 2010 data from CIA Factbook.

Governments, like any other legal entity, can take out loans, issue bonds and make financial investments. Government debt (also known as public debt or national debt) is money (or credit) owed by any level of government; either central or federal government, municipal government or local government. Some local governments issue bonds based on their taxing authority, such as tax increment bonds or revenue bonds.

As the government represents the people, government debt can be seen as an indirect debt of the taxpayers. Government debt can be categorized as internal debt, owed to lenders within the country, and external debt, owed to foreign lenders. Governments usually borrow by issuing securities such as government bonds and bills. Less creditworthy countries sometimes borrow directly from commercial banks or international institutions such as the International Monetary Fund or the World Bank.

Most government budgets are calculated on a cash basis, meaning that revenues are recognized when collected and outlays are recognized when paid. Some consider all government liabilities, including future pension payments and payments for goods and services the government has contracted for but not yet paid, as government debt. This approach is called accrual accounting, meaning that obligations are recognized when they are acquired, or accrued, rather than when they are paid.

Seigniorage

Seigniorage is the net revenue derived from the issuing of currency. It arises from the difference between the face value of a coin or bank note and the cost of producing, distributing and eventually retiring it from circulation. Seigniorage is an important source of revenue for some national banks, although it provides a very small proportion of revenue for advanced industrial countries.

Public finance through state enterprise

Public finance in centrally planned economies has differed in fundamental ways from that in market economies. Some state-owned enterprises generated profits that helped finance government activities. The government entities that operate for profit are usually manufacturing and financial institutions, services such as nationalized healthcare do not operate for a profit to keep costs low for consumers. The Soviet

Union relied heavily on turnover taxes on retail sales. Sales of natural resources, and especially petroleum products, were an important source of revenue for the Soviet Union.

In market-oriented economies with substantial state enterprise, such as in Venezuela, the state-run oil company PSDVA provides revenue for the government to fund its operations and programs that would otherwise be profit for private owners. In various mixed economies, the revenue generated by state-run or state-owned enterprises are used for various state endeavors; typically the revenue generated by state and government agencies goes into a sovereign wealth fund. An example of this is the Alaska Permanent Fund and Singapore's Temasek Holdings.

Various market socialist systems or proposals utilize revenue generated by state-run enterprises to fund social dividends, eliminating the need for taxation altogether.

Government Finance Statistics and Methodology

Macroeconomic data to support public finance economics are generally referred to as fiscal or government finance statistics (GFS). *The Government Finance Statistics Manual 2001 (GFSM 2001)* is the internationally accepted methodology for compiling fiscal data. It is consistent with regionally accepted methodologies such as the *European System of Accounts 1995* and consistent with the methodology of the *System of National Accounts (SNA1993)* and broadly in line with its most recent update, the *SNA2008*.

Measuring the public sector

The size of governments, their institutional composition and complexity, their ability to carry out large and sophisticated operations, and their impact on the other sectors of the economy warrant a well-articulated system to measure government economic operations.

The *GFSM 2001* addresses the institutional complexity of government by defining various levels of government. The main focus of the *GFSM 2001* is the general government sector defined as the group of entities capable of implementing public policy through the provision of primarily nonmarket goods and services and the redistribution of income and wealth, with both activities supported mainly by compulsory levies on other sectors. The *GFSM 2001* disaggregates the general government into subsectors: central government, state government, and local government (See Figure 1). The concept of general government does not include public corporations. The general government plus the public corporations comprise the public sector (See Figure 2).

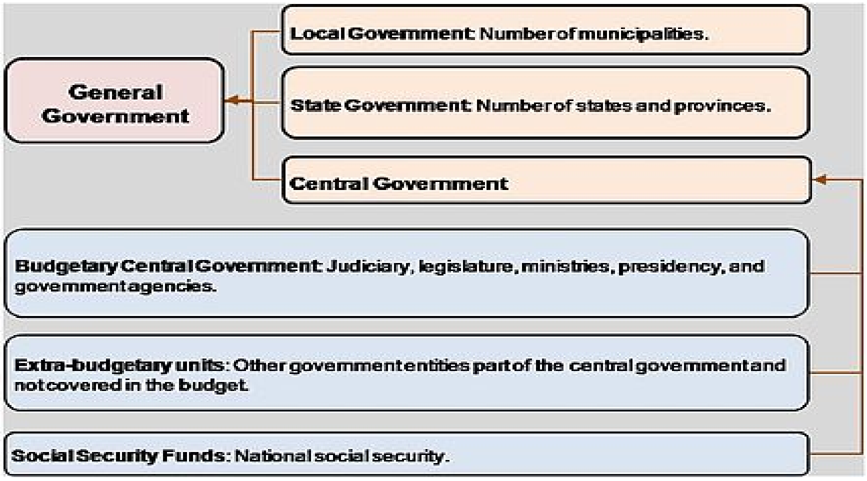

Figure 1: General Government (IMF *Government Finance Statistics Manual 2001*(Washington, 2001) pp.13

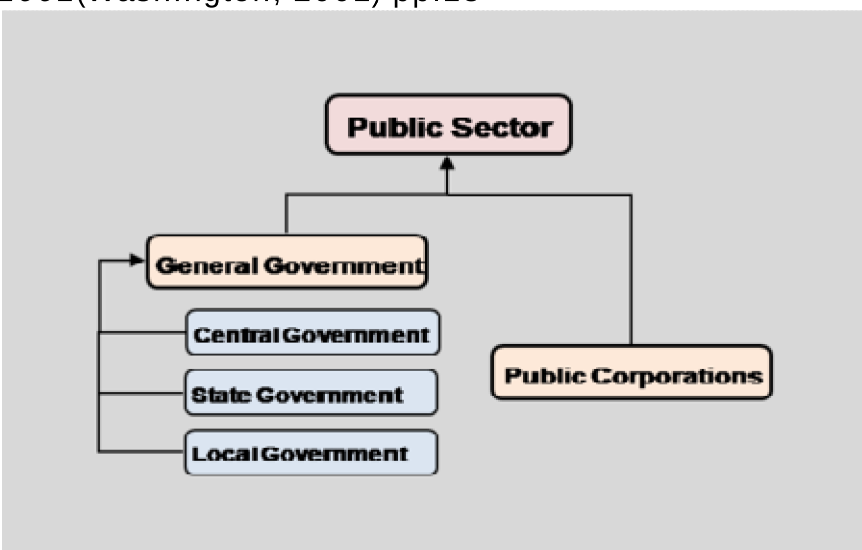

Figure 2: Public Sector(IMF *Government Finance Statistics Manual 2001*(Washington, 2001) pp.15

The general government sector of a nation includes all non-private sector institutions, organisations and activities. The general government sector, by convention, includes all the public corporations that are not able to cover at least 50 % of their costs by sales, and, therefore, are considered non-market producers.[8]

In the European System of Accounts[9], the sector "general government" has been defined as containing:

- "All institutional units which are other non-market producers whose output is intended for individual and collective consumption, and mainly financed by compulsory payments made by units belonging to other sectors, and/or all institutional units principally engaged in the redistribution of national income and wealth".[8]

Therefore, the main functions of general government units are :

- to organise or redirect the flows of money, goods and services or other assets among corporations, among households, and between corporations and households; in the purpose of social justice, increased efficiency or other aims legitimised by the citizens; examples are the redistribution of national income and wealth, the corporate income tax paid by companies to finance unemployment benefits, the social contributions paid by employees to finance the pension systems;
- to produce goods and services to satisfy households' needs (e.g. state health care) or to collectively meet the needs of the whole community (e.g. defence, public order and safety).[8]

The general government sector, in the European System of Accounts, has four sub-sectors:

1. central government
2. state government
3. local government
4. social security funds

"Central government"[10] consists of all administrative departments of the state and other central agencies whose responsibilities cover the whole economic territory of a country, except for the administration of social security funds.

"State government"[11] is defined as the separate institutional units that exercise some government functions below those units at central government level and above those units at local government level, excluding the administration of social security funds.

"Local government"[12] consists of all types of public administration whose responsibility covers only a local part of the economic territory, apart from local agencies of social security funds.

"Social security fund"[13] is a central, state or local institutional unit whose main activity is to provide social benefits. It fulfils the two following criteria:

- by law or regulation (except those about government employees), certain population groups must take part in the scheme and have to pay contributions;
- general government is responsible for the management of the institutional unit, for the payment or approval of the level of the contributions and of the benefits, independent of its role as a supervisory body or employer.

The *GFSM 2001* framework is similar to the financial accounting of businesses. For example, it recommends that governments produce a full set of financial statements including the statement of government operations (akin to the income statement), the balance sheet, and a cash flow statement. Two other similarities between the GFSM 2001 and business financial accounting are the recommended use of accrual accounting as the basis of recording and the presentations of stocks of assets and liabilities at market value. It is an improvement on the prior methodology -

Government Finance Statistics Manual 1986 – based on cash flows and without a balance sheet statement.

Users of GFS

The *GFSM 2001* recommends standard tables including standard fiscal indicators that meet a broad group of users including policy makers, researchers, and investors in sovereign debt. Government finance statistics should offer data for topics such as the fiscal architecture, the measurement of the efficiency and effectiveness of government expenditures, the economics of taxation, and the structure of public financing. The *GFSM 2001* provides a blueprint for the compilation, recording, and presentation of revenues, expenditures, stocks of assets, and stocks of liabilities. The *GFSM 2001* also defines some indicators of effectiveness in government's expenditures, for example the compensation of employees as a percentage of expense. The *GFSM 2001* includes a functional classification of expense as defined by the Classification of Functions of Government (COFOG) .

This functional classification allows policy makers to analyze expenditures on categories such as health, education, social protection, and environmental protection. The financial statements can provide investors with the necessary information to assess the capacity of a government to service and repay its debt, a key element determining sovereign risk, and risk premia. Like the risk of default of a private corporation, sovereign risk is a function of the level of debt, its ratio to liquid assets, revenues and expenditures, the expected growth and volatility of these revenues and expenditures, and the cost of servicing the debt. The government's financial statements contain the relevant information for this analysis.

The government's balance sheet presents the level of the debt; that is the government's liabilities. The memorandum items of the balance sheet provide additional information on the debt including its maturity and whether it is owed to domestic or external residents. The balance sheet also presents a disaggregated classification of financial and non-financial assets.

These data help estimate the resources a government can potentially access to repay its debt. The statement of operations ("income statement") contains the revenue and expense accounts of the government. The revenue accounts are divided into subaccounts, including the different types of taxes, social contributions, dividends from the public sector, and royalties from natural resources. Finally, the interest expense account is one of the necessary inputs to estimate the cost of servicing the debt.

Fiscal Data Using the *GFSM 2001* Methodology

GFS can be accessible through several sources. The International Monetary Fund publishes GFS in two publications: *International Financial Statistics* and the *Government Finance Statistics Yearbook*. The World Bank gathers information on external debt. On a regional level, the Organization for Economic Co-operation and Development (OECD) compiles general government account data for its members, and Eurostat, following a methodology compatible with the GFSM 2001, compiles GFS for the members of the European Union.

INSURANCE

Insurance is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for payment. An insurer is a company selling the insurance; the insured, or policyholder, is the person or entity buying the insurance policy. The amount to be charged for a certain amount of insurance coverage is called the premium. Risk management, the practice of appraising and controlling risk, has evolved as a discrete field of study and practice.

The transaction involves the insured assuming a guaranteed and known relatively small loss in the form of payment to the insurer in exchange for the insurer's promise to compensate (indemnify) the insured in the case of a financial (personal) loss. The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insured will be financially compensated.

Principles

Insurance involves pooling funds from *many* insured entities (known as exposures) to pay for the losses that some may incur. The insured entities are therefore protected from risk for a fee, with the fee being dependent upon the frequency and severity of the event occurring. In order to be insurable, the risk insured against must meet certain characteristics in order to be an insurable risk. Insurance is a commercial enterprise and a major part of the financial services industry, but individual entities can also self-insure through saving money for possible future losses.[1]

Insurability

Main article: Insurability

Risk which can be insured by private companies typically share seven common characteristics:[2]

1. **Large number of similar exposure units**: Since insurance operates through pooling resources, the majority of insurance policies are provided for individual members of large classes, allowing insurers to benefit from the law of large numbers in which predicted losses are similar to the actual losses. Exceptions include Lloyd's of London, which is famous for insuring the life or health of actors, sports figures and other famous individuals. However, all exposures will have particular differences, which may lead to different premium rates.
2. **Definite loss**: The loss takes place at a known time, in a known place, and from a known cause. The classic example is death of an insured person on a life insurance policy. Fire, automobile accidents, and worker injuries may all easily meet this criterion. Other types of losses may only be definite in theory.

Occupational disease, for instance, may involve prolonged exposure to injurious conditions where no specific time, place or cause is identifiable. Ideally, the time, place and cause of a loss should be clear enough that a reasonable person, with sufficient information, could objectively verify all three elements.

3. **Accidental loss**: The event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be pure, in the sense that it results from an event for which there is only the opportunity for cost. Events that contain speculative elements, such as ordinary business risks or even purchasing a lottery ticket, are generally not considered insurable.
4. **Large loss**: The size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be able to pay claims. For small losses these latter costs may be several times the size of the expected cost of losses. There is hardly any point in paying such costs unless the protection offered has real value to a buyer.
5. **Affordable premium**: If the likelihood of an insured event is so high, or the cost of the event so large, that the resulting premium is large relative to the amount of protection offered, it is not likely that the insurance will be purchased, even if on offer. Further, as the accounting profession formally recognizes in financial accounting standards, the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, the transaction may have the form of insurance, but not the substance. (See the US Financial Accounting Standards Board standard number 113)
6. **Calculable loss**: There are two elements that must be at least estimable, if not formally calculable: the probability of loss, and the attendant cost. Probability of loss is generally an empirical exercise, while cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy and a proof of loss associated with a claim presented under that policy to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim.
7. **Limited risk of catastrophically large losses**: Insurable losses are ideally independent and non-catastrophic, meaning that the losses do not happen all at once and individual losses are not severe enough to bankrupt the insurer; insurers may prefer to limit their exposure to a loss from a single event to some small portion of their capital base. Capital constrains insurers' ability to sell earthquake insurance as well as wind insurance in hurricane zones. In the US, flood risk is insured by the federal government. In commercial fire insurance it is possible to find single properties whose total exposed value is well in excess of any individual insurer's capital constraint. Such properties are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market.

Legal

When a company insures an individual entity, there are basic legal requirements. Several commonly cited legal principles of insurance include:[3]

1. Indemnity – the insurance company indemnifies, or compensates, the insured in the case of certain losses only up to the insured's interest.
2. Insurable interest – the insured typically must directly suffer from the loss. Insurable interest must exist whether property insurance or insurance on a person is involved. The concept requires that the insured have a "stake" in the loss or damage to the life or property insured. What that "stake" is will be determined by the kind of insurance involved and the nature of the property ownership or relationship between the persons.
3. Utmost good faith – the insured and the insurer are bound by a good faith bond of honesty and fairness. Material facts must be disclosed.
4. Contribution – insurers which have similar obligations to the insured contribute in the indemnification, according to some method.
5. Subrogation – the insurance company acquires legal rights to pursue recoveries on behalf of the insured; for example, the insurer may sue those liable for insured's loss.
6. Causa proxima, or proximate cause – the cause of loss (the peril) must be covered under the insuring agreement of the policy, and the dominant cause must not be excluded
7. Mitigation - In case of any loss or casualty, the asset owner must attempt to keep the loss to a minimum, as if the asset was not insured.

Indemnification

Main article: Indemnity

To "indemnify" means to make whole again, or to be reinstated to the position that one was in, to the extent possible, prior to the happening of a specified event or peril. Accordingly, life insurance is generally not considered to be indemnity insurance, but rather "contingent" insurance (i.e., a claim arises on the occurrence of a specified event). There are generally two types of insurance contracts that seek to indemnify an insured:

1. an "indemnity" policy, and
2. a "pay on behalf" or "on behalf of"[4] policy.

The difference is significant on paper, but rarely material in practice.

An "indemnity" policy will never pay claims until the insured has paid out of pocket to some third party; for example, a visitor to your home slips on a floor that you left wet and sues you for $10,000 and wins. Under an "indemnity" policy the homeowner would have to come up with the $10,000 to pay for the visitor's fall and then would be "indemnified" by the insurance carrier for the out of pocket costs (the $10,000).[4][5]

Under the same situation, a "pay on behalf" policy, the insurance carrier would pay the claim and the insured (the homeowner in the above example) would not be out of pocket for anything. Most modern liability insurance is written on the basis of "pay on behalf" language.[4]

An entity seeking to transfer risk (an individual, corporation, or association of any type, etc.) becomes the 'insured' party once risk is assumed by an 'insurer', the insuring party, by means of a contract, called an insurance policy. Generally, an insurance contract includes, at a minimum, the following elements: identification of participating parties (the insurer, the insured, the beneficiaries), the premium, the period of coverage, the particular loss event covered, the amount of coverage (i.e., the amount to be paid to the insured or beneficiary in the event of a loss), and exclusions (events not covered). An insured is thus said to be "indemnified" against the loss covered in the policy.

When insured parties experience a loss for a specified peril, the coverage entitles the policyholder to make a claim against the insurer for the covered amount of loss as specified by the policy. The fee paid by the insured to the insurer for assuming the risk is called the premium. Insurance premiums from many insureds are used to fund accounts reserved for later payment of claims — in theory for a relatively few claimants — and for overhead costs. So long as an insurer maintains adequate funds set aside for anticipated losses (called reserves), the remaining margin is an insurer's profit.

Auto insurance

Auto insurance protects the policyholder against financial loss in the event of an incident involving a vehicle they own, such as in a traffic collision.

Coverage typically includes:

1. Property coverage, for damage to or theft of the car;
2. Liability coverage, for the legal responsibility to others for bodily injury or property damage;
3. Medical coverage, for the cost of treating injuries, rehabilitation and sometimes lost wages and funeral expenses.

Most countries, such as the United Kingdom, require drivers to buy some, but not all, of these coverages. When a car is used as collateral for a loan the lender usually requires specific coverage.

Gap insurance

Gap insurance covers the excess amount on your auto loan in an instance where your insurance company does not cover the entire loan. Depending on the companies specific policies it might or might not cover the deductible as well. This coverage is marketed for those who put low down payments, have high interest rates on their loans, and those with 60 month or longer terms. Gap insurance is typically offered by your finance company when you first purchase your vehicle. Most auto insurance companies offer this coverage to consumers as well. If you are unsure if GAP coverage had been purchased, you should check your vehicle lease or purchase documentation.

Home insurance

Home insurance provides coverage for damage or destruction of the policyholder's home. In some geographical areas, the policy may exclude certain types of risks, such as flood or earthquake, that require additional coverage. Maintenance-related issues are typically the homeowner's responsibility. The policy may include inventory, or this can be bought as a separate policy, especially for people who rent housing. In some countries, insurers offer a package which may include liability and legal responsibility for injuries and property damage caused by members of the household, including pets.[22]

Health insurance

Health insurance policies cover the cost of medical treatments. Dental insurance, like medical insurance protects policyholders for dental costs. In the US and Canada, dental insurance is often part of an employer's benefits package, along with health insurance.

Accident, sickness and unemployment insurance

Workers' compensation, or employers' liability insurance, is compulsory in some countries

- Disability insurance policies provide financial support in the event of the policyholder becoming unable to work because of disabling illness or injury. It provides monthly support to help pay such obligations as mortgage loans and credit cards. Short-term and long-term disability policies are available to individuals, but considering the expense, long-term policies are generally obtained only by those with at least six-figure incomes, such as doctors, lawyers, etc. Short-term disability insurance covers a person for a period typically up to six months, paying a stipend each month to cover medical bills and other necessities.
- Long-term disability insurance covers an individual's expenses for the long term, up until such time as they are considered permanently disabled and thereafter. Insurance companies will often try to encourage the person back into employment in preference to and before declaring them unable to work at all and therefore totally disabled.
- Disability overhead insurance allows business owners to cover the overhead expenses of their business while they are unable to work.
- Total permanent disability insurance provides benefits when a person is permanently disabled and can no longer work in their profession, often taken as an adjunct to life insurance.
- Workers' compensation insurance replaces all or part of a worker's wages lost and accompanying medical expenses incurred because of a job-related injury.

Casualty

Casualty insurance insures against accidents, not necessarily tied to any specific property. It is a broad spectrum of insurance that a number of other types of insurance could be classified, such as auto, workers compensation, and some liability insurances.

- Crime insurance is a form of casualty insurance that covers the policyholder against losses arising from the criminal acts of third parties. For example, a company can obtain crime insurance to cover losses arising from theft or embezzlement.
- Political risk insurance is a form of casualty insurance that can be taken out by businesses with operations in countries in which there is a risk that revolution or other political conditions could result in a loss.

Life

Life insurance provides a monetary benefit to a decedent's family or other designated beneficiary, and may specifically provide for income to an insured person's family, burial, funeral and other final expenses. Life insurance policies often allow the option of having the proceeds paid to the beneficiary either in a lump sum cash payment or an annuity.

Annuities provide a stream of payments and are generally classified as insurance because they are issued by insurance companies, are regulated as insurance, and require the same kinds of actuarial and investment management expertise that life insurance requires. Annuities and pensions that pay a benefit for life are sometimes regarded as insurance against the possibility that a retiree will outlive his or her financial resources. In that sense, they are the complement of life insurance and, from an underwriting perspective, are the mirror image of life insurance.

Certain life insurance contracts accumulate cash values, which may be taken by the insured if the policy is surrendered or which may be borrowed against. Some policies, such as annuities and endowment policies, are financial instruments to accumulate or liquidate wealth when it is needed.

In many countries, such as the US and the UK, the tax law provides that the interest on this cash value is not taxable under certain circumstances. This leads to widespread use of life insurance as a tax-efficient method of saving as well as protection in the event of early death.

In the US, the tax on interest income on life insurance policies and annuities is generally deferred. However, in some cases the benefit derived from tax deferral may be offset by a low return. This depends upon the insuring company, the type of policy and other variables (mortality, market return, etc.). Moreover, other income tax saving vehicles (e.g., IRAs, 401(k) plans, Roth IRAs) may be better alternatives for value accumulation.

Burial insurance

Burial insurance is a very old type of life insurance which is paid out upon death to cover final expenses, such as the cost of a funeral. The Greeks and Romans introduced burial insurance circa 600 AD when they organized guilds called "benevolent societies" which cared for the surviving families and paid funeral expenses of members upon death. Guilds in the Middle Ages served a similar purpose, as did friendly societies during Victorian times.

Property

Property insurance provides protection against risks to property, such as fire, theft or weather damage. This may include specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, inland marine insurance or boiler insurance. The term *property insurance* may, like casualty insurance, be used as a broad category of various subtypes of insurance, some of which are listed below:

- Aviation insurance protects aircraft hulls and spares, and associated liability risks, such as passenger and third-party liability. Airports may also appear under this subcategory, including air traffic control and refuelling operations for international airports through to smaller domestic exposures.

- Boiler insurance (also known as boiler and machinery insurance, or equipment breakdown insurance) insures against accidental physical damage to boilers, equipment or machinery.

- Builder's risk insurance insures against the risk of physical loss or damage to property during construction. Builder's risk insurance is typically written on an "all risk" basis covering damage arising from any cause (including the negligence of the insured) not otherwise expressly excluded. Builder's risk insurance is coverage that protects a person's or organization's insurable interest in materials, fixtures and/or equipment being used in the construction or renovation of a building or structure should those items sustain physical loss or damage from an insured peril.[23]

- Crop insurance may be purchased by farmers to reduce or manage various risks associated with growing crops. Such risks include crop loss or damage caused by weather, hail, drought, frost damage, insects, or disease.[24]

- Earthquake insurance is a form of property insurance that pays the policyholder in the event of an earthquake that causes damage to the property. Most ordinary home insurance policies do not cover earthquake damage. Earthquake insurance policies generally feature a high deductible. Rates depend on location and hence the likelihood of an earthquake, as well as the construction of the home.

- Fidelity bond is a form of casualty insurance that covers policyholders for losses incurred as a result of fraudulent acts by specified individuals. It usually insures a business for losses caused by the dishonest acts of its employees.

- Flood insurance protects against property loss due to flooding. Many insurers in the US do not provide flood insurance in some parts of the country. In response to this, the federal government created the National Flood Insurance Program which serves as the insurer of last resort.

- Home insurance, also commonly called hazard insurance, or homeowners insurance (often abbreviated in the real estate industry as HOI), is the type of property insurance that covers private homes, as outlined above.

- Landlord insurance covers residential and commercial properties which are rented to others. Most homeowners' insurance covers only owner-occupied homes.

- Marine insurance and marine cargo insurance cover the loss or damage of vessels at sea or on inland waterways, and of cargo in transit, regardless of the method of transit. When the owner of the cargo and the carrier are separate corporations, marine cargo insurance typically compensates the owner of cargo for losses sustained from fire, shipwreck, etc., but excludes losses that can be recovered from the carrier or the carrier's insurance. Many marine insurance underwriters will include "time element" coverage in such policies, which extends the indemnity to cover loss of profit and other business expenses attributable to the delay caused by a covered loss.

- Supplemental natural disaster insurance covers specified expenses after a natural disaster renders the policyholder's home uninhabitable. Periodic payments are made directly to the insured until the home is rebuilt or a specified time period has elapsed.

- Surety bond insurance is a three-party insurance guaranteeing the performance of the principal.

Terrorism insurance provides protection against any loss or damage caused by terrorist activities. In the US in the wake of 9/11, the Terrorism Risk Insurance Act 2002 (TRIA) set up a federal Program providing a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism. The program was extended until the end of 2014 by the Terrorism Risk Insurance Program Reauthorization Act 2007 (TRIPRA).

- Volcano insurance is a specialized insurance protecting against damage arising specifically from volcanic eruptions.

- Windstorm insurance is an insurance covering the damage that can be caused by wind events such as hurricanes.

Liability

Liability insurance is a very broad superset that covers legal claims against the insured. Many types of insurance include an aspect of liability coverage. For example, a homeowner's insurance policy will normally include liability coverage which protects the insured in the event of a claim brought by someone who slips and falls on the property; automobile insurance also includes an aspect of liability insurance that indemnifies against the harm that a crashing car can cause to others' lives, health, or property. The protection offered by a liability insurance policy is twofold: a legal defense in the event of a lawsuit commenced against the policyholder and indemnification (payment on behalf of the insured) with respect to a settlement or court verdict. Liability policies typically cover only the negligence of the insured, and will not apply to results of wilful or intentional acts by the insured.

Public liability insurance covers a business or organization against claims should its operations injure a member of the public or damage their property in some way.

- Directors and officers liability insurance (D&O) protects an organization (usually a corporation) from costs associated with litigation resulting from errors made by directors and officers for which they are liable.
- Environmental liability insurance protects the insured from bodily injury, property damage and cleanup costs as a result of the dispersal, release or escape of pollutants.
- Errors and omissions insurance is business liability insurance for professionals such as insurance agents, real estate agents and brokers, architects, third-party administrators (TPAs) and other business professionals.
- Prize indemnity insurance protects the insured from giving away a large prize at a specific event. Examples would include offering prizes to contestants who can make a half-court shot at a basketball game, or a hole-in-one at a golf tournament.
- Professional liability insurance, also called professional indemnity insurance (PI), protects insured professionals such as architectural corporations and medical practitioners against potential negligence claims made by their patients/clients. Professional liability insurance may take on different names depending on the profession. For example, professional liability insurance in reference to the medical profession may be called medical malpractice insurance.

Credit

Credit insurance repays some or all of a loan when certain circumstances arise to the borrower such as unemployment, disability, or death.

- Mortgage insurance insures the lender against default by the borrower. Mortgage insurance is a form of credit insurance, although the name "credit insurance" more often is used to refer to policies that cover other kinds of debt.
- Many credit cards offer payment protection plans which are a form of credit insurance.
- Trade credit insurance is business insurance over the accounts receivable of the insured. The policy pays the policy holder for covered accounts receivable if the debtor defaults on payment.

Other types

- All-risk insurance is an insurance that covers a wide-range of incidents and perils, except those noted in the policy. All-risk insurance is different from peril-specific insurance that cover losses from only those perils listed in the policy.[25] In car insurance, all-risk policy includes also the damages caused by the own driver.

High-value horses may be insured under a bloodstock policy

- Bloodstock insurance covers individual horses or a number of horses under common ownership. Coverage is typically for mortality as a result of accident, illness or disease but may extend to include infertility, in-transit loss, veterinary fees, and prospective foal.
- Business interruption insurance covers the loss of income, and the expenses incurred, after a covered peril interrupts normal business operations.
- Collateral protection insurance (CPI) insures property (primarily vehicles) held as collateral for loans made by lending institutions.
- Defense Base Act (DBA) insurance provides coverage for civilian workers hired by the government to perform contracts outside the US and Canada. DBA is required for all US citizens, US residents, US Green Card holders, and all employees or subcontractors hired on overseas government contracts. Depending on the country, foreign nationals must also be covered under DBA. This coverage typically includes expenses related to medical treatment and loss of wages, as well as disability and death benefits.
- Expatriate insurance provides individuals and organizations operating outside of their home country with protection for automobiles, property, health, liability and business pursuits.
- Kidnap and ransom insurance is designed to protect individuals and corporations operating in high-risk areas around the world against the perils of kidnap, extortion, wrongful detention and hijacking.
- Legal expenses insurance covers policyholders for the potential costs of legal action against an institution or an individual. When something happens which triggers the need for legal action, it is known as "the event". There are two main types of legal expenses insurance: before the event insurance and after the event insurance.
- Locked funds insurance is a little-known hybrid insurance policy jointly issued by governments and banks. It is used to protect public funds from tamper by unauthorized parties. In special cases, a government may authorize its use in protecting semi-private funds which are liable to tamper. The terms of this type of insurance are usually very strict. Therefore it is used only in extreme cases where maximum security of funds is required.
- Livestock insurance is a specialist policy provided to, for example, commercial or hobby farms, aquariums, fish farms or any other animal holding. Cover is available for mortality or economic slaughter as a result of accident, illness or disease but can extend to include destruction by government order.
- Media liability insurance is designed to cover professionals that engage in film and television production and print, against risks such as defamation.
- Nuclear incident insurance covers damages resulting from an incident involving radioactive materials and is generally arranged at the national level. (See the nuclear exclusion clause and for the US the Price-Anderson Nuclear Industries Indemnity Act.)
- Pet insurance insures pets against accidents and illnesses; some companies cover routine/wellness care and burial, as well.
- Pollution insurance usually takes the form of first-party coverage for contamination of insured property either by external or on-site sources. Coverage is also afforded for liability to third parties arising from contamination of air, water, or land due to the sudden and accidental release

of hazardous materials from the insured site. The policy usually covers the costs of cleanup and may include coverage for releases from underground storage tanks. Intentional acts are specifically excluded.

- Purchase insurance is aimed at providing protection on the products people purchase. Purchase insurance can cover individual purchase protection, warranties, guarantees, care plans and even mobile phone insurance. Such insurance is normally very limited in the scope of problems that are covered by the policy.
- Title insurance provides a guarantee that title to real property is vested in the purchaser and/or mortgagee, free and clear of liens or encumbrances. It is usually issued in conjunction with a search of the public records performed at the time of a real estate transaction.
- Travel insurance is an insurance cover taken by those who travel abroad, which covers certain losses such as medical expenses, loss of personal belongings, travel delay, and personal liabilities.
- Tuition insurance insures students against involuntary withdrawal from cost-intensive educational institutions
- Interest rate insurance protects the holder from adverse changes in interest rates, for instance for those with a variable rate loan or mortgage

Insurance financing vehicles

- Fraternal insurance is provided on a cooperative basis by fraternal benefit societies or other social organizations.[26]
- No-fault insurance is a type of insurance policy (typically automobile insurance) where insureds are indemnified by their own insurer regardless of fault in the incident.
- Protected self-insurance is an alternative risk financing mechanism in which an organization retains the mathematically calculated cost of risk within the organization and transfers the catastrophic risk with specific and aggregate limits to an insurer so the maximum total cost of the program is known. A properly designed and underwritten Protected Self-Insurance Program reduces and stabilizes the cost of insurance and provides valuable risk management information.
- Retrospectively rated insurance is a method of establishing a premium on large commercial accounts. The final premium is based on the insured's actual loss experience during the policy term, sometimes subject to a minimum and maximum premium, with the final premium determined by a formula. Under this plan, the current year's premium is based partially (or wholly) on the current year's losses, although the premium adjustments may take months or years beyond the current year's expiration date. The rating formula is guaranteed in the insurance contract. Formula: retrospective premium = converted loss + basic premium × tax multiplier. Numerous variations of this formula have been developed and are in use.
- Formal self insurance is the deliberate decision to pay for otherwise insurable losses out of one's own money. This can be done on a formal basis by establishing a separate fund into which funds are deposited on a periodic basis, or by simply forgoing the purchase of available insurance and paying out-of-pocket. Self insurance is usually used to pay for high-frequency, low-severity losses. Such losses, if covered by conventional insurance, mean

having to pay a premium that includes loadings for the company's general expenses, cost of putting the policy on the books, acquisition expenses, premium taxes, and contingencies. While this is true for all insurance, for small, frequent losses the transaction costs may exceed the benefit of volatility reduction that insurance otherwise affords.

- Reinsurance is a type of insurance purchased by insurance companies or self-insured employers to protect against unexpected losses. Financial reinsurance is a form of reinsurance that is primarily used for capital management rather than to transfer insurance risk.
- Social insurance can be many things to many people in many countries. But a summary of its essence is that it is a collection of insurance coverages (including components of life insurance, disability income insurance, unemployment insurance, health insurance, and others), plus retirement savings, that requires participation by all citizens. By forcing everyone in society to be a policyholder and pay premiums, it ensures that everyone can become a claimant when or if he/she needs to. Along the way this inevitably becomes related to other concepts such as the justice system and the welfare state. This is a large, complicated topic that engenders tremendous debate, which can be further studied in the following articles (and others):
    - National Insurance
    - Social safety net
    - Social security
    - Social Security debate (United States)
    - Social Security (United States)
    - Social welfare provision
- Stop-loss insurance provides protection against catastrophic or unpredictable losses. It is purchased by organizations who do not want to assume 100% of the liability for losses arising from the plans. Under a stop-loss policy, the insurance company becomes liable for losses that exceed certain limits called deductibles.

Closed community self-insurance

Some communities prefer to create virtual insurance amongst themselves by other means than contractual risk transfer, which assigns explicit numerical values to risk. A number of religious groups, including the Amish and some Muslim groups, depend on support provided by their communities when disasters strike. The risk presented by any given person is assumed collectively by the community who all bear the cost of rebuilding lost property and supporting people whose needs are suddenly greater after a loss of some kind. In supportive communities where others can be trusted to follow community leaders, this tacit form of insurance can work. In this manner the community can even out the extreme differences in insurability that exist among its members. Some further justification is also provided by invoking the moral hazard of explicit insurance contracts.

In the United Kingdom, The Crown (which, for practical purposes, meant the civil service) did not insure property such as government buildings. If a government building was damaged, the cost of repair would be met from public funds because, in the long run, this was cheaper than paying insurance premiums. Since many UK government buildings have been sold to property companies, and rented back, this arrangement is now less common and may have disappeared altogether.

Insurance companies

Insurance companies may be classified into two groups:

- Life insurance companies, which sell life insurance, annuities and pensions products.
- Non-life, general, or property/casualty insurance companies, which sell other types of insurance.

General insurance companies can be further divided into these sub categories.

- Standard lines
- Excess lines

In most countries, life and non-life insurers are subject to different regulatory regimes and different tax and accounting rules. The main reason for the distinction between the two types of company is that life, annuity, and pension business is very long-term in nature — coverage for life assurance or a pension can cover risks over many decades. By contrast, non-life insurance cover usually covers a shorter period, such as one year.

In the United States, standard line insurance companies are insurers that have received a license or authorization from a state for the purpose of writing specific kinds of insurance in that state, such as automobile insurance or homeowners' insurance.[27] They are typically referred to as "admitted" insurers. Generally, such an insurance company must submit its rates and policy forms to the state's insurance regulator to receive his or her prior approval, although whether an insurance company must receive prior approval depends upon the kind of insurance being written. Standard line insurance companies usually charge lower premiums than excess line insurers and may sell directly to individual insureds. They are regulated by state laws, which include restrictions on rates and forms, and which aim to protect consumers and the public from unfair or abusive practices.[27] These insurers also are required to contribute to state guarantee funds, which are used to pay for losses if an insurer becomes insolvent.[27]

Excess line insurance companies (also known as Excess and Surplus) typically insure risks not covered by the standard lines insurance market, due to a variety of reasons (e.g., new entity or an entity that does not have an adequate loss history, an entity with unique risk characteristics, or an entity that has a loss history that does not fit the underwriting requirements of the standard lines insurance market).[27] They are typically referred to as non-admitted or unlicensed insurers.[27] Non-admitted insurers are generally not licensed or authorized in the states in which they write business, although they must be licensed or authorized in the state in which they are domiciled.[27] These companies have more flexibility and can react faster than standard line insurance companies because they are not required to file rates and forms.[27] However, they still have substantial regulatory requirements placed upon them.

Most states require that excess line insurers submit financial information, articles of incorporation, a list of officers, and other general information.[27] They also may not write insurance that is typically available in the admitted market, do not participate in state guarantee funds (and therefore policyholders do not have any recourse through these funds if an insurer becomes insolvent and cannot pay claims), may pay higher taxes, only may write coverage for a risk if it has been rejected by three different admitted insurers, and only when the insurance producer placing the business has a surplus lines license.[27] Generally, when an excess line insurer writes a policy, it must, pursuant to state laws, provide disclosure to the policyholder that the policyholder's policy is being written by an excess line insurer.[27]

On July 21, 2010, President Barack Obama signed into law the Nonadmitted and Reinsurance Reform Act of 2010 ("NRRA"), which took effect on July 21, 2011 and was part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The NRRA changed the regulatory paradigm for excess line insurance. Generally, under the NRRA, only the insured's home state may regulate and tax the excess line transaction.[28]

Insurance companies are generally classified as either mutual or stock companies. Mutual companies are owned by the policyholders, while stockholders (who may or may not own policies) own stock insurance companies.

Demutualization of mutual insurers to form stock companies, as well as the formation of a hybrid known as a mutual holding company, became common in some countries, such as the United States, in the late 20th century. However, not all states permit mutual holding companies.

Other possible forms for an insurance company include reciprocals, in which policyholders reciprocate in sharing risks, and Lloyd's organizations.

Insurance companies are rated by various agencies such as A. M. Best. The ratings include the company's financial strength, which measures its ability to pay claims. It also rates financial instruments issued by the insurance company, such as bonds, notes, and securitization products.

Reinsurance companies are insurance companies that sell policies to other insurance companies, allowing them to reduce their risks and protect themselves from very large losses. The reinsurance market is dominated by a few very large companies, with huge reserves. A reinsurer may also be a direct writer of insurance risks as well.

Captive insurance companies may be defined as limited-purpose insurance companies established with the specific objective of financing risks emanating from their parent group or groups. This definition can sometimes be extended to include some of the risks of the parent company's customers. In short, it is an in-house self-insurance vehicle. Captives may take the form of a "pure" entity (which is a 100% subsidiary of the self-insured parent company); of a "mutual" captive (which insures the collective risks of members of an industry); and of an "association" captive (which self-insures individual risks of the members of a professional, commercial or industrial association). Captives represent commercial, economic and tax advantages to their sponsors because of the reductions in costs they help create and for the ease of insurance risk management and the flexibility for cash flows they generate. Additionally, they may provide coverage of risks which is neither available nor offered in the traditional insurance market at reasonable prices.

The types of risk that a captive can underwrite for their parents include property damage, public and product liability, professional indemnity, employee benefits, employers' liability, motor and medical aid expenses. The captive's exposure to such risks may be limited by the use of reinsurance.

Captives are becoming an increasingly important component of the risk management and risk financing strategy of their parent. This can be understood against the following background:

- heavy and increasing premium costs in almost every line of coverage;
- difficulties in insuring certain types of fortuitous risk;
- differential coverage standards in various parts of the world;
- rating structures which reflect market trends rather than individual loss experience;
- insufficient credit for deductibles and/or loss control efforts.

There are also companies known as 'insurance consultants'. Like a mortgage broker, these companies are paid a fee by the customer to shop around for the best insurance policy amongst many companies. Similar to an insurance consultant, an 'insurance broker' also shops around for the best insurance policy amongst many companies. However, with insurance brokers, the fee is usually paid in the form of commission from the insurer that is selected rather than directly from the client.

Neither insurance consultants nor insurance brokers are insurance companies and no risks are transferred to them in insurance transactions. Third party administrators are companies that perform underwriting and sometimes claims handling services for insurance companies. These companies often have special expertise that the insurance companies do not have.

The financial stability and strength of an insurance company should be a major consideration when buying an insurance contract. An insurance premium paid currently provides coverage for losses that might arise many years in the future. For that reason, the viability of the insurance carrier is very important. In recent years, a number of insurance companies have become insolvent, leaving their policyholders with no coverage (or coverage only from a government-backed insurance pool or other arrangement with less attractive payouts for losses). A number of independent rating agencies provide information and rate the financial viability of insurance companies.

Global insurance premiums grew by 2.7% in inflation-adjusted terms in 2010 to $4.3 trillion, climbing abovepre-crisis levels. The return to growth and record premiums generated during the year followed two years of decline in real terms. Life insurance premiums increased by 3.2% in 2010 and non-life premiums by 2.1%. While industrialised countries saw an increase in premiums of around 1.4%, insurance markets in emerging economies saw rapid expansion with 11% growth in premium income. The global insurance industry was sufficiently capitalised to withstand the financial crisis of 2008 and 2009 and most insurance companies restored their capital to pre-crisis levels by the end of 2010. With the continuation of the gradual recovery of the global economy, it is likely the insurance industry will continue to see growth in premium income both in industrialised countries and emerging markets in 2011.

Advanced economies account for the bulk of global insurance. With premium income of $1,620bn, Europe was the most important region in 2010, followed by North America $1,409bn and Asia $1,161bn. Europe has however seen a decline in premium income during the year in contrast to the growth seen in North America and Asia. The top four countries generated more than a half of premiums. The US and Japan alone accounted for 40% of world insurance, much higher than their 7% share of the global population. Emerging economies accounted forover 85% of the world’s population but only around 15% of premiums. Their markets are however growing at a quicker pace. [29]

Regulatory differences

In the United States, insurance is regulated by the states under the McCarran-Ferguson Act, with "periodic proposals for federal intervention", and a nonprofit coalition of state insurance agencies called the National Association of Insurance Commissioners works to harmonize the country's different laws and regulations.[30] The National Conference of Insurance Legislators (NCOIL) also works to harmonize the different state laws.[31]

In the European Union, the Third Non-Life Directive and the Third Life Directive, both passed in 1992 and effective 1994, created a single insurance market in Europe and allowed insurance companies to offer insurance anywhere in the EU (subject to permission from authority in the head office) and allowed insurance consumers to purchase insurance from any insurer in the EU.[32]

The insurance industry in China was nationalized in 1949 and thereafter offered by only a single state-owned company, the People's Insurance Company of China, which was eventually suspended as demand declined in a communist environment. In 1978, market reforms led to an increase in the market and by 1995 a comprehensive Insurance Law of the People's Republic of China[33] was passed, followed in 1998 by the formation of China Insurance Regulatory Commission (CIRC), which has broad regulatory authority over the insurance market of China.[34]

In India, IRDA is insurance regulatory authority. As per the section 4 of IRDA Act' 1999, Insurance Regulatory and Development Authority (IRDA), which was constituted by an act of parliament. National Insurance Academy, Pune is apex insurance capacity builder institute promoted with support from Ministry of Finance and by LIC, Life & General Insurance compnies.

Controversies

Insurance insulates too much

An insurance company may inadvertently find that its insureds may not be as risk-averse as they might otherwise be (since, by definition, the insured has transferred the risk to the insurer), a concept known as moral hazard. To reduce their own financial exposure, insurance companies have contractual clauses that mitigate their obligation to provide coverage if the insured engages in behavior that grossly magnifies their risk of loss or liability.[*citation needed*]

For example, life insurance companies may require higher premiums or deny coverage altogether to people who work in hazardous occupations or engage in dangerous sports. Liability insurance providers do not provide coverage for liability arising from intentional torts committed by or at the direction of the insured. Even if a provider were so irrational as to want to provide such coverage, it is against the public policy of most countries to allow such insurance to exist, and thus it is usually illegal.[*citation needed*]

Complexity of insurance policy contracts

Insurance policies can be complex and some policyholders may not understand all the fees and coverages included in a policy. As a result, people may buy policies on unfavorable terms. In response to these issues, many countries have enacted detailed statutory and regulatory regimes governing every aspect of the insurance business, including minimum standards for policies and the ways in which they may be advertised and sold.

For example, most insurance policies in the English language today have been carefully drafted in plain English; the industry learned the hard way that many courts will not enforce policies against insureds when the judges themselves cannot understand what the policies are saying. Typically, courts construe ambiguities in insurance policies against the insurance company and in favor of coverage under the policy.

Many institutional insurance purchasers buy insurance through an insurance broker. While on the surface it appears the broker represents the buyer (not the insurance company), and typically counsels the buyer on appropriate coverage and policy limitations, it should be noted that in the vast majority of cases a broker's compensation comes in the form of a commission as a percentage of the insurance premium, creating a conflict of interest in that the broker's financial interest is tilted towards encouraging an insured to purchase more insurance than might be necessary at a higher price. A broker generally holds contracts with many insurers, thereby allowing the broker to "shop" the market for the best rates and coverage possible.

Insurance may also be purchased through an agent. Unlike a broker, who represents the policyholder, an agent represents the insurance company from whom the policyholder buys. Just as there is a potential conflict of interest with a broker, an agent has a different type of conflict. Because agents work directly for the insurance company, if there is a claim the agent may advise the client to the benefit of the insurance company. It should also be noted that agents generally can not offer as broad a range of selection compared to an insurance broker.

An independent insurance consultant advises insureds on a fee-for-service retainer, similar to an attorney, and thus offers completely independent advice, free of the financial conflict of interest of brokers and/or agents. However, such a consultant must still work through brokers and/or agents in order to secure coverage for their clients.

Limited consumer benefits

In United States, economists and consumer advocates generally consider insurance to be worthwhile for low-probability, catastrophic losses, but not for high-probability, small losses. Because of this, consumers are advised to select high deductibles and to not insure losses which would not cause a disruption in their life. However, consumers have shown a tendency to prefer low deductibles and to prefer to insure relatively high-probability, small losses over low-probability, perhaps due to not understanding or ignoring the low-probability risk.[35] This is associated with reduced purchasing of insurance against low-probability losses, and may result in increased inefficiencies from moral hazard.[35]

Redlining

Redlining is the practice of denying insurance coverage in specific geographic areas, supposedly because of a high likelihood of loss, while the alleged motivation is unlawful discrimination. Racial profiling or redlining has a long history in the property insurance industry in the United States. From a review of industry underwriting and marketing materials, court documents, and research by government agencies, industry and community groups, and academics, it is clear that race has long affected and continues to affect the policies and practices of the insurance industry.[36]

In July, 2007, The Federal Trade Commission (FTC) released a report presenting the results of a study concerning credit-based insurance scores in automobile insurance. The study found that these scores are effective predictors of risk. It also showed that African-Americans and Hispanics are substantially overrepresented in the lowest credit scores, and substantially underrepresented in the highest, while Caucasians and Asians are more evenly spread across the scores. The credit scores were also found to predict risk within each of the ethnic groups, leading the FTC to conclude that the scoring models are not solely proxies for redlining. The FTC indicated little data was available to evaluate benefit of insurance scores to consumers.[37] The report was disputed by representatives of the Consumer Federation of America, the National Fair Housing Alliance, the National Consumer Law Center, and the Center for Economic Justice, for relying on data provided by the insurance industry. [38]

All states have provisions in their rate regulation laws or in their fair trade practice acts that prohibit unfair discrimination, often called redlining, in setting rates and making insurance available.[39]

In determining premiums and premium rate structures, insurers consider quantifiable factors, including location, credit scores, gender, occupation, marital status, and education level. However, the use of such factors is often considered to be unfair or unlawfully discriminatory, and the reaction against this practice has in some instances led to political disputes about the ways in which insurers determine premiums and regulatory intervention to limit the factors used.

An insurance underwriter's job is to evaluate a given risk as to the likelihood that a loss will occur. Any factor that causes a greater likelihood of loss should theoretically be charged a higher rate. This basic principle of insurance must be followed if insurance companies are to remain solvent.[*citation needed*] Thus, "discrimination" against (i.e., negative differential treatment of) potential insureds in the risk evaluation and premium-setting process is a necessary by-product of the fundamentals of insurance underwriting. For instance, insurers charge older people significantly higher premiums than they charge younger people for term life insurance. Older people are thus treated differently than younger people (i.e., a distinction is made, discrimination occurs). The rationale for the differential treatment goes to the heart of the risk a life insurer takes: Old people are likely to die sooner than young people, so the risk of loss (the insured's death) is greater in any given period of time and therefore the risk premium must be higher to cover the greater risk. However, treating insureds differently when there is no actuarially sound reason for doing so is unlawful discrimination.

What is often missing from the debate is that prohibiting the use of legitimate, actuarially sound factors means that an insufficient amount is being charged for a given risk, and there is thus a deficit in the system.[*citation needed*] The failure to address the deficit may mean insolvency and hardship for all of a company's insureds.[*citation needed*] The options for addressing the deficit seem to be the following: Charge the deficit to the other policyholders or charge it to the government (i.e., externalize outside of the company to society at large).[*citation needed*]

Insurance patents

New assurance products can now be protected from copying with a business method patent in the United States.

A recent example of a new insurance product that is patented is Usage Based auto insurance. Early versions were independently invented and patented by a major US auto insurance company, Progressive Auto Insurance (U.S. Patent 5,797,134) and a Spanish independent inventor, Salvador Minguijon Perez (EP 0700009).

Many independent inventors are in favor of patenting new insurance products since it gives them protection from big companies when they bring their new insurance products to market. Independent inventors account for 70% of the new US patent applications in this area.

Many insurance executives are opposed to patenting insurance products because it creates a new risk for them. The Hartford insurance company, for example, recently had to pay $80 million to an independent inventor, Bancorp Services, in order to settle a patent infringement and theft of trade secret lawsuit for a type of corporate owned life insurance product invented and patented by Bancorp.

There are currently about 150 new patent applications on insurance inventions filed per year in the United States. The rate at which patents have issued has steadily risen from 15 in 2002 to 44 in 2006.[40]

Inventors can now have their insurance US patent applications reviewed by the public in the Peer to Patent program.[41] The first insurance patent application to be posted was US2009005522 “Risk assessment company”. It was posted on March 6, 2009. This patent application describes a method for increasing the ease of changing insurance companies.[42]

The insurance industry and rent-seeking

Certain insurance products and practices have been described as rent-seeking by critics.[*citation needed*] That is, some insurance products or practices are useful primarily because of legal benefits, such as reducing taxes, as opposed to providing protection against risks of adverse events. Under United States tax law, for example, most owners of variable annuities and variable life insurance can invest their premium payments in the stock market and defer or eliminate paying any taxes on their investments until withdrawals are made. Sometimes this tax deferral is the only reason people use these products.[*citation needed*] Another example is the legal infrastructure which allows life insurance to be held in an irrevocable trust which is used to pay an estate tax while the proceeds themselves are immune from the estate tax.

Religious concerns

Muslim scholars have varying opinions about insurance. Insurance policies that earn interest are generally considered to be a form of *riba*[43] (usury) and some consider even policies that do not earn interest to be a form of *gharar* (speculation). Some argue that *gharar* is not present due to the actuarial science behind the underwriting.

Jewish rabbinical scholars also have expressed reservations regarding insurance as an avoidance of God's will but most find it acceptable in moderation.

Some Christians believe insurance represents a lack of faith[46] and there is a long history of resistance to commercial insurance in Anabaptist communities (Mennonites, Amish, Hutterites, Brethren in Christ) but many participate in community-based self-insurance programs that spread risk within their communities

Debt consolidation entails taking out one loan to pay off many others. This is often done to secure a lower interest rate, secure a fixed interest rate or for the convenience of servicing only one loan.

Debt consolidation can simply be from a number of unsecured loans into another unsecured loan, but more often it involves a secured loan against an asset that serves as collateral, most commonly a house. In this case, a mortgage is secured against the house. The collateralization of the loan allows a lower interest rate than without it, because by collateralizing, the asset owner agrees to allow the forced sale (foreclosure) of the asset to pay back the loan. The risk to the lender is reduced so the interest rate offered is lower.

Sometimes, debt consolidation companies can discount the amount of the loan. When the debtor is in danger of bankruptcy, the debt consolidator will buy the loan at a discount. A prudent debtor can shop around for consolidators who will pass along some of the savings. Consolidation can affect the ability of the debtor to discharge debts in bankruptcy, so the decision to consolidate must be weighed carefully.

Debt consolidation

Debt consolidation is often advisable in theory when someone is paying credit card debt.[2] Credit cards can carry a much larger interest rate than even an unsecured loan from a bank. Debtors with property such as a home or car may get a lower rate through a secured loan using their property as collateral.[2] Then the total interest and the total cash flow paid towards the debt is lower allowing the debt to be paid off sooner, incurring less interest.

PENSIONS

A **pension** is a fixed sum paid regularly to a person, typically, given following a retirement from service.[1] Pensions should not be confused with severance pay; the former is paid in regular installments, while the latter is paid in one lump sum.

The terms retirement plan or superannuation refer to a pension granted upon retirement.[2] Retirement plans may be set up by employers, insurance companies, the government or other institutions such as employer associations or trade unions. Called *retirement plans* in the United States, they are commonly known as *pension schemes* in the United Kingdom and Ireland and *superannuation plans* or *super*[3] in Australia and New Zealand. Retirement pensions are typically in the form of a guaranteed life annuity, thus insuring against the risk of longevity.

A pension created by an employer for the benefit of an employee is commonly referred to as an occupational or employer pension. Labor unions, the government, or other organizations may also fund pensions. Occupational pensions are a form of deferred compensation, usually advantageous to employee and employer for tax reasons. Many pensions also contain an additional insurance aspect, since they often will pay benefits to survivors or disabled beneficiaries. Other vehicles (certain lottery payouts, for example, or an annuity) may provide a similar stream of payments.

The common use of the term *pension* is to describe the payments a person receives upon retirement, usually under pre-determined legal and/or contractual terms. A recipient of a retirement pension is known as a *pensioner* or *retiree*.

Types of pensions

Employment-based pensions (retirement plans)

A retirement plan is an arrangement to provide people with an income during retirement when they are no longer earning a steady income from employment. Often retirement plans require both the employer and employee to contribute money to a fund during their employment in order to receive defined benefits upon retirement. It is a tax deferred savings vehicle that allows for the tax-free accumulation of a fund for later use as a retirement income. Funding can be provided in other ways, such as from labor unions, government agencies, or self-funded schemes. Pension plans are therefore a form of "deferred compensation". A SSAS is a type of employment-based Pension in the UK.

Social and state pensions

Many countries have created funds for their citizens and residents to provide income when they retire (or in some cases become disabled). Typically this requires payments throughout the citizen's working life in order to qualify for benefits later on. A basic state pension is a "contribution based" benefit, and depends on an individual's contribution history. For examples, see National Insurance in the UK, or Social Security in the USA. Many countries have also put in place a "social pension". These are regular, tax-funded non-contributory cash transfers paid to older people. Over 80 countries have social pensions.[4] Examples are the Old Age Grant in South Africa and the universal Superannuation scheme in New Zealand[4].

Disability pensions

Some pension plans will provide for members in the event they suffer a disability. This may take the form of early entry into a retirement plan for a disabled member below the normal retirement age.

Benefits

Retirement plans may be classified as *defined benefit* or *defined contribution* according to how the benefits are determined.[5] A defined benefit plan guarantees a certain payout at retirement, according to a fixed formula which usually depends on the member's salary and the number of years' membership in the plan. A defined contribution plan will provide a payout at retirement that is dependent upon the amount of money contributed and the performance of the investment vehicles utilized.

Some types of retirement plans, such as *cash balance* plans, combine features of both defined benefit and defined contribution plans. They are often referred to as *hybrid* plans. Such plan designs have become increasingly popular in the US since the 1990s. Examples include Cash Balance and Pension Equity plans.

Defined benefit plans

Main article: Defined benefit pension plan

A traditional defined benefit (DB) plan is a plan in which the benefit on retirement is determined by a set formula, rather than depending on investment returns. In the US, 26 U.S.C. § 414(j) specifies a defined benefit plan to be any pension plan that is not a defined contribution plan (see below) where a defined contribution plan is any plan with individual accounts. A traditional pension plan that *defines* a *benefit* for an employee upon that employee's retirement is a defined benefit plan.

Traditionally, retirement plans have been administered by institutions which exist specifically for that purpose, by large businesses, or, for government workers, by the government itself. A traditional form of defined benefit plan is the *final salary* plan, under which the pension paid is equal to the number of years worked, multiplied by the member's salary at retirement, multiplied by a factor known as the *accrual rate*. The final accrued amount is available as a monthly pension or a lump sum, but usually monthly.

The benefit in a defined benefit pension plan is determined by a formula that can incorporate the employee's pay, years of employment, age at retirement, and other factors. A simple example is a Dollars Times Service plan design that provides a certain amount per month based on the time an employee works for a company. For example, a plan offering $100 a month per year of service would provide $3,000 per month to a retiree with 30 years of service. While this type of plan is popular among unionized workers, Final Average Pay (FAP) remains the most common type of defined benefit plan offered in the United States. In FAP plans, the average salary over the final years of an employee's career determines the benefit amount.

Averaging salary over a number of years means that the calculation is averaging different dollars. For example, if salary is averaged over five years, and retirement is in 2009, then salary in 2004 dollars is averaged with salary in 2005 dollars, etc., with 2004 dollars being worth more than the dollars of succeeding years. The pension is then paid in first year of retirement dollars, in this example 2009 dollars, with the lowest value of any dollars in the calculation. Thus inflation in the salary averaging years has a considerable impact on purchasing power and cost, both being reduced equally by inflation

This effect of inflation can be eliminated by converting salaries in the averaging years to first year of retirement dollars, and then averaging.

In the United Kingdom, benefits are typically indexed for inflation (known as Retail Prices Index (RPI)) as required by law for registered pension plans.[6] Inflation during an employee's retirement affects the purchasing power of the pension; the higher the inflation rate, the lower the purchasing power of a fixed annual pension. This effect can be mitigated by providing annual increases to the pension at the rate of inflation (usually capped, for instance at 5% in any given year). This method is advantageous for the employee since it stabilizes the purchasing power of pensions to some extent.

If the pension plan allows for early retirement, payments are often reduced to recognize that the retirees will receive the payouts for longer periods of time. In the United States, under the Employee Retirement Income Security Act of 1974, any reduction factor less than or equal to the actuarial early retirement reduction factor is acceptable.[7]

Many DB plans include early retirement provisions to encourage employees to retire early, before the attainment of normal retirement age (usually age 65). Companies would rather hire younger employees at lower wages. Some of those provisions come in the form of additional *temporary* or *supplemental benefits*, which are payable to a certain age, usually before attaining normal retirement age.[8]

Funding

Defined benefit plans may be either *funded* or *unfunded*.

In an *unfunded* defined benefit pension, no assets are set aside and the benefits are paid for by the employer or other pension sponsor as and when they are paid. Pension arrangements provided by the state in most countries in the world are unfunded, with benefits paid directly from current workers' contributions and taxes. This method of financing is known as *Pay-as-you-go* (PAYGO or PAYG).[9] The social security systems of many European countries are unfunded[*citation needed*], having benefits paid directly out of current taxes and social security contributions, although several countries have hybrid systems which are partially funded. Spain set up the Social Security Reserve Fund and France set up the Pensions Reserve Fund; in Canada the wage-based retirement plan (CPP) is funded, with assets managed by the CPP Investment Board while the U.S. Social Security system is funded by investment in special U.S. Treasury Bonds.

In a *funded* plan, contributions from the employer, and sometimes also from plan members, are invested in a fund towards meeting the benefits. The future returns on the investments, and the future benefits to be paid, are not known in advance, so there is no guarantee that a given level of contributions will be enough to meet the benefits. Typically, the contributions to be paid are regularly reviewed in a valuation of the plan's assets and liabilities, carried out by an actuary to ensure that the pension fund will meet future payment obligations. This means that in a defined benefit pension, investment risk and investment rewards are typically assumed by the sponsor/employer and not by the individual. If a plan is not well-funded, the plan sponsor may not have the financial resources to continue funding the plan. In many countries, such as the USA, the UK and Australia, most private defined benefit plans are funded[*citation needed*], because governments there provide tax incentives to funded plans (in Australia they are mandatory). In the United States, non-church-based private employers must pay an insurance-type premium to the Pension Benefit Guaranty Corporation, a government agency whose role is to encourage the continuation and maintenance of voluntary private pension plans and provide timely and uninterrupted payment of pension benefits.

Criticisms

Traditional defined benefit plan designs (because of their typically flat accrual rate and the decreasing time for interest discounting as people get closer to retirement age) tend to exhibit a J-shaped accrual pattern of benefits, where the present value of benefits grows quite slowly early in an employee's career and accelerates significantly in mid-career: in other words it costs more to fund the pension for older employees than for younger ones (an "age bias"). Defined benefit pensions tend to be less portable than defined contribution plans, even if the plan allows a lump sum cash benefit at termination. Most plans, however, pay their benefits as an annuity, so retirees do not bear the risk of low investment returns on contributions or of outliving their retirement income. The open-ended nature of these risks to the employer is the reason given by many employers for switching from defined benefit to defined contribution plans over recent years. The risks to the employer can sometimes be mitigated by discretionary elements in the benefit structure, for instance in the rate of increase granted on accrued pensions, both before and after retirement.

The age bias, reduced portability and open ended risk make defined benefit plans better suited to large employers with less mobile workforces, such as the public sector (which has open-ended support from taxpayers). This coupled with a lack of foresight on the employers part means a large proportion of the workforce are kept in the dark over future investment schemes.

Defined benefit plans are sometimes criticized as being paternalistic as they enable employers or plan trustees to make decisions about the type of benefits and family structures and lifestyles of their employees. However they are typically more valuable than defined contribution plans in most circumstances and for most employees (mainly because the employer tends to pay higher contributions than under defined contribution plans), so such criticism is rarely harsh.

The "cost" of a defined benefit plan is not easily calculated, and requires an actuary or actuarial software. However, even with the best of tools, the cost of a defined benefit plan will always be an estimate based on economic and financial assumptions. These assumptions include the average retirement age and lifespan of the employees, the returns to be earned by the pension plan's investments and any additional taxes or levies, such as those required by the Pension Benefit Guaranty Corporation in the U.S. So, for this arrangement, the benefit is relatively secure but the contribution is uncertain even when estimated by a professional.

Examples

Many countries offer state-sponsored retirement benefits, beyond those provided by employers, which are funded by payroll or other taxes. The United States Social Security system is similar to a defined benefit pension arrangement, albeit one that is constructed differently than a pension offered by a private employer.

Individuals that have worked in the UK and have paid certain levels of national insurance deductions can expect an income from the state pension scheme after their normal retirement. The state pension is currently divided into two parts: the basic state pension, State Second [tier] Pension scheme called S2P. Individuals will qualify for the basic state pension if they have completed sufficient years contribution to their national insurance record. The S2P pension scheme is earnings related and depends on earnings in each year as to how much an individual can expect to receive. It is possible for an individual to forgo the S2P payment from the state, in lieu of a payment made to an appropriate pension scheme of their choice, during their working life. For more details see UK pension provision.

Defined contribution plans

In a defined contribution plan, contributions are paid into an individual account for each member. The contributions are invested, for example in the stock market, and the returns on the investment (which may be positive or negative) are credited to the individual's account. On retirement, the member's account is used to provide retirement benefits, sometimes through the purchase of an annuity which then provides a regular income. Defined contribution plans have become widespread all over the world in recent years, and are now the dominant form of plan in the private sector in many countries. For example, the number of defined benefit plans in the US has been steadily declining, as more and more employers see pension contributions as a large expense avoidable by disbanding the defined benefit plan and instead offering a defined contribution plan.

Money contributed can either be from employee salary deferral or from employer contributions. The portability of defined contribution pensions is legally no different from the portability of defined benefit plans. However, because of the cost of administration and ease of determining the plan sponsor's liability for defined contribution plans (you do not need to pay an actuary to calculate the lump sum equivalent that you do for defined benefit plans) in practice, defined contribution plans have become generally portable.

In a defined contribution plan, investment risk and investment rewards are assumed by each individual/employee/retiree and not by the sponsor/employer, and these risks may be substantial. In addition, participants do not necessarily purchase annuities with their savings upon retirement, and bear the risk of outliving their assets. (In the United Kingdom, for instance, it is a legal requirement to use the bulk of the fund to purchase an annuity.)

The "cost" of a defined contribution plan is readily calculated, but the benefit from a defined contribution plan depends upon the account balance at the time an employee is looking to use the assets. So, for this arrangement, the *contribution is known* but the *benefit is unknown* (until calculated).

Despite the fact that the participant in a defined contribution plan typically has control over investment decisions, the plan sponsor retains a significant degree of fiduciary responsibility over investment of plan assets, including the selection of investment options and administrative providers.

Examples

In the United States, the legal definition of a defined contribution plan is a plan providing for an individual account for each participant, and for benefits based solely on the amount contributed to the account, plus or minus income, gains, expenses and losses allocated to the account (see 26 U.S.C. § 414(i)). Examples of defined contribution plans in the United States include Individual Retirement Accounts (IRAs) and 401(k) plans. In such plans, the employee is responsible, to one degree or another, for selecting the types of investments toward which the funds in the retirement plan are allocated. This may range from choosing one of a small number of pre-determined mutual funds to selecting individual stocks or other securities. Most self-directed retirement plans are characterized by certain tax advantages, and some provide for a portion of the employee's contributions to be matched by the employer. In exchange, the funds in such plans may not be withdrawn by the investor prior to reaching a certain age—typically the year the employee reaches 59.5 years old-- (with a small number of exceptions) without incurring a substantial penalty.

In the US, defined contribution plans are subject to IRS limits on how much can be contributed, known as the section 415 limit. In 2009, the total deferral amount, including employee contribution plus employer contribution, was limited to $49,000 or 100% of compensation, whichever is less. The employee-only limit in 2009 is $16,500 with a $5,500 catch-up. These numbers may increase each year and are indexed to compensate for the effects of inflation.

Examples of defined contribution pension schemes in other countries are, the UK's personal pensions and proposed National Employment Savings Trust (NEST), Germany's Riester plans, Australia's Superannuation system and New Zealand's KiwiSaver scheme. Individual pension savings plans also exist in Austria, Czech Republic, Denmark, Greece, Finland, Ireland, Netherlands, Slovenia and Spain

Hybrid and cash balance plans

Hybrid plan designs combine the features of defined benefit and defined contribution plan designs.

A cash balance plan is a defined benefit plan made by the employer, with the help of consulting actuaries (like Kwasha Lipton, who it is said created the cash balance plan) to appear as if they were defined contribution plans. They have *notional balances* in hypothetical accounts where, typically, each year the plan administrator will contribute an amount equal to a certain percentage of each participant's salary; a second contribution, called *interest credit*, is made as well. These are not actual contributions and further discussion is beyond the scope of this entry suffice it to say that there is currently much controversy. In general, they are usually treated as defined benefit plans for tax, accounting and regulatory purposes. As with defined benefit plans, investment risk in hybrid designs is largely borne by the plan sponsor. As with defined contribution designs, plan benefits are expressed in the terms of a notional *account balance,* and are usually paid as cash balances upon termination of employment. These features make them more portable than traditional defined benefit plans and perhaps more attractive to a more highly mobile workforce.

Target benefit plans are defined contribution plans made to match (or resemble) defined benefit plans.

Contrasting types of retirement plans

Advocates of defined contribution plans point out that each employee has the ability to tailor the investment portfolio to his or her individual needs and financial situation, including the choice of how much to contribute, if anything at all. However, others state that these apparent advantages could also hinder some workers who might not possess the financial savvy to choose the correct investment vehicles or have the discipline to voluntarily contribute money to retirement accounts. This debate parallels the discussion currently going on in the U.S., where many Republican leaders favor transforming the Social Security system, at least in part, to a self-directed investment plan.

Financing

There are various ways in which a pension may be financed.

Defined contribution pensions, by definition, are funded, as the "guarantee" made to employees is that specified (defined) contributions will be made during an individual's working life.

There are many ways to finance your pension and save for retirement. Pension plans can be set up by your employer, matching your contribution each month, by the state or personally through a pension scheme with a financial institution, such as a bank or brokerage firm. Pension plans often come with a tax break depending on the country and plan type.

For example Canadian's have the option to open a Registered Retirement Savings Plan (RRSP), as well as a range of employee and state pension programs[12]. This plan allows contributions to this account to be marked as un-taxable income and remain un-taxed until withdrawal. Most country's governments will provide advice on pension schemes.

Wealth management is an investment advisory discipline that incorporates financial planning, investment portfolio management and a number of aggregated financial services. High Net worth Individuals (HNWIs), small business owners and families who desire the assistance of a credentialed financial advisory specialist call upon wealth managers to coordinate retail banking, estate planning, legal resources, tax professionals and investment management. Wealth managers can be an independent Certified Financial Planner, MBAs, Chartered Strategic Wealth Professional,[1] CFA Charterholders or any credentialed professional money manager who works to enhance the income, growth and tax favored treatment of long-term investors. Wealth management is often referred to as a high-level form of private banking for the especially affluent. One must already have accumulated a significant amount of wealth for wealth management strategies to be effective.

Financial risk management is the practice of creating economic value in a firm by using financial instruments to manage exposure to risk, particularly credit risk and market risk. Other types include Foreign exchange, Shape, Volatility, Sector, Liquidity, Inflation risks, etc. Similar to general risk management, financial risk management requires identifying its sources, measuring it, and plans to address them.

Financial risk management can be qualitative and quantitative. As a specialization of risk management, financial risk management focuses on when and how to hedge using financial instruments to manage costly exposures to risk.

In the banking sector worldwide, the Basel Accords are generally adopted by internationally active banks for tracking, reporting and exposing operational, credit and market risks.

When to use financial risk management

Finance theory (i.e., financial economics) prescribes that a firm should take on a project when it increases shareholder value. Finance theory also shows that firm managers cannot create value for shareholders, also called its investors, by taking on projects that shareholders could do for themselves at the same cost.

When applied to financial risk management, this implies that firm managers should not hedge risks that investors can hedge for themselves at the same cost. This notion was captured by the hedging irrelevance proposition: *In a perfect market, the firm cannot create value by hedging a risk when the price of bearing that risk within the firm is the same as the price of bearing it outside of the firm.* In practice, financial markets are not likely to be perfect markets.

This suggests that firm managers likely have many opportunities to create value for shareholders using financial risk management. The trick is to determine which risks are cheaper for the firm to manage than the shareholders. A general rule of thumb, however, is that market risks that result in unique risks for the firm are the best candidates for financial risk management.

The concepts of financial risk management change dramatically in the international realm. Multinational Corporations are faced with many different obstacles in overcoming these challenges. There has been some research on the risks firms must consider when operating in many countries, such as the three kinds of foreign exchange exposure for various future time horizons: transactions exposure,[1] accounting exposure,[2] and economic exposure.[3]

Megaprojects (sometimes also called "major programs") have been shown to be particularly risky in terms of finance. Financial risk management is therefore particularly pertinent for megaprojects and special methods have been developed for such risk management.[4][5]

A **financial market** is a market in which people and entities can trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural goods.

There are both general markets (where many commodities are traded) and specialized markets (where only one commodity is traded). Markets work by placing many interested buyers and sellers, including households, firms, and government agences, in one "place", thus making it easier for them to find each other. An economy which relies primarily on interactions between buyers and sellers to allocate resources is known as a market economy in contrast either to a command economy or to a non-market economy such as a gift economy.

In finance, financial markets facilitate:

- The raising of capital (in the capital markets)
- The transfer of risk (in the derivatives markets)
- Price discovery

- Global transactions with integration of financial markets
- The transfer of liquidity (in the money markets)
- International trade (in the currency markets)

– and are used to match those who want capital to those who have it.

Typically a borrower issues a receipt to the lender promising to pay back the capital. These receipts are securities which may be freely bought or sold. In return for lending money to the borrower, the lender will expect some compensation in the form of interest or dividends. This return on investment is a necessary part of markets to ensure that funds are supplied to them.

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Course Name	: International Trade & Investment Policies

Course Description
The Course explores a holistic overview of International trade, models of International trade, risks involved in International trade, history of International trade, protectionism policies, World Trade Organization (WTO) and its relevance in International trade, exploratory meaning of investment, Foreign Direct Investment (FDI), Multilateral Agreement on Investment (MAI), trade and development and Economic integration.

Course Objectives
- To help students grasp the importance of practicing trade across their country boundaries.
- To enable student learn the implications of different protectionism policies to the growing economies.
- To assist students in getting exposed to different investment knowledge relevant to local, national and international levels.
- To ensure that student develop the ability to understand legal frameworks that guide international trade to bring about comprehensive development.

Course Content
Introduction
- Definition of international trade
- Overview of international trade
- Models of international trade
- Assumptions of the models
- Applicability of the models
- Risks involved in international trade
- Operating agreements
- Their history

Protectionism
- Definition of the term Protectionism
- History of protectionism
- Protectionism in the United States
- Protectionist policies
- Arguments for and against protectionism

World Trade Organization
- What is world trade organization
- Functions of world trade organization
- Principles of the trading system
- Organizational structure
- Voting system
- Dispute settlement
- Accession and membership
- Agreements which WTO oversees
- Legal frameworks

Investment

- Description of the term investment
- Investment related to business of a firm-business management
- Investment in relation to finance
- Real estate as the instrument of investment
- Diversification
- Return expectations while diversifying

Foreign direct investment (FDI)

- Definition of foreign direct investment
- History of FDI
- Classification of foreign direct investment
- Methods used in FDI
- Debates about the benefits of FDI for low-income countries
- Foreign direct investment in the United States, China
- Divestment
- Divestment for financial goals
- Methods of divestment

Multilateral Agreement on Investment (MAI)

- Definition of MAI
- Background of MAI
- Purposes and provisions
- Negotiations
- Arguments against MAI

Trade and Development

- Relationship between trade and development
- Overview of the concepts
- Market access to developed countries
- Barriers to trade
- Market access to developing countries
- Market access is vital but not enough
- Support for participation in trade and the global economy

Economic integration

- Broad term of Economic integration
- Objective of economic integration
- History of economic integration
- Success factors for economic integration
- Obstacles to economic integration
- Global economic integration

Mode of delivery Face to face lectures

Assessment
Coursework 40%
Exams 60%
Total Mark 100%

International trade and Investment policies

International trade is exchange of capital, goods, and services across international borders or territorie In most countries, it represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history (see Silk Road, Amber Road), 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 on the international trade system. Increasing international trade is crucial to the continuance of globalization. International trade is a major source of economic revenue for any nation that is considered a world power. Without international trade, nations would be limited to the goods and services produced within their own borders.

International trade is in principle not different from domestic trade as the motivation and the behavior of parties involved in a trade does not change fundamentally depending on whether trade is across a border or not. The main difference is that international trade is typically more costly than domestic trade. The reason is that a border typically imposes additional costs such as tariffs, time costs due to border delays and costs associated with country differences such as language, the legal system or a different culture.

International trade uses a variety of currencies, the most important of which are held as foreign reserves by governments and central banks. Here the percentage of global cumulative reserves held for each currency between 1995 and 2005 are shown: the US dollar is the most sought-after currency, with the Euro in strong demand as well.

Another difference between domestic and international trade is that factors of production such as capital and labor are typically more mobile within a country than across countries. Thus international trade is mostly restricted to trade in goods and services, and only to a lesser extent to trade in capital, labor or other factors of production. Then trade in goods and services can serve as a substitute for trade in factors of production. Instead of importing the factor of production a country can import goods that make intensive use of the factor of production and are thus embodying the respective factor. An example is the import of labor-intensive goods by the United States from China. Instead of importing Chinese labor the United States is importing goods from China that were produced with Chinese labor. International trade is also a branch of economics, which, together with international finance, forms the larger branch of international economics.

Models used to predict trade patterns

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. The main merit of Ricardin model is that it assumes technology differences between countries. The Ricardian model makes the following assumptions:

1. Labor is the only primary input to production (labor is considered to be the ultimate source of value).
2. Constant Marginal Product of Labor (MPL) (Labor productivity is constant, constant returns to scale, and simple technology.)
3. Limited amount of labor in the economy
4. Labor is perfectly mobile among sectors but not internationally.
5. Perfect competition (price-takers).

The Ricardian model measures in the short-run, therefore technology differs internationally. This supports the fact that countries follow their comparative advantage and allows for specialization.

Modern development of the Ricardian model

The Ricardian trade model was studied by Graham, Jones, McKenzie and others. All the theories excluded intermediate goods, or traded input goods such as materials and capital goods. McKenzie(1954), Jones(1961) and Samuelson(2001)emphasised that condiderable gains from trade would be lost once intermediate goods were excluded from trade. In a famous comment McKenzie 1954 pointed that "A moment's consideration will convince one that Lancashire would be unlikely to produce cotton cloth if the cotton had to be grown in England.

Recently, the theory was extended to the case that includes traded intermediates.Thus the "labor only" assumption (#1 above) was removed from the theory. Thus the new Ricardian theory, or the Ricardo-Sraffa model, as it is sometimes named, theoretically includes capital goods such as machines and materials, which are traded across countries. In the time of global trade, this assumption is much more realistic than the Heckscher-Ohlin model, which assumes that capital is fixed inside the country and does not move internatioally.

Heckscher-Ohlin model

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 a capital abundance.

The H-O model makes the following core assumptions:

1. Labor and capital flow freely between sectors
2. The production of shoes is labor intensive and computers is capital intensive
3. The amount of labor and capital in two countries differ (difference in endowments)
4. free trade
5. technology is the same across countries (long-term)
6. Tastes are the same.

The problem with the H-O theory is that it excludes the trade of capital goods (including materials and fuels). In the H-O theory, labor and capital are fixed entities endowed to each country. In a modern economy, capital goods are traded internationally. Gains from trade of intermediate goods are considerable, as it was emphasized by Samuelson (2001).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. This theory differs from the theories of comparative advantage and absolute advantage since these theory focuses on the productivity of the production process for a particular good. On the contrary, the Heckscher-Ohlin theory states that a country should specialise production and export using the factors that are most abundant, and thus the cheapest. Not produce, as earlier theories stated, the goods it produces most efficiently.

Reality and Applicability of the Heckscher-Ohlin Model

The Heckscher-Ohlin theory is preferred to the Ricardo theory by many economists, because it makes fewer simplifying assumptions. In 1953, Wassily Leontief published a study, where he tested the validity of the Heckscher-Ohlin theory The study showed that the U.S was more abundant in capital compared to other countries, therefore the U.S would export capital- intensive goods and import labour-intensive goods. Leontief found out that the U.S's export was less capital intensive than import.

After the appearance of Leontief's paradox, many researchers tried to save the Heckscher-Ohlin theory, either by new methods of measurement, or either by new interpretations. Leamer emphasized that Leontief did not interpret HO theory properly and claimed that with a right interpretation paradox did not occur. Brecher and Choudri found that, if Leamer was right, the American workers consumption per head should be lower than the workers world average consumption.

Many other trials followed but most of them failed. Many of famous textbook writers, including Krugman and Obstfeld and Bowen, Hollander and Viane, are negative about the validity of H-O model. After examining the long history of empirical research, Bowen, Hollander and Viane concluded: "Recent tests of the factor abundance theory [H-O theory and its developed form into many-commodity and many-factor case] that directly examine the H-O-V equations also indicate the rejection of the theory."Heckscher-Ohlin theory is not well adapted to the analyze South-North trade problems. The assumptions of HO are less realistic with respect to N-S than N-N (or S-S) trade. Income differences between North and South is the one that third world cares most. The factor price equalization [a consequence of HO theory] has not shown much sign of realization. HO model assumes identical production functions between countries. This is highly unrealistic. Technological gap between developed and developing countries is the main concern of the poor countries.

Specific factors model

In this model, labor mobility between industries is possible while capital is immobile between industries in the short-run. Thus, this model can be interpreted as a 'short run' version of the Heckscher-Ohlin model. 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 (i.e. labor and capital) are likely to have opposing agendas when lobbying for controls over immigration of labor. Conversely, both owners of capital and labor 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.

New Trade Theory

New Trade theory tries to explain several facts about trade, which the two main models above have difficulty with. These include the fact that most trade is between countries with similar factor endowment and productivity levels, and the large amount of multinational production(i.e.foreign direct investment) which exists. In one example of this framework, the economy exhibits monopolistic competition and increasing returns to scale.

Gravity model

Gravity model of trade

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 for international trade

This belief became the dominant thinking among western nations since then. In the years since the Second World War, controversial multilateral treaties like the General Agreement on Tariffs and Trade (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 nations, 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 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, the North American Free Trade Agreement (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 because of opposition from the populations of Latin American nations. Similar agreements such as the Multilateral Agreement on Investment (MAI) have also failed in recent years.

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. Many economists have attempted to portray tariffs as the underlining reason behind the collapse in world trade that many believe seriously deepened the depression.

Risk in international trade

Companies doing business across international borders face many of the same risks as would normally be evident in strictly domestic transactions. For

example, Buyer insolvency (purchaser cannot pay);

- Non-acceptance (buyer rejects goods as different from the agreed upon specifications);
- Credit risk (allowing the buyer to take possession of goods prior to payment);
- Regulatory risk (e.g., a change in rules that prevents the transaction);
- Intervention (governmental action to prevent a transaction being completed);
- Political risk (change in leadership interfering with transactions or prices); and
- War and Acts of God.

In addition, international trade also faces the risk of unfavorable exchange rate movements (and, the potential benefit of favorable movements).

2. Borders

Borders define geographic boundaries of political entities or legal jurisdictions, such as governments, states or sub national administrative divisions. They may foster the setting up of buffer zones. Some borders are fully or partially controlled, and may be crossed legally only at designated border checkpoints.

Definitions of borders

In the past many borders were not clearly defined lines, but were neutral zones called marchlands. This has been reflected in recent times with the neutral zones that were set up along part of Saudi Arabia's borders with Kuwait and Iraq (however, these zones no longer exist). In modern times the concept of a marchland has been replaced by that of the clearly defined and demarcated border. For the purposes of border control, airports and seaports are also classed as borders. Most countries have some form of border control to restrict or limit the movement of people, animals, plants, and goods into or out of the country. Under international law, each country is generally permitted to define the conditions which have to be met by a person to legally cross its borders by its own laws, and to prevent persons from crossing its border when this happens in violation of those laws.

In order to cross borders, the presentation of passports and visas or other appropriate forms of identity document is required by some legal orders. To stay or work within a country's borders aliens (foreign persons) may need special immigration documents or permits that authorize them to do so.

Moving goods across a border often requires the payment of excise tax, often collected by customs officials. Animals (and occasionally humans) moving across borders may need to go into quarantine to prevent the spread of exotic or infectious diseases. Most countries prohibit carrying illegal drugs or endangered animals across their borders. Moving goods, animals or people illegally across a border, without declaring them, seeking permission, or deliberately evading official inspection constitutes smuggling.

Border economics

The presence of borders often fosters certain economic features or anomalies. Wherever two jurisdictions come into contact, special economic opportunities arise for border trade. Smuggling provides a classic case; contrariwise, a border region may flourish on the provision of excise or of import–export services — legal or quasi-legal, corrupt or corruption-free. Different regulations on either side of a border may encourage services to position themselves at or near that border: thus the provision of pornography, of prostitution, of alcohol and/or of narcotics may cluster around borders, city limits, county lines, ports and airports. In a more planned and official context, Special Economic Zones (SEZs) often tend to cluster near borders or ports.

Human economic traffic across borders (apart from kidnapping), may involve mass commuting between workplaces and residential settlements. The removal of internal barriers to commerce, as in France after the French Revolution or in Europe since the 1940s, de-emphasizes border-based economic activity and fosters free trade. Euro regions are similar official structures built around commuting across borders.

International finance

International finance is the branch of economics that studies the dynamics of exchange rates, foreign investment, and how these affect international trade. It also studies international projects, international investments and capital flows, and trade deficits. It includes the study of futures, options and currency swaps. Together with international trade theory, international finance is also a branch of international economics.

Some of the theories which are important in international finance include the Mundell-Fleming model, the optimum currency area (OCA) theory, as well as the purchasing power parity (PPP) theory. Moreover, whereas international trade theory makes use of mostly microeconomic methods and theories, international finance theory makes use of predominantly intermediate and advanced macroeconomic methods and concepts.

International economics is concerned with the effects upon economic activity of international differences in productive resources and consumer preferences and the institutions that affect them. It seeks to explain the patterns and consequences of transactions and interactions between the inhabitants of different countries, including trade, investment and migration.

- **International trade** studies goods-and-services flows across international boundaries from supply-and-demand factors, economic integration, and policy variables such as tariff rates and trade quotas.
- **International finance** studies the flow of capital across international financial markets, and the effects of these movements on exchange rates.
- **International monetary economics** and **macroeconomics** studies money and macro flows across countries.

International trade

Scope and methodology

The economic theory of international trade differs from the remainder of economic theory mainly because of the comparatively limited international mobility of the capital and labour [8]. In that respect, it would appear to differ in degree rather than in principle from the trade between remote regions in one country. Thus the methodology of international trade economics differs little from that of the remainder of economics. However, the direction of academic research on the subject has been influenced by the fact that governments have often sought to impose restrictions upon international trade, and the motive for the development of trade theory has often been a wish to determine the consequences of such restrictions.

The branch of trade theory which is conventionally categorized as "classical" consists mainly of the application of deductive logic, originating with Ricardo's Theory of *Comparative Advantage* and developing into a range of theorems that depend for their practical value upon the realism of their postulates. "Modern" trade theory, on the other hand, depends mainly upon *empirical analysis*.

Classical theory

The law of *comparative advantage* provides a logical explanation of international trade as the rational consequence of the comparative advantages that arise from inter-regional differences - regardless of how those differences arise. Since its exposition by John Stuart Mill the techniques of neo-classical economics have been applied to it to model the patterns of trade that would result from various postulated sources of comparative advantage. However, extremely restrictive (and often unrealistic) assumptions have had to be adopted in order to make the problem amenable to theoretical analysis. The best-known of the resulting models, the Heckscher-Ohlin theorem (H-O) depends upon the assumptions of no international differences of technology, productivity, or consumer preferences; no obstacles to pure competition or free trade and no scale economies. On those assumptions, it derives a model of the trade patterns that would arise solely from international differences in the relative abundance of labour and capital (referred to as factor endowments). The resulting theorem states that, on those assumptions, a country with a relative abundance of capital would export capital-intensive products and import labour-intensive products. The theorem proved to be of very limited predictive value, as was demonstrated by what came to be known as the "Leontief Paradox" (the discovery that, despite its capital-rich factor endowment, America was exporting labour-intensive products and importing capital-intensive products) Nevertheless the theoretical techniques (and many of the assumptions) used in deriving the H-O model were subsequently used to derive further theorems. The Stolper-Samuelson theorem , which is often described as a corollary of the H-O theorem, was an early example. In its most general form it states that if the price of a good rises (falls) then the price of the factor used intensively in that industry will also rise (fall) while the price of the other factor will fall (rise). In the international trade context for which it was devised it means that trade lowers the real wage of the scarce factor of production, and protection from trade raises it. Another corollary of the H-O theorem is Samuelson's factor price equalisation theorem which states that as trade between countries tends to equalise their product prices, it tends also to equalise the prices paid to their factors of production. Those theories have sometimes been taken to mean that trade between an industrialised country and a developing country would lower the wages of the unskilled in the industrialised country. (But, as noted below, that conclusion depends upon the unlikely assumption that productivity is the same in the two countries). Large numbers of learned papers have been produced in attempts to elaborate on the H-O and Stolper-Samuelson theorems, and while many of them are considered to provide valuable insights, they have seldom proved to be directly applicable to the task of explaining trade patterns.)

Modern theory

Modern trade theory moves away from the restrictive assumptions of the H-O theorem and explores the effects upon trade of a range of factors, including technology and scale economies. It makes extensive use of *econometrics* to identify from the available statistics, the contribution of particular factors among the many different factors that affect trade. The contribution of differences of technology have been evaluated in several such studies. The temporary advantage arising from a country's development of a new technology is seen as contributory factor in one study Other researchers have found research and development expenditure, patents issued, and the availability of skilled labor, to be indicators of the technological leadership that enables some countries to produce a flow of such technological innovations. and have found that technology leaders tend to export hi-tech products to others and receive imports of more standard products from them. Another econometric study also established a correlation between country size and the share of exports made up of goods in the production of which there are scale economies . It is further suggested in that study that internationally-traded goods fall into three categories, each with a different type of comparative advantage:

- goods that are produced by the extraction and routine processing of available natural resources – such as coal, oil and wheat, for which developing countries often have an advantage compared with other types of production – which might be referred to as "Ricardo goods";
- low-technology goods, such as textiles and steel, that tend to migrate to countries with appropriate factor endowments - which might be referred to as "Heckscher-Ohlin goods"; and,
- high-technology goods and high scale-economy goods, such as computers and aeroplanes, for which the comparative advantage arises from the availability of R&D resources and specific skills and the proximity to large sophisticated markets.

The effects of international trade

Gains

There is a strong presumption that any exchange that is freely undertaken will benefit both parties, but that does not exclude the possibility that it may be harmful to others. However (on assumptions that included constant returns and competitive conditions) Paul Samuelson has proved that it will always be possible for the gainers from international trade to compensate the losers . Moreover, in that proof, Samuelson did not take account of the gains to others resulting from wider consumer choice, from the international specialisation of productive activities - and consequent economies of scale, and from the transmission of the benefits of technological innovation. An OECD study has suggested that there are further dynamic gains resulting from better resource allocation, deepening specialisation, increasing returns to R&D, and technology spillover. The authors found the evidence concerning growth rates to be mixed, but that there is strong evidence that a 1 per cent increase in openness to trade increases the level of GDP per capita by between 0.9 per cent and 2.0 per cent . They suggested that much of the gain arises from the growth of the most productive firms at the expense of the less productive. Those findings and others have contributed to a broad consensus among economists that trade confers very substantial net benefits, and that government restrictions upon trade are generally damaging.

Factor price equalization

Nevertheless there have been widespread misgivings about the effects of international trade upon wage earners in developed countries. Samuelson's factor price equalisation theorem indicates that, if productivity were the same in both countries, the effect of trade would be to bring about equality in wage rates. As noted above, that theorem is sometimes taken to mean that trade between an industrialised country and a developing country would lower the wages of the unskilled in the industrialised country. However, it is unreasonable to assume that productivity would be the same in a low-wage developing country as in a high-wage developed country. A 1999 study has found international differences in wage rates to be approximately matched by corresponding differences in productivity . (Such discrepancies that remained were probably the result of over-valuation or under-valuation of exchange rates, or of inflexibilities in labour markets.) It has been argued that, although there may sometimes be short-term pressures on wage rates in the developed countries, competition between employers in developing countries can be expected eventually to bring wages into line with their employees' *marginal products*. Any remaining international wage differences would then be the result of productivity differences, so that there would be no difference between unit labour costs in developing and developed countries, and no downward pressure on wages in the developed countries.

Terms of trade

There has also been concern that international trade could operate against the interests of developing countries. Influential studies published in 1950 by the Argentine economist Raul Prebisch and the British economist Hans Singer suggested that there is a tendency for the prices of agricultural products to fall relative to the prices of manufactured goods; turning the *terms of trade* against the developing countries and producing an unintended transfer of wealth from them to the developing countries. Their findings have been confirmed by a number of subsequent studies, although it has been suggested that the effect may be due to *quality bias* in the index numbers used or to the possession of *market power* by manufacturers . The Prebisch/Singer findings remain controversial, but they were used at the time - and have been used subsequently - to suggest that the developing countries should erect barriers against manufactured imports in order to nurture their own "infant industries" and so reduce their need to export agricultural products. The arguments for and against such a policy are similar to those concerning the *protection* of infant industries in general.

Infant industries

The term "infant industry" is used to denote a new industry which has prospects of becoming profitable in the long-term, but which would be unable to survive in the face of competition from imported goods. That is a situation that can occur because time is needed either to achieve potential *economies of scale*, or to acquire potential *learning curve* economies. Successful identification of such a situation followed by the temporary imposition of a barrier against imports can, in principle, produce substantial benefits to the country that applies it – a policy known as "import substitution industrialization". Whether such policies succeed depends upon governments' skills in picking winners, and there might reasonably be expected to be both successes and failures. It has been claimed that North Korea's automobile industry owes its existence to initial protection against imports , but a study of infant industry protection in Turkey reveals the absence of any association between productivity gains and degree of protection, such as might be expected of a successful import substitution policy. . Another study provides descriptive evidence suggesting that attempts at import substitution industrialisation since the 1970s have usually failed , but the empirical evidence on the question has been contradictory and inconclusive . It has been argued that the case against import substitution industrialization is not that it is bound to fail, but that subsidies and tax incentives do the job better]. It has also been pointed out that, in any case, trade restrictions could not be expected to correct the domestic market imperfections that often hamper the development of infant industries

Trade policies

Economists' findings about the benefits of trade have often been rejected by government policy-makers, who have frequently sought to protect domestic industries against foreign competition by erecting barriers, such as *tariffs* and *quotas*, against imports. Average tariff levels of around 15 per cent in the late 19th century rose to about 30 percent in the 1930s, following the passage in the United States of the Smoot-Hawley Act . Mainly as the result of international agreements under the auspices of the General Agreement on Tariffs and Trade (GATT) and subsequently the World Trade Organisation (WTO), average tariff levels were progressively reduced to about 7 per cent during the second half of the 20th century, and some other trade restrictions were also removed. The restrictions that remain are nevertheless of major economic importance: among other estimates the World Bank estimated in 2004 that the removal of all trade restrictions would yield benefits of over $500 billion a year by 2015 . The largest of the remaining trade-distorting policies are those concerning agriculture. In the OECD countries government payments account for 30 per cent of farmers' receipts and tariffs of over 100 per cent are common OECD economists estimate that cutting all agricultural tariffs and subsidies by 50% would set off a chain reaction in realignments of production and consumption patterns that would add an extra $26 billion to annual world income.

Quotas prompt foreign suppliers to raise their prices toward the domestic level of the importing country. That relieves some of the competitive pressure on domestic suppliers, and both they and the foreign suppliers gain at the expense of a loss to consumers, and to the domestic economy, in addition to which there is a *deadweight loss* to the world economy. When quotas were banned under the rules of the General Agreement on Tariffs and Trade (GATT), the United States, Britain and the European Union made use of equivalent arrangements known as *voluntary restraint agreements* (VRAs) or voluntary export restraints (VERs) which were negotiated with the governments of exporting countries (mainly Japan) - until they too were banned. Tariffs have been considered to be less harmful than quotas, although it can be shown that their welfare effects differ only when there are significant upward or downward trends in imports. Governments also impose a wide range of non-tariff barriers that are similar in effect to quotas, some of which are subject to WTO agreements A recent example has been the application of the *precautionary principle* to exclude innovatory products].

International Finance

Scope and methodology

The economics of international finance do not differ in principle from the economics of international trade but there are significant differences of emphasis. The practice of international finance tends to involve greater uncertainties and risks because the assets that are traded are claims to flows of returns that often extend many years into the future. Markets in financial assets tend to be more volatile than markets in goods and services because decisions are more often revised and more rapidly put into effect. There is the share presumption that a transaction that is freely undertaken will benefit both parties, but there is a much greater danger that it will be harmful to others. For example, mismanagement of mortgage lending in the United States led in 2008 to banking failures and credit shortages in other developed countries, and sudden reversals of international flows of capital have often led to damaging financial crises in developing countries. And, because of the incidence of rapid change, the methodology of *comparative statics* has fewer applications than in the theory of international trade, and *empirical analysis* is more widely employed. Also, the consensus among economists concerning its principal issues is narrower and more open to controversy than is the consensus about international trade.

Exchange rates and capital mobility

A major change in the organisation of international finance occurred in the latter years of the twentieth century, and economists are still debating its implications. At the end of the second world war the national signatories to the Bretton Woods Agreement had agreed to maintain their currencies each at a fixed exchange rate with the United States dollar, and the United States government had undertaken to buy gold on demand at a fixed rate of $35 per ounce. In support of those commitments, most signatory nations had maintained strict control over their nationals' use of foreign exchange and upon their dealings in international financial assets. But in 1971 the United States government announced that it was suspending the convertibility of the dollar, and there followed a progressive transition to the current regime of *floating exchange rates* in which most governments no longer attempt to control their exchange rates or to impose controls upon access to foreign currencies or upon access to international financial markets. The behavior of the international financial system was transformed. Exchange rates became very volatile and there was an extended series of damaging financial crises. One study estimated that by the end of the twentieth century there had been 112 banking crises in 93 countries , another that there had been 26 banking crises, 86 currency crises and 27 mixed banking and currency crises - many times more than in the previous post-war years.

The outcome was not what had been expected. In making an influential case for flexible exchange rates in the 1950s, Milton Friedman had claimed that if there were any resulting instability, it would mainly be the consequence of macroeconomic instability but an empirical analysis in 1999 found no apparent connection ·Economists began to wonder whether the expected advantages of freeing financial markets from government intervention were in fact being realized .Neoclassical theory had led them to expect capital to flow from the capital-rich developed economies to the capital-poor developing countries - because the returns to capital there would be higher. Flows of financial capital would tend to increase the level of investment in the developing countries by reducing their costs of capital, and the direct investment of physical capital would tend to promote specialization and the transfer of skills and technology. However, theoretical considerations alone cannot determine the balance between those benefits and the costs of volatility, and the question has had to be tackled by empirical analysis. A 2006 International Monetary Fund working paper offers a summary of the empirical evidence The authors found little evidence either of the benefits of the liberalization of capital movements, or of claims that it is responsible for the spate of financial crises. They suggest that net benefits can be achieved by countries that are able to meet threshold conditions of financial competence but that for others, the benefits are likely to be delayed, and vulnerability to interruptions of capital flows is likely to be increased.

Policies and Institutions

Although the majority of developed countries now have "floating" exchange rates, some of them – together with many developing countries – maintain exchange rates that are nominally "fixed", usually with the US dollar or the euro. The adoption of a fixed rate requires intervention in the foreign exchange market by the country’s central bank, and is usually accompanied by a degree of control over its citizens’ access to international markets. A controversial case in point is the policy of the Chinese government who had, until 2005, maintained the renminbi at a fixed rate to the dollar, but have since "pegged" it to a basket of currencies. It is frequently alleged that in doing so they are deliberately holding its value lower than if it were allowed to float (but there is evidence to the contrary . Some governments have abandoned their national currencies in favour of the common currency of a currency area such as the "*eurozone*" and some, such as Denmark, have retained their national currencies but have pegged them at a fixed rate to an adjacent common currency. On an international scale, the economic policies promoted by the International Monetary Fund (IMF) have had a major influence, especially upon the developing countries. The IMF was set up in 1944 to encourage international cooperation on monetary matters, to stabilise exchange rates and create an international payments system. Its principal activity is the payment of loans to help member countries to overcome *balance of payments problems*, mainly by restoring their depleted currency reserves. Their loans are, however, conditional upon the introduction of economic measures by recipient governments that are considered by the Fund's economists to provide conditions favourable to recovery. Their recommended economic policies are broadly those that have been adopted in the United States and the other major developed countries (known as the "*Washington Consensus*") and have often included the removal of all restrictions upon incoming investment. The Fund has been severely criticised by Joseph Stiglitz and others for what they consider to be the inappropriate enforcement of those policies and for failing to warn recipient countries of the dangers that can arise from the volatility of capital movements.

International financial stability

From the time of the Great Depression onwards, regulators and their economic advisors have been aware that economic and financial crises can spread rapidly from country to country, and that financial crises can have serious economic consequences. For many decades, that awareness led governments to impose strict controls over the activities and conduct of banks and other credit agencies, but in the 1980s many governments pursued a policy of deregulation in the belief that the resulting efficiency gains would outweigh any *systemic risk*s. The extensive financial innovations that followed are described in the article on financial economics. One of their effects has been greatly to increase the international inter-connectedness of the financial markets and to create an international financial system with the characteristics known in control theory as "complex-interactive". The stability of such a system is difficult to analyze because there are many possible failure sequences. The internationally-systemic crises that followed included the equity crash of October 1987 , the Japanese asset price collapse of the 1990s the Asian financial crisis of 1997the Russian government default of 1998 (which brought down the Long-Term Capital Management hedge fund) and the 2007-8 sub-prime mortgages crisis. The symptoms have generally included collapses in asset prices, increases in risk premiums, and general reductions in liquidity. Measures designed to reduce the vulnerability of the international financial system have been put forward by several international institutions. The Bank for International Settlements made two successive recommendations (Basel I and Basel II concerning the regulation of banks, and a coordinating group of regulating authorities, and the Financial Stability Forum, that was set up in 1999 to identify and address the weaknesses in the system, has put forward some proposals in an interim report .

Free trade

Free trade is a type of trade policy that allows traders to act and transact without interference from government. According to the law of comparative advantage the policy permits trading partners mutual gains from trade of goods and services.

Under a free trade policy, prices are a reflection of true supply and demand, and are the sole determinant of resource allocation. Free trade differs from other forms of trade policy where the allocation of goods and services amongst trading countries are determined by artificial prices that do not reflect the true nature of supply and demand. These artificial prices are the result of protectionist trade policies, whereby governments intervene in the market through price adjustments and supply restrictions. Such government interventions generally increase the cost of goods and services to both consumers and producers.

Interventions include subsidies, taxes and tariffs, non-tariff barriers, such as regulatory legislation and quotas, and even inter-government managed trade agreements such as the North American Free Trade Agreement (NAFTA) and Central America Free Trade Agreement (CAFTA) (contrary to their formal titles) and any governmental market intervention resulting in artificial prices that do not reflect the principles of supply and demand.

Most states conduct trade polices that are to a lesser or greater degree protectionist. One ubiquitous protectionist policy employed by states comes in the form agricultural subsidies whereby countries attempt to protect their agricultural industries from outside competition by creating artificial low prices for their agricultural goods.

Free trade agreements are a key element of customs unions and free trade areas. The details and differences of these agreements are covered in their respective articles.

In literature

The value of free trade was first observed and documented by Adam Smith in his *magnum opus*, *The Wealth of Nations*, in 1776.Later, David Ricardo made a case for free trade by presenting specialized an economic proof featuring a single factor of production with constant productivity of labor in two goods, but with relative productivity between the goods different across two countries.] Ricardo's model demonstrated the benefits of trading via specialization—states could acquire more than their labor alone would permit them to produce. This basic model ultimately led to the formation of one of the fundamental laws of economics: The Law of Comparative Advantage. The Law of Comparative Advantage states that each member in a group of trading partners should specialize in and produce the goods in which they possess lowest opportunity costs relative to other trading partners. This specialization permits trading partners to then exchange their goods produced as a function of specialization. Under a policy of free trade, trade via specialization maximizes labor, wealth and quantity of goods produce, exceeding what an equal number of autarkic states could produce.

Features of free trade

Free trade implies the following features

- trade of goods without taxes (including tariffs) or other trade barriers (*e.g.,* 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

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The United States and free trade

Trade in colonial America was regulated by the British mercantile system through the Acts of Trade and Navigation. Until the 1760s, few colonists openly advocated for free trade, in part because regulations were not strictly enforced—New England was famous for smuggling—but also because colonial merchants did not want to compete with foreign goods and shipping. According to historian Oliver Dickerson, a desire for free trade was not one of the causes of the American Revolution. "The idea that the basic mercantile practices of the eighteenth century were wrong," wrote Dickerson, "was not a part of the thinking of the Revolutionary leaders Free trade came to what would become the United States as a result of American Revolutionary War, when the British Parliament issued the Prohibitory Act, blockading colonial ports. The Continental Congress responded by effectively declaring economic independence, opening American ports to foreign trade on April 6, 1776. According to historian John W. Tyler, "Free trade had been forced on the Americans, like it or not."

The 1st U.S. Secretary of the Treasury, Alexander Hamilton, advocated tariffs to help protect infant industries in his "Report on Manufactures." This was a minority position, however, which the "Jeffersonians" strongly opposed for the most part. Later, in the 19th century, statesmen such as Senator Henry Clay continued Hamilton's themes within the Whig Party under the name "American System." The opposition Democratic Party contested several elections throughout the 1830s, 1840s, and 1850s in part over the issue of the tariff and protection of industry. The Democratic Party favored moderate tariffs used for government revenue only, while the Whig's favored higher protective tariffs to protect favored industries. The economist Henry Charles Carey became a leading proponent of the "American System" of economics. This mercantilist "American System" was opposed by the Democratic Party of Andrew Jackson, Martin Van Buren, James K. Polk, Franklin Pierce, and James Buchanan.

The fledgling Republican Party led by Abraham Lincoln, who called himself a "Henry Clay tariff Whig," strongly opposed free trade and implemented at 44 percent tariff during the Civil War in part to pay for railroad subsidies, the war effort, and to protect favored industries. President William McKinley stated the United States' stance under the Republican Party (which won every election for President until 1912, except the two non-consecutive terms of Grover Cleveland) as thus:

"Under free trade the trader is the master and the producer the slave. Protection is but the law of nature, the law of self-preservation, of self-development, of securing the highest and best destiny of the race of man. [It is said] that protection is immoral.... Why, if protection builds up and elevates 63,000,000 [the U.S. population] of people, the influence of those 63,000,000 of people elevates the rest of the world. We cannot take a step in the pathway of progress without benefitting mankind everywhere. Well, they say, ‘Buy where you can buy the cheapest'.... Of course, that applies to labor as to everything else. Let me give you a maxim that is a thousand times better than that, and it is the protection maxim: ‘Buy where you can pay the easiest.' And that spot of earth is where labor wins its highest rewards."

On the other side:

The growing Free Trade Movement sought an end to the tariffs and corruption in state and federal governments by every means available to them, leading to several outcomes. The first and most important was the rise of the Democratic Party with Grover Cleveland at its helm. The next most important were the rise of the "Mugwumps" within the Republican party. For many Jeffersonian radicals, neither went far enough or sufficiently effective in their efforts and looked for alternatives. The first major movement of the radical Jeffersonians evolved from the insights of a young journalist and firebrand, Henry George. - Kenneth R. Gregg, George Mason University History News Network

The tariff and support of protection to support the growth of infrastructure and industrialization of the nation became a leading tenet of the Republican Party thereafter until the Eisenhower administration and the onset of the Cold War, when the Democratic and Republican parties switched positions.

In the 1930s, the US adopted the protectionist Hawley-Smoot Tariff Act which raised rates to all time highs beyond the Lincoln levels, which many economists believe exacerbated the Great Depression. Europe, which had less protectionism at the time, had largely come out of the depression while the US remained mired in the depression. Franklin D. Roosevelt resorted to Hamilton's earlier formula of tariff Reciprocity coupled with subsidy to industry which went unbroken until the 1970s when protectionism was reduced after the Kennedy Round of trade talks in the late sixties.

Since the end of World War II, in part due to industrial supremacy and the onset of the Cold War, the U.S. government has become one of the most consistent proponents of reduced tariff barriers and free trade, having helped establish the General Agreement on Tariffs and Trade (GATT) and later the World Trade Organization (WTO); although it had rejected an earlier version in the 1950s (International Trade Organization or ITO). Since the 1970s U.S. government has negotiated numerous managed trade agreements, such as the North American Free Trade Agreement (NAFTA) in the 1990s, the Dominican Republic-Central America Free Trade Agreement (CAFTA) in 2006, and a number of bilateral agreements (such as with Jordan).

Current status

Status of WTO negotiations: members (including dual-representation with the European Union) Draft Working Party Report or Factual Summary adopted Goods and/or Services offers submitted Memorandum on Foreign Trade Regime submitted observer, negotiations to start later or no Memorandum on FTR submitted frozen procedures or no negotiations in the last 3 years no official interaction with the WTO

Most (but not all) countries in the world are members of the World Trade Organization (see map), which limits in certain ways but does not eliminate tariffs and other trade barriers. Most countries are also members of regional free trade areas (see map) which lower trade barriers among participating countries.

Most countries prohibit foreign airlines from cabotage (transporting passengers between two domestic locations), and foreign landing rights are generally restricted, but open skies agreements have become more common.

Notable contemporary trade barriers include ongoing tariffs, import quotas, sanctions and embargoes, currency manipulation of the Chinese yuan with respect to the U.S. dollar, agricultural subsidies in developed countries, and buy American laws.

Economics of free trade

Economic models

Two simple ways to understand the potential benefits of free trade are through David Ricardo's theory of comparative advantage and by analyzing the impact of a tariff or import quota.

The pink regions are the net loss to society caused by the existence of the tariff.

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.[10]

The chart at the right analyzes the effect of the imposition of an import tariff on some imaginary good. Prior to the tariff, the price of the good in the world market (and hence in the domestic market) is P. The tariff increases the domestic price to P. The higher price causes domestic production to increase from Q^{S1} to Q^{S2} and causes domestic consumption to decline from Q^{C1} to Q^{C2}. This has three main effects on societal welfare. Consumers are made worse off because the consumer surplus (green region) becomes smaller. Producers are better off because the producer surplus (yellow region) is made larger. The government also has additional tax revenue (blue region). However, the loss to consumers is greater than the gains by producers and the government. The magnitude of this societal loss is shown by the two pink triangles. Removing the tariff and having free trade would be a net gain for society.

An almost identical analysis of this tariff from the perspective of a net producing country yields parallel results. From that country's perspective, the tariff leaves producers worse off and consumers better off, but the net loss to producers is larger than the benefit to consumers (there is no tax revenue in this case because the country being analyzed is not collecting the tariff). Under similar analysis, export tariffs, import quotas, and export quotas all yield nearly identical results. Sometimes consumers are better off and producers worse off, and sometimes consumers are worse off and producers are better off, but the imposition of trade restrictions causes a net loss to society because the losses from trade restrictions are larger than the gains from trade restrictions. Free trade creates winners and losers, but theory and empirical evidence show that the size of the winnings from free trade are larger than the losses.

Trade diversion

According to mainstream economic theory, global free trade is a net benefit to society, but the selective application of free trade agreements to some countries and tariffs on others can sometimes lead to economic inefficiency through the process of trade diversion. It is economically efficient for a good to be produced by the country which is the lowest cost producer, but this will not always take place if a high cost producer has a free trade agreement while the low cost producer faces a high tariff. Applying free trade to the high cost producer (and not the low cost producer as well) can lead to trade diversion and a net economic loss. This is why many economists place such high importance on negotiations for global tariff reductions, such as the Doha Round.

Opinion of economists

The literature analysing the economics of free trade is extremely rich with extensive work having been done on the theoretical and empirical effects. Though it creates winners and losers, the broad consensus among members of the economics profession in the U.S. is that free trade is a large and unambiguous net gain for society. In a 2006 survey of American economists (83 responders), "87.5% agree that the U.S. should eliminate remaining tariffs and other barriers to trade" and "90.1% disagree with the suggestion that the U.S. should restrict employers from outsourcing work to foreign countries." Quoting Harvard economics professor N. Gregory Mankiw, "Few propositions command as much consensus among professional economists as that open world trade increases economic growth and raises living standards." Nonetheless, quoting Prof. Peter Soderbaum of Malardalen University, Sweden, "This neoclassical trade theory focuses on one dimension, i.e., the price at which a commodity can be delivered and is extremely narrow in cutting off a large number of other considerations about impacts on employment in different parts of the world, about environmental impacts and on culture." Most free traders would agree that there are winners and losers from free trade, but argue that this is not a reason to argue against free trade, because free trade is supposed to bring overall gain due to idea that the winners have gained enough to make up for the losses of the losers and then some. Chang argues otherwise, saying that the economy could shrink as a result, and that some people being worse off due to trade displacement without recourse to welfare assistance to find a better job (as might be expected in poor countries) is not acceptable.In an assessment of the literature on the theory and empirical research relating to the benefits of free trade, Sonali Deraniyagala and Ben Fine found that much of the work was flawed, and concluded that the extent to which free trade benefits economic development is unknown Theoretical arguments are largely dependent upon specific empirical assumptions which may or may not hold true. In the empirical literature, many studies suggest the relationship is ambiguous, and the data and econometrics underlying a set of empirical papers showing positive results have been critiqued. The best of these papers use a simplified model, and the worst involve the regression of an index of economic performance on an index of openness to trade, with a mix of these two approaches common. In some cases, Deraniyagala and Fine claim, these indexes of openness actually reflect trade volume rather than policy orientation. They also observe that it is difficult to disentangle the effects of reverse causality and numerous exogenous variables.

In *Kicking Away the Ladder*, Ha-Joon Chang reviews the history of free trade policies and economic growth, and notes that many of the now-industrialized countries had significant barriers to trade throughout their history. Protectionism under the auspices of the infant industry argument (related to import substitution industrialization), was first pursued by Alexander Hamilton in the 1790s in opposition to the admonition of Adam Smith, who advised that the United States focus on agriculture, where it had a comparative advantage. In the 1840s Friedrich List, known as the father of the infant industry argument,advocated the infant industry argument for Germany. Chang's research shows that the United States and Britain, sometimes considered to be the homes of free trade policy, were aggressive protectionists. Britain did end its protectionism when it achieved technological superiority in the late 1850s with the repeal of the Corn Laws, but tariffs on manufactured products had returned to 23% by 1950. The United States maintained weighted average tariffs on manufactured products of approximately 40-50% up until the 1950s, augmented by the natural protectionism of high transportation costs in the 1800s The most consistent practitioners of free trade have been Switzerland, the Netherlands, and to a lesser degree Belgium.

Chang describes the export-oriented industrialization policies of the Asian Tigers as "far more sophisticated and fine-tuned than their historical equivalents".

American intellectual Noam Chomsky argues that David Ricardo's theory of comparative advantage, often offered to promote free trade, assumes that capital is more or less immobile and labor highly mobile, but today these assumptions have been reversed in practice.

Opposition

The relative costs, benefits and beneficiaries of free trade are debated by academics, governments and interest groups. A number of arguments for and against in the ongoing public debate can be seen in the free trade debate article.

Arguments for protectionism fall into the economic category (trade hurts the economy) or the moral category (the effects of trade might help the economy, but have ill effects in other areas). The moral category is wide, including concerns of income inequality, environmental degradation, supporting child labor and sweatshops, race to the bottom, wage slavery, accentuating poverty in poor countries, harming national defense, and forcing cultural change.

Free trade is often opposed by domestic industries that would have their profits and market share reduced by lower prices for imported goods.For example, if United States tariffs on imported sugar were reduced, U.S. sugar producers would receive lower prices and profits, while U.S. sugar consumers would spend less for the same amount of sugar because of those same lower prices. Economics says that consumers would necessarily gain more than producers would lose. Since each of those few domestic sugar producers would lose a lot while each of a great number of consumers would gain only a little, domestic producers are more likely to mobilize against the lifting of tariffs. More generally, producers often favor domestic subsidies and tariffs on imports in their home countries, while objecting to subsidies and tariffs in their export markets.

Socialists frequently oppose free trade on the ground that it allows maximum exploitation of workers by capital. For example, Karl Marx wrote in *The Communist Manifesto*, "The bourgeoisie... has set up that single, unconscionable freedom -- Free Trade. In one word, for exploitation, veiled by religious and political illusions, it has substituted naked, shameless, direct, brutal exploitation."

"Free trade" is opposed by many anti-globalization groups, based on their assertion that free trade agreements generally do not increase the economic freedom of the poor, and frequently make them poor These opponents see free trade deals as being materially harmful to the common people, whether these agreements are really for free trade or for government-managed trade. Nevertheless, if the deals are essentially for government-managed trade, arguing against them is not a direct argument against free trade *per se*. For example, it is argued that it would be wrong to let subsidized corn from the U.S. into Mexico freely under NAFTA at prices well below production cost (dumping) because of its ruinous effects to Mexican farmers. Of course, such subsidies violate free trade, so this argument is not actually against the principle of free trade, but rather its selective implementation.

Latin America performed poorly since tariff cuts in 1980s and 1990s, compared to protectionist China and Southeast Asia According to Samuelson, it is wrong to assume a necessary surplus of winnings over losings The paper, "Will inventions A or B lower or raise the new market-clearing real wage rates that sustain high-to-full employment" condemned "economists' over-simple complacency about globalization" and said that workers don't always win. Some economists try to emphasize that trade barriers should exist to help poor nations build domestic industries and give rich nations time to retrain workers.

Ecuadorian President Rafael Correa has denounced the "sophistry of free trade" in an introduction he wrote for a book titled *The Hidden Face of Free Trade Accords*, written in part by Correa's current Energy Minister Alberto Acosta. Citing as his source the book *Kicking Away the Ladder*, written by Ha-Joon Chang, Correa identified the difference between an "American system" opposed to a "British System" of free trade. The latter, he says, was explicitly viewed by the Americans as "part of the British imperialist system." According to Correa, Chang showed that it was Treasury Secretary Alexander Hamilton, and not Friedrich List, who was the first to present a systematic argument defending industrial protectionism.

The following alternatives for free trade are proposed balanced trade, fair trade, protectionism and Tobin tax.

Promotors

On April 1st, 2009, The Freedom to Trade Coalition an initiative of the International Policy Network and the Atlas Economic Research Foundation, comprising over 76 civil society organisation from 48 countries - launched an open letter calling on all governments to eliminate trade barrieres. Signatories include Nobel Prize winning economist Vernon Smith, former US Secretary of State George Shultz, former Prime Minste of Estonia Mart Laar, former Kremlin chief economist Andrei Illarionov and many other eminent economists, philosophers and other academics. In total, over 3,000 people have so far signed the letter including over 1,000 academics.

Warning of the dangers of resurgent protectionism, the letter observes : " Protectionism creates poverty, not prosperity. Protectionism doesn't even "protect" domestic jobs or indistries; it destroy them, by harming export industries and industries that rely on imports to make their goods. Raising loval prices of steel by "protecting" local steel companies just raises the cost of producing cars and the many other goods made with steel. Protectionism is a fool's game"

The Freedom to Trade coalition has also committed itself to monitoring the actions of government around the world.

Comparative advantage

In economics, the **law of comparative advantage** refers to the ability of a party (an individual, a firm, or a country) to produce a particular good or service at a lower opportunity cost than another party. It is the ability to produce a product most efficiently given all the other products that could be produced. It can be contrasted with absolute advantage which refers to the ability of a party to produce a particular good at a lower absolute cost than another.

Comparative advantage explains how trade can create value for both parties even when one can produce all goods with fewer resources than the other. The net benefits of such an outcome are called gains from trade.

Origins of the theory

Comparative advantage was first described by Robert Torrens in 1815 in an essay on the Corn Laws. He concluded it was to England's advantage to trade with Portugal in return for grain, even though it might be possible to produce that grain more cheaply in England than Portugal.

However the term is usually attributed to David Ricardo who explained it in his 1817 book *On the Principles of Political Economy and Taxation* in an example involving England and Portugal. In Portugal it is possible to produce both wine and cloth with less labor than it would take to produce the same quantities 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 wine at a lower price, closer to the cost of cloth. The conclusion drawn is that each country can gain by specializing in the good where it has comparative advantage, and trading that good for the other.

Examples

The following hypothetical examples explain the reasoning behind the theory. In Example 2 all assumptions are italicized for easy reference, and some are explained at the end of the example.

Example 1

Two men live alone on 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. He is also, 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.

Despite the fact that the younger man has absolute advantage in all activities, it is not in the interest of either of them to work in isolation since they both can benefit from specialization and exchange. If the two men divide the work according to comparative advantage then the young man will specialize in tasks at which he is most productive, while the older man will concentrate on tasks where his productivity is only a little less than that of the young man. Such an arrangement will increase total production for a given amount of labor supplied by both men and it will benefit both of them.

Example 2

Suppose there are two countries *of equal size*, **Northland** and **Southland**, that both produce and consume two goods, **Food** and **Clothes**. The productive capacities and efficiencies of the countries are such that if both countries devoted all their resources to Food production, output would be as follows:

- Northland: 100 tonnes
- Southland: 400 tonnes

If all the resources of the countries were allocated to the production of Clothes, output would be:

- Northland: 100 tonnes
- Southland: 200 tonnes

Assuming each has *constant opportunity costs of production* between the two products and both economies have *full employment at all times*. All *factors of production are mobile within the countries* between clothing and food industries, but are *immobile between the countries*. *The price mechanism must be working to provide perfect competition*.

Southland has an absolute advantage over Northland in the production of Food and Clothing. There seems to be no mutual benefit in trade between the economies, as Southland is more efficient at producing both products. The **opportunity costs** shows otherwise. Northland's opportunity cost of producing one tonne of Food is one tonne of Clothes and vice versa. Southland's opportunity cost of one tonne of Food is 0.5 tonne of Clothes. The opportunity cost of one tonne of Clothes is 2 tonnes of Food. Southland has a comparative advantage in food production, because of its lower opportunity cost of production with respect to Northland. Northland has a comparative advantage over Southland in the production of clothes, the opportunity cost of which is higher in Southland with respect to Food than in Northland.

To show these different opportunity costs lead to mutual benefit if the countries specialize production and trade, consider the countries produce and consume only domestically. The volumes are:

This example includes no formulation of the preferences of consumers in the two economies which would allow the determination of the international exchange rate of Clothes and Food. Given the production capabilities of each country, in order for trade to be worthwhile Northland requires a price of at least one tonne of Food in exchange for one tonne of Clothes; and Southland requires at least one tonne of Clothes for two tonnes of Food. The exchange price will be somewhere between the two. The remainder of the example works with an international trading price of one tonne of Food for 2/3 tonne of Clothes.

If both specialize in the goods in which they have comparative advantage, their outputs will be:

World production of food increased. Clothing production remained the same. Using the exchange rate of one tonne of Food for 2/3 tonne of Clothes, Northland and Southland are able to trade to yield the following level of consumption:

Northland traded 50 tonnes of Clothing for 75 tonnes of Food. Both benefited, and now consume at points outside their production possibility frontiers.

Assumptions in Example 2

- **Two countries, two goods** - the theory is no different for larger numbers of countries and goods, but the principles are clearer and the argument easier to follow in this simpler case.
- **Equal size economies** - again, this is a simplification to produce a clearer example.
- **Full employment** - if one or other of the economies has less than full employment of factors of production, then this excess capacity must usually be used up before the comparative advantage reasoning can be applied.
- **Constant opportunity costs** - a more realistic treatment of opportunity costs the reasoning is broadly the same, but specialization of production can only be taken to the point at which the opportunity costs in the two countries become equal. This does not invalidate the principles of comparative advantage, but it does limit the magnitude of the benefit.

- **Perfect mobility of factors of production within countries** - this is necessary to allow production to be switched *without cost*. In real economies this cost will be incurred: capital will be tied up in plant (sewing machines are not sowing machines) and labour will need to be retrained and relocated. This is why it is sometimes argued that 'nascent industries' should be protected from fully liberalised international trade during the period in which a high cost of entry into the market (capital equipment, training) is being paid for.
- **Immobility of factors of production between countries** - why are there different rates of productivity? The modern version of comparative advantage (developed in the early twentieth century by the Swedish economists Eli Heckscher and Bertil Ohlin) attributes these differences to differences in nations' factor endowments. A nation will have comparative advantage in producing the good that uses intensively the factor it produces abundantly. For example: suppose the US has a relative abundance of capital and India has a relative abundance of labor. Suppose further that cars are capital intensive to produce, while cloth is labor intensive. Then the US will have a comparative advantage in making cars, and India will have a comparative advantage in making cloth. If there is international factor mobility this can change nations' relative factor abundance. The principle of comparative advantage still applies, but who has the advantage in what can change.
- **Negligible Transport Cost** - Cost is not a cause of concern when countries decided to trade. It is ignored and not factored in.
- **Assume that half the resources are used to produce each good in each country.** This takes place before specialization
- **Perfect competition** - this is a standard assumption that allows perfectly efficient allocation of productive resources in an idealized free market.

Example 3

The economist Paul Samuelson provided another well known example in his *Economics*. Suppose that in a particular city the best lawyer happens also to be the best secretary, that is he would be the most productive lawyer and he would also be the best secretary in town. However, if this lawyer focused on the task of being an attorney and, instead of pursuing both occupations at once, employed a secretary, both the output of the lawyer and the secretary would increase.

Effects on the economy

Conditions that maximize comparative advantage do not automatically resolve trade deficits. In fact, in many real world examples where comparative advantage is attainable may in fact require a trade deficit. For example, the amount of goods produced can be maximized, yet it may involve a net transfer of wealth from one country to the other, often because economic agents have widely different rates of saving.

As the markets change over time, the ratio of goods produced by one country versus another variously changes while maintaining the benefits of comparative advantage. This can cause national currencies to accumulate into bank deposits in foreign countries where a separate currency is used.

Macroeconomic monetary policy is often adapted to address the depletion of a nation's currency from domestic hands by the issuance of more money, leading to a wide range of historical successes and failures.

Criticism

Free mobility of capital in a globalized world

Ricardo explicitly bases his argument on an assumed immobility of capital:

> *" ... if capital freely flowed towards those countries where it could be most profitably employed, there could be no difference in the rate of profit, and no other difference in the real or labor price of commodities, than the additional quantity of labor required to convey them to the various markets where they were to be sold."*

He explains why from his point of view (anno 1817) this is a reasonable assumption: *"Experience, however, shows, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connexions, and entrust himself with all his habits fixed, to a strange government and new laws, checks the emigration of capital."*

Some scholars, notably Herman Daly, an American ecological economist and professor at the School of Public Policy of University of Maryland, have voiced concern over the applicability of Ricardo's theory of comparative advantage in light of a perceived increase in the mobility of capital: *"International trade (governed by comparative advantage) becomes, with the introduction of free capital mobility, interregional trade (governed by Absolute advantage)."*

Protectionism

Protectionism is the economic policy of restraining trade between states, through methods such as tariffs on imported goods, restrictive quotas, and a variety of other restrictive government regulations designed to discourage imports, and prevent foreign take-over of local markets and companies. This policy is closely aligned with anti-globalization, and contrasts with free trade, where government barriers to trade are kept to a minimum. The term is mostly used in the context of economics, where **protectionism** refers to policies or doctrines which protect businesses and workers within a country by restricting or regulating trade with foreign nations.

Protectionism in the United States

Free trade and protectionism are regional issues. Free trade in America is the policy of economics developed by American slave holding states and protectionism is a northern, manufacturing issue. Although not as animating an issue as slavery, differences in trade between the two regions contributed to the Civil War and remain a point of national difference even today.

Historically, southern slave holding states, because of their low cost manual labor, had little perceived need for mechanization, and supported having the right to purchase manufactured goods from any nation. Thus they called themselves free traders.

Northern states, on the other hand, sought to develop a manufacturing capacity, and successfully raised tariffs to allow nascent Northern manufacturers to compete with their more efficient British competitors. Beginning with 1st U.S. Secretary of the Treasury Alexander Hamilton's "Report on Manufactures", in which he advocated tariffs to help protect infant industries, including bounties (subsidies) derived in part from those tariffs, the United States was the leading nation opposed to "free trade" theory. Throughout the 19th century, leading U.S. statesmen, including Senator Henry Clay, continued Hamilton's themes within the Whig Party under the name "American System."

The opposed Southern Democratic Party contested several elections throughout the 1830s, 1840s, and 1850s in part over the issue of the tariff and protection of industry. However, Southern Democrats were never as strong in the US House as the more populated North. The Northern Whigs sought and got higher protective tariffs, over the bitter resistance of the South. One Southern state precipitated what was called the nullification crisis over the issue of tariffs, arguing that states had the right to ignore federal laws. Mostly over the issue of abolition and other scandals, the Whigs would ultimately collapse, leaving a void into which the fledgling Republican Party, led by Abraham Lincoln, would fill. Lincoln, who called himself a "Henry Clay tariff Whig", strongly opposed free trade. He implemented a 44 percent tariff during the Civil War in part to pay for the building of the Union-Pacific Railroad, the war effort, and to protect American industry.

This support for Northern industry was ultimately successful. By President Lincoln's term, the northern manufacturing states had ten times the GDP of the South. Armed with this economic advantage, the North was easily able to defeat the South by starving the South of weapons through a near total blockade, while at the same time was able to supply its own army with everything from heavy artillery to repeating Henry rifles.

With the North winning the Civil War, Republican dominance was assured over the Democrats. Republicans continued to dominate American politics until around the early 20th century. President William McKinley stated the United States' stance under the Republican Party as thus:

> "Under free trade the trader is the master and the producer the slave. Protection is but the law of nature, the law of self-preservation, of self-development, of securing the highest and best destiny of the race of man. [It is said] that protection is immoral.... Why, if protection builds up and elevates 63,000,000 [the U.S. population] of people, the influence of those 63,000,000 of people elevates the rest of the world. We cannot take a step in the pathway of progress without benefiting mankind everywhere. Well, they say, ‘Buy where you can buy the cheapest'.... Of course, that applies to labor as to everything else. Let me give you a maxim that is a thousand times better than that, and it

is the protection maxim: ‘Buy where you can pay the easiest.' And that spot of earth is where labor wins its highest rewards."

Southern Democrats gradually rebuilt their party, and allied themselves with Northern Progressives. They had many differences but both were staunchly opposed to the great corporate trusts that had built up, and Republican corruption was endemic. This marriage of convenience to face a common enemy reinvigorated the Democratic Party, which catapulted back into power. Northern Progressives sought free trade to undermine the power base of Republicans - Woodrow Wilson would admit as much in a speech to Congress. A brief resurgence by Republicans in the 1920s was disastrous for them. Woodrow Wilson's ideological understudy, Franklin Roosevelt, would essentially blame the Great Depression upon the protectionist policies exemplified by the previous Republican President, Herbert Hoover.

The Democratic Party would continue to advance free trade, to appeal to its southern wing, carefully balancing a growing voice among its labor side for restraint. Free trade were among the postwar goals of the Allies in World War II, and many rounds of discussions and treaties would gradually advance this cause. Having been stuck with the blame for the Great Depression, Republicans would gradually become zealots of free trade, a position they retain to this day.

In the 1960s, the Democratic Party lost its Southern base as it, in concert with northern Republicans, passed numerous Civil Rights reforms. The Republican party leveraged its free trade zealotry, along with a tacit disapproval of civil rights reforms, to gain those Southern Votes. Thus, the Republican Party, traded regions with the Democratic Party. Ironically, having supported free trade so vocally in response to having been labeled as Herbert Hoover instigators of the Great Depression, Republicans, in the election of 2008, found themselves condemned for not being protectionist.

Protectionist policies

A variety of policies can be used to achieve protectionist goals. These include:

1. *Tariffs*: Typically, tariffs (or taxes) are imposed on imported goods. Tariff rates usually vary according to the type of goods imported. Import tariffs will increase the cost to importers, and increase the price of imported goods in the local markets, thus lowering the quantity of goods imported. Tariffs may also be imposed on exports, and in an economy with floating exchange rates, export tariffs have similar effects as import tariffs. However, since export tariffs are often perceived as 'hurting' local industries, while import tariffs are perceived as 'helping' local industries, export tariffs are seldom implemented.
2. *Import quotas*: To reduce the quantity and therefore increase the market price of imported goods. The economic effects of an import quota is similar to that of a tariff, except that the tax revenue gain from a tariff will instead be distributed to those who receive import licenses. Economists often suggest that import licenses be auctioned to the highest bidder, or that import quotas be replaced by an equivalent tariff.

3. *Administrative Barriers*: Countries are sometimes accused of using their various administrative rules (eg. regarding food safety, environmental standards, electrical safety, etc.) as a way to introduce barriers to imports.
4. *Anti-dumping legislation* Supporters of anti-dumping laws argue that they prevent "dumping" of cheaper foreign goods that would cause local firms to close down. However, in practice, anti-dumping laws are usually used to impose trade tariffs on foreign exporters.
5. *Direct Subsidies*: Government subsidies (in the form of lump-sum payments or cheap loans) are sometimes given to local firms that cannot compete well against foreign imports. These subsidies are purported to "protect" local jobs, and to help local firms adjust to the world markets.
6. *Export Subsidies*: Export subsidies are often used by governments to increase exports. Export subsidies are the opposite of export tariffs, exporters are paid a percentage of the value of their exports. Export subsidies increase the amount of trade, and in a country with floating exchange rates, have effects similar to import subsidies.
7. Exchange Rate manipulation: A government may intervene in the foreign exchange market to lower the value of its currency by selling its currency in the foreign exchange market. Doing so will raise the cost of imports and lower the cost of exports, leading to an improvement in its trade balance. However, such a policy is only effective in the short run, as it will most likely lead to inflation in the country, which will in turn raise the cost of exports, and reduce the relative price of imports.

De facto protectionism

In the modern trade arena many other initiatives besides tariffs have been called protectionist. For example, some commentators, such as Jagdish Bhagwati, see developed countries efforts in imposing their own labor or environmental standards as protectionism. Also, the imposition of restrictive certification procedures on imports are seen in this light.

Further, others point out that free trade agreements often have protectionist provisions such as intellectual property, copyright, and patent restrictions that benefit large corporations. These provisions restrict trade in music, movies, drugs, software, and other manufactured items to high cost producers with quotas from low cost producers set to zero

Arguments for protectionism

Opponents of free trade often argue that the comparative advantage argument for free trade has lost its legitimacy in a globally integrated world—in which capital is free to move internationally. Herman Daly, a leading voice in the discipline of ecological economics, emphasizes that although Ricardo's theory of comparative advantage is one of the most elegant theories in economics, its application to the present day is illogical: "Free capital mobility totally undercuts Ricardo's comparative advantage argument for free trade in goods, because that argument is explicitly and essentially premised on capital (and other factors) being immobile between nations. Under the new globalization regime, capital tends simply to flow to wherever costs are lowest—that is, to pursue absolute advantage."

Protectionists fault the free trade model as being reverse protectionism in disguise, that of using tax policy to protect foreign manufacturers from domestic competition. By ruling out revenue tariffs on foreign products, government must fully rely on domestic taxation to provide its revenue, which falls disproportionately on domestic manufacturing. As Paul Craig Roberts notes: "[Foreign discrimination of US products] is reinforced by the US tax system, which imposes no appreciable tax burden on foreign goods and services sold in the US but imposes a heavy tax burden on US producers of goods and services regardless of whether they are sold within the US or exported to other countries."

Infant industry argument

: Infant industry argument

Some proponents of protectionism claim that imposing tariffs that help protect newly founded infant industries allows those domestic industries to grow and become self-sufficient within the international economy once they reach a reasonable size.

Arguments against protectionism

Protectionism is frequently criticized as harming the people it is meant to help. Nearly all mainstream economists instead support free trade. Economic theory, under the principle of comparative advantage, shows that the gains from free trade outweigh any losses as free trade creates more jobs than it destroys because it allows countries to specialize in the production of goods and services in which they have a comparative advantage.Protectionism results in deadweight loss; this loss to overall welfare gives no-one any benefit, unlike in a free market, where there is no such total loss. According to economist Stephen P. Magee, the benefits of free trade outweigh the losses by as much as 100 to 1.

Most economists, including Nobel prize winners Milton Friedman and Paul Krugman, believe that free trade helps workers in developing countries, even though they are not subject to the stringent health and labor standards of developed countries. This is because "the growth of manufacturing — and of the myriad of other jobs that the new export sector creates — has a ripple effect throughout the economy" that creates competition among producers, lifting wages and living conditions. Economists have suggested that those who support protectionism ostensibly to further the interests of third world workers are in fact being disingenuous, seeking only to protect jobs in developed countries. Additionally, workers in the third world only accept jobs if they are the best on offer, as all mutually consensual exchanges must be of benefit to both sides, else they wouldn't be entered into freely. That they accept low-paying jobs from first world companies shows that their other employment prospects are worse.

Alan Greenspan, former chair of the American Federal Reserve, has criticized protectionist proposals as leading "to an atrophy of our competitive ability. ... If the protectionist route is followed, newer, more efficient industries will have less scope to expand, and overall output and economic welfare will suffer."

Protectionism has also been accused of being one of the major causes of war. Proponents of this theory point to the constant warfare in the 17th and 18th centuries among European countries whose governments were predominantly mercantilist and protectionist, the American Revolution, which came about primarily due to British tariffs and taxes, as well as the protective policies preceding both World War I and World War II. According to Frederic Bastiat, "When goods cannot cross borders, armies will."

Current world trends

Since the end of World War II, it has been the stated policy of most First World countries to eliminate protectionism through free trade policies enforced by international treaties and organizations such as the World Trade Organization. Certain policies of First World governments have been criticized as protectionist, however, such as the Common Agricultural Policyin the European Union and proposed "Buy American" provisions in economic recovery packages in the United States.

The current round of trade talks by the World Trade Organization is the Doha Development Round and the last session of talks in Geneva, Switzerland led to an impassé. The leaders' statement in the G20 meeting in London in early 2009 included a promise to continue the Doha Round.

Economic integration

Economic integration is a term used to describe how different aspects between economies are integrated. The basics of this theory were written by the Hungarian Economist Béla Balassa in the 1960s. As economic integration increases, the barriers of trade between markets diminishes. The most integrated economy today, between independent nations, is the European Union and its euro zone.

Economist Fritz Machlup traces the origin of the term 'economic integration' to a group of five economists writing in the 1940s, including Wilhelm Röpke, Ludwig von Mises and Friedrich von Hayek. Economic integration was a foundational plank of US foreign policy after World War II

The degree of economic integration can be categorized into six stages:

1. Preferential trading area
2. Free trade area
3. Customs union
4. Common market
5. Economic and monetary union
6. Complete economic integration

Economic integration also tends to precede political integration. In fact, Balassa believed that supranational common markets, with their free movement of economic factors across national borders, naturally generate demand for further integration, not only economically (via monetary unions) but also politically--and, thus, that economic communities naturally evolve into political unions over time.

Trade creation

Trade creation is an economic term related to international economics in which trade is created by the formation of a customs union.

Occurrence of Trade Creation

When a customs union is formed, the member nations establish a free trade area amongst themselves and a common external tariff on non-member nations. As a result, the member nations establish greater trading ties between themselves now that protectionist barriers such as tariffs, quotas, and non-tariff barriers such as subsidies have been eliminated. The result is an increase in trade among member nations in the good or service of each nation's comparative advantage.

Downside of Trade Creation

The creation of trade is important to the nation entering the customs union in that increased specialization may hurt other industries. Arguments for protectionism, such as the infant industry argument, national defense, outsourcing, and issues with health and safety regulations are brought to mind. However, customs unions are typically formed with friendly nations, eliminating the national defense argument, and in the long run serves to create more jobs and output due to specialization.

Trade diversion

Trade diversion is an economic term related to international economics in which trade is diverted from a more efficient exporter towards a less efficient one by the formation of a free trade agreement.

Occurrence

When a country applies the same tariff to all nations, it will always import from the most efficient producer, since the more efficient nation will provide the goods at a lower price. With the establishment of a bilateral or regional free trade agreement, that may not be the case. If the agreement is signed with a less-efficient nation, it may well be that their products become cheaper in the importing market than those from the more-efficient nation, since there are taxes for only one of them. Consequently, after the establishment of the agreement, the importing country would acquire products from a higher-cost producer, instead of the low-cost producer from which it was importing until then. In other words, this would cause a trade diversion.

Term

The term was coined by Jacob Viner in *The Customs Union Issue* in 1950. In its literal meaning the term was however incomplete, as it failed to capture all welfare effects of discriminatory tariff liberalization, and it was not useful when it came to non-tariff barriers. Economists have however dealt with this incompleteness in two ways. Either they stretched the original meaning to cover all welfare effects, or they introduced new terms like trade expansion or internal versus external trade creation.

Downside

Diverted trade may hurt the non-member nation economically and politically and create a strained relationship between the two nations. The decreased output of the good or service traded from one nation with a high comparative advantage to a nation of lower comparative advantage works against creating more efficiency and therefore more overall surplus. It is widely believed by economists that trade diversion is harmful to consumers.

Example

An example of trade diversion is the UK's import of lamb, before Britain joined the EU most lamb imports came from New Zealand, the cheapest lamb producer, however when Britain joined the EU the common external tariff made it more expensive to import lamb from New Zealand than countries inside the union, thus France became the majority exporter of lamb to the UK. Trade was diverted from New Zealand, and created between France and the UK. Balance of trade

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 of output in an economy over a certain period. It is the relationship between a nation's imports and exports. A favourable balance of trade is known as a **trade surplus** and consists of exporting more than is imported; an unfavourable 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.

Definition

The balance of trade forms part of the current account, which 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 trade can be problematic because of problems with recording and collecting data. As an illustration of this problem, when official data for all the 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.

Factors that can affect the balance of trade include:

- The cost of production (land, labor, capital, taxes, incentives, etc.) in the exporting economy vis-à-vis those in the importing economy;
- The cost and availability of raw materials, intermediate goods and other inputs;
- Exchange rate movements;
- Multilateral, bilateral and unilateral taxes or restrictions on trade;
- Non-tariff barriers such as environmental, health or safety standards;
- The availability of adequate foreign exchange with which to pay for imports; and
- Prices of goods manufactured at home (influenced by the responsiveness of supply)

In addition, the trade balance 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) the trade balance will worsen at the same stage in the business cycle.

Since the mid 1980s, United States has had a growing deficit in tradeable goods, especially with Asian nations (China and Japan) which now hold large sums of U.S debt that has funded the consumption.The U.S. has a trade surplus with nations such as Australia and Canada. The issue of trade deficits can be complex. Trade deficits generated in tradeable goods such as manufactured goods or software may impact domestic employment to different degrees than trade deficits in raw materials.

Economies such as Canada, Japan, and Germany which have savings surpluses, typically run trade surpluses. China, a high growth economy, has tended to run trade surpluses. A higher savings rate generally corresponds to a trade surplus. Correspondingly, the United States with its lower savings rate has tended to run high trade deficits, especially with Asian nations.

Views on economic impact

Economists are sometimes divided on the economic impact of the trade deficit.

Conditions where trade deficits may be considered harmful

Those who ignore the effects of long run trade deficits may be confusing David Ricardo's principle of comparative advantage with Adam Smith's principle of absolute advantage, specifically ignoring the latter. The economist Paul Craig Roberts notes that the comparative advantage principles developed by David Ricardo do not hold where the factors of production are internationally mobile, a phenomenon described by economist Stephen S. Roach, where one country exploits the cheap labor of another, would be a case of absolute advantage that is not mutually beneficial.Detioráting U.S. net international investment position (NIIP) has caused concern among economists over the effects of outsourcing and high U.S. trade deficits over the long-run.

Since the stagflation of the 1970s, the U.S. economy has been characterized by slower GDP growth. In 1985, the U.S. began its growing trade deficit with China. Over the long run, nations with trade surpluses tend also to have a savings surplus. The U.S. has been plagued by persistently lower savings rates than its trading partners which tend to have trade surpluses. Germany, France, Japan, and Canada have maintained higher savings rates than the U.S. over the long run. Some economists believe that GDP and employment can be dragged down by an over-large deficit over the long run.Wealth-producing primary sector jobs in the U.S. such as those in manufacturing and computer software have often been replaced by much lower paying wealth-consuming jobs such those in retail and government in the service sector when the economy recovered from recessions. Some economists contend that the U.S. is borrowing to fund consumption of imports while accumulating unsustainable amounts of debt.

In 2006, the primary economic concerns centered around: high national debt ($9 trillion), high non-bank corporate debt ($9 trillion), high mortgage debt ($9 trillion), high financial institution debt ($12 trillion), high unfunded Medicare liability ($30 trillion), high unfunded Social Security liability ($12 trillion), high external debt (amount owed to foreign lenders) and a serious deterioration in the United States net international investment position (NIIP) (-24% of GDP), high trade deficits, and a rise in illegal immigration.

These issues have raised concerns among economists and unfunded liabilities were mentioned as a serious problem facing the United States in the President's 2006 State of the Union address. On June 26 2009, Jeff Immelt, the CEO of General Electric, called for the United States to increase its manufacturing base employment to 20% of the workforce, commenting that the U.S. has outsourced too much in some areas and can no longer rely on the financial sector and consumer spending to drive demand.

Conditions where trade imbalances may not be harmful

Small trade imbalances are generally not considered to be harmful to either the importing or exporting economy. However, when a national trade imbalance expands beyond prudence (generally thought to be several percent of GDP, for several years), adjustments tend to occur. While unsustainable imbalances may persist for long periods (cf, Singapore and New Zealand’s surpluses and deficits, respectively), the distortions likely to be caused by large flows of wealth out of one economy and into another tend to become intolerable.

In simple terms, trade deficits are paid for out of foreign exchange reserves, and may continue until such reserves are depleted. At such a point, the importer can no longer continue to purchase more than is sold abroad. This is likely to have exchange rate implications: a sharp loss of value in the deficit economy's exchange rate with the surplus economy's currency will change the relative price of tradable goods, and facilitate a return to balance or (more likely) an over-shooting into surplus the other direction.

More complexly, an economy may be unable to export enough goods to pay for its imports, but is able to find funds elsewhere. Service exports, for example, are more than sufficient to pay for Hong Kong's domestic goods export shortfall. In poorer countries, foreign aid may fill the gap while in rapidly developing economies a capital account surplus often off-sets a current-account deficit. Finally, there are some economies where transfers from nationals working abroad contribute significantly to paying for imports. The Philippines, Bangladesh and Mexico are examples of transfer-rich economies.

Milton Friedman on trade deficits

In the 1980s, Milton Friedman, the Nobel Prize-winning economist and father of Monetarism, contended that some of the concerns of trade deficits are unfair criticisms in an attempt to push macroeconomic policies favorable to exporting industries.

Prof. Friedman argued that trade deficits are not necessarily important as high exports raise the value of the currency, reducing aforementioned exports, and vise versa for imports, thus naturally removing trade deficits not due to investment. Milton Friedman's son, David D. Friedman, shares this view and cites the comparative advantage concepts of David Ricardo. In the late 1970s and early 1980s, the U.S. had experienced high inflation and Friedman's policy positions tended to defend the stronger dollar at that time. He stated his belief that these trade deficits were not necessarily harmful to the economy at the time since the currency comes back to the country (country A sells to country B, country B sells to country C who buys from country A, but the trade deficit only includes A and B). However, it may be in one form or another including the possible tradeoff of foreign control of assets. In his view, the "worst case scenario" of the currency never returning to the country of origin was actually the best possible outcome: the country actually purchased its goods by exchanging them for pieces of cheaply-made paper. As Friedman put it, this would be the same result as if the exporting country burned the dollars it earned, never returning it to market circulation. This position is a more refined version of the theorem first discovered by David Hume. Hume argued that England could not permanently gain from exports, because hoarding gold (i.e., currency) would make gold more plentiful in England; therefore, the prices of English goods would rise, making them less attractive exports and making foreign goods more attractive imports. In this way, countries' trade balances would balance out.

Friedman believed that deficits would be corrected by free markets as floating currency rates rise or fall with time to encourage or discourage imports in favor of the exports, reversing again in favor of imports as the currency gains strength. In the real world, a potential difficulty is that currency markets are far from a free market, with government and central banks being major players, and this is unlikely to change within the foreseeable future. Nevertheless, recent developments have shown that the global economy is undergoing a fundamental shift. For many years the U.S. has bore world has lent and sold. However, as Friedman predicted, this paradigm appears to be changing.

As of October 2007, the U.S. dollar weakened against the euro, British pound, and many other currencies. For instance, the euro hit $1.42 in October 2007, the strongest it has been since its birth in 1999. Against this backdrop, American exporters are finding quite favorable overseas markets for their products and U.S. consumers are responding to their general housing slowdown by slowing their spending. Furthermore, China, the Middle East, central Europe and Africa are absorbing more of the world's imports which in the end may result in a world economy that is more evenly balanced. All of this could well add up to a major readjustment of the U.S. trade deficit, which as a percentage of GDP, began in 1991.

Friedman and other economists have pointed out that a large trade deficit (importation of goods) signals that the country's currency is strong and desirable. To Friedman, a trade deficit simply meant that consumers had opportunity to purchase and enjoy more goods at lower prices; conversely, a trade surplus implied that a country was exporting goods its own citizens did not get to consume or enjoy, while paying high prices for the goods they actually received.

Friedman contended that the structure of the balance of payments was misleading. In an interview with Charlie Rose, he stated that "on the books" the US is a net borrower of funds, using those funds to pay for goods and services. He essentially claimed that the foreign assets were not carried on the books at their higher, truer value.

Friedman presented his analysis of the balance of trade in *Free to Choose*, widely considered his most significant popular work.

Warren Buffett on trade deficits

The successful American businessman and investor Warren Buffett was quoted in the Associated Press (January 20, 2006) as saying "The U.S trade deficit is a bigger threat to the domestic economy than either the federal budget deficit or consumer debt and could lead to political turmoil... Right now, the rest of the world owns $3 trillion more of us than we own of them."

John Maynard Keynes on the balance of trade

In the last few years of his life, John Maynard Keynes was much preoccupied with the question of balance in international trade. He was the leader of the British delegation to the United Nations Monetary and Financial Conference in 1944 that established the Bretton Woods system of international currency management.

He was the principal author of a proposal—the so-called Keynes Plan—for an International Clearing Union. The two governing principles of the plan were that the problem of settling outstanding balances should be solved by 'creating' additional 'international money', and that debtor and creditor should be treated almost alike as disturbers of equilibrium. In the event, though, the plans were rejected, in part because *"American opinion was naturally reluctant to accept the principal of equality of treatment so novel in debtor-creditor relationships"*.

His view, supported by many economists and commentators at the time, was that creditor nations may be just as responsible as debtor nations for disequilibrium in exchanges and that both should be under an obligation to bring trade back into a state of balance. Failure for them to do so could have serious consequences. In the words of Geoffrey Crowther, then editor of The Economist, *"If the economic relationships between nations are not, by one means or another, brought fairly close to balance, then there is no set of financial arrangements that can rescue the world from the impoverishing results of chaos."*

These ideas were informed by events prior to the Great Depression when—in the opinion of Keynes and others—international lending, primarily by the United States, exceeded the capacity of sound investment and so got diverted into non-productive and speculative uses, which in turn invited default and a sudden stop to the process of lending.

Influenced by Keynes, economics texts in the immediate post-war period put a significant emphasis on balance in trade. For example, the second edition of the popular introductory textbook, *An Outline of Money*, devoted the last three of its ten chapters to questions of foreign exchange management and in particular the 'problem of balance'. However, in more recent years, since the end of the Bretton Woods system in 1971, with the increasing influence of Monetarist schools of thought in the 1980s, and particularly in the face of large sustained trade imbalances, these concerns—and particularly concerns about the destabilising affects of large trade surpluses—have largely disappeared from mainstream economics discourse and Keynes' insights have slipped from view, they are receiving some attention again in the wake of the financial crisis of 2007–2009.

Physical balance of trade

Monetary balance of trade is different from physical balance of trade (which is expressed in amount of raw materials). Developed countries usually import a lot of primary raw materials from developing countries at low prices. Often, these materials are then converted into finished products, and a significant amount of value is added. Although for instance the EU (as well as many other developed countries) has a balanced monetary balance of trade, its physical trade balance (especially with developing countries) is negative, meaning that a lot less material is exported than imported.

Balance of payments

In economics, the **balance of payments**, (or **BOP**) measures the payments that flow between any individual country and all other countries. It is used to summarize all international economic transactions for that country during a specific time period, usually a year. The BOP is determined by the country's exports and imports of goods, services, and financial capital, as well as financial transfers. It reflects all payments and liabilities to foreigners (debits) and all payments and obligations received from foreigners (credits). Balance of payments is one of the major indicators of a country's status in international trade, with net capital outflow.

The balance, like other accounting statements, is prepared in a single currency, usually the domestic. Foreign assets and flows are valued at the exchange rate of the time of transaction.

IMF definition

The IMF definition: "**Balance of Payments** is a statistical statement that summarizes transactions between residents and nonresidents during a period." The balance of payments comprises the **current account** and the **capital account** (or the **financial account**). "Together, these accounts balance in the sense that the sum of the entries is conceptually **zero**."

- The **current account** consists of the **goods and services account**, the primary income account and the secondary income account.
- The **capital account** is much smaller than the other two and consists primarily of debt forgiveness and assets from migrants coming to or leaving the country.
- The **financial account** consists of asset inflows and outflows, such as international purchases of stocks, bonds and real estate.

Balance of payments identity

The balance of payments identity states that:

> Current Account = Capital Account + Financial Account + Net Errors and Omissions

This is a convention of double entry accounting, where all debit entries must be booked along with corresponding credit entries such that the net of the Current Account will have a corresponding net of the Capital and Financial Accounts:

$$X + K_i = M + K_o$$

where:

- X = exports
- M = imports
- K_i = capital inflows
- K_o = capital outflows

Rearranging, we have:

$$(X - M) = K_o - K_i,$$

yielding the BOP identity.

The basic principle behind the identity is that a country can only *consume more than it can produce* (a current account deficit) if it *is supplied capital from abroad* (a capital account surplus).

Mercantile thought prefers a so-called balance of payments surplus where the net current account is in surplus or, more specifically, a positive balance of trade.

A **balance of payments equilibrium** is defined as a condition where the sum of debits and credits from the current account and the capital and financial accounts equal to zero; in other words, equilibrium is where

$$\text{Current account} + (\text{Capital and financial accounts}) = 0$$

This is a condition where there are no changes in Official Reserves.When there is no change in Official Reserves, the balance of payments may also be stated as follows:

$$\text{Current account} = -(\text{Capital and financial accounts})$$

or:

$$\text{Current account deficit (or surplus)} = \text{Capital and financial account surplus (or}$$

Canada's Balance of Payments currently satisfies this criterion. It is the only large monetary authority with no Changes in Reserves.

History

Historically these flows simply were not carefully measured due to difficulty in measurement, and the flow proceeded in many commodities and currencies without restriction, clearing being a matter of judgment by individual private banks and the governments that licensed them to operate. Mercantilism was a theory that took special notice of the balance of payments and sought simply to monopolize gold, in part to keep it out of the hands of potential military opponents (a large "war chest" being a prerequisite to start a war, whereupon much trade would be embargoed) but mostly upon the theory that large domestic gold supplies will provide lower interest rates. This theory has not withstood the test of facts.

As mercantilism gave way to classical economics, and private currencies were taxed out of existence, the market systems were later regulated in the 19th century by the gold standard which linked central banks by a convention to redeem "hard currency" in gold. After World War II this system was replaced by the Bretton Woods institutions (the International Monetary Fund and Bank for International Settlements) which pegged currency of participating nations to the US dollar and German mark, which was redeemable nominally in gold. In the 1970s this redemption ceased, leaving the system with respect to the United States without a formal base, yet the peg to the Mark somewhat remained. Strangely, since leaving the gold standard and abandoning interference with Dollar foreign exchange, the surplus in the Income Account has decayed exponentially, and has remained negligible as a percentage of total debits or credits for decades. Some consider the system today to be based on oil, a universally desirable commodity due to the dependence of so much infrastructural capital on oil supply; however, no central bank stocks reserves of crude oil. Since OPEC oil transacts in US dollars, and most major currencies are subject to sudden large changes in price due to unstable central banks, the US dollar remains a reserve currency, but is increasingly challenged by the euro, and to a small degree the pound.

The United States has been running a current account deficit since the early 1980s. The U.S. current account deficit has grown considerably in recent years, reaching record high levels in 2006 both in absolute terms ($758 billion) and as a fraction of GDP (6%).

Criticism

According to Murray Rothbard:

> “ Fortunately, the absurdity of worrying about the balance of payments is made evident by focusing on inter-state trade. For nobody worries about the balance of payments between New York and New Jersey, or, for that matter, between Manhattan and Brooklyn, because there are no customs officials recording such trade and such balances. ”

Trade facilitation.

Trade facilitation looks at how procedures and controls governing the movement of goods across national borders can be improved to reduce associated cost burdens and maximise efficiency while safeguarding legitimate regulatory objectives. Business costs may be a direct function of collecting information and submitting declarations or an indirect consequence of border checks in the form of delays and associated time penalties, forgone business opportunities and reduced competitiveness.

Understanding and use of the term “trade facilitation” varies in the literature and amongst practitioners. "Trade facilitation" is largely used by institutions which seek to improve the regulatory interface between government bodies and traders at national borders. The WTO, in an online training package, once defined trade facilitation as: “The simplification and harmonisation of international trade procedures” where trade procedures are the “activities, practices and formalities involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade”.

In defining the term, many trade facilitation proponents will also make reference to trade finance and the procedures applicable for making payments (e.g. via a commercial banks). For example UN/CEFACT defines trade facilitation as "the simplification, standardization and harmonization of procedures and associated information flows required to move goods from seller to buyer and to make payment".

Occasionally, the term trade facilitation is extended to address a wider agenda in economic development and trade to include: the improvement of transport infrastructure, the removal of government corruption, the modernization of customs administration, the removal of other non-tariff trade barriers, as well as export marketing and promotion.

Examples of regulatory activity in international trade

Fiscal: Collection of customs duties, excise duties and other indirect taxes; payment mechanisms

Safety and security: Security and anti smuggling controls; dangerous goods; vehicle checks; immigration and visa formalities

Environment and health: Phytosanitary, veterinary and hygiene controls; health and safety measures; CITES controls; ships' waste

Consumer protection: Product testing; labelling; conformity checks with marketing standards (e.g. fruit and vegetables)

Trade policy: Administration of quota restrictions; export refunds

Topics and issues in trade facilitation

Trade facilitation has its intellectual roots in the fields of logistics and supply chain management. Trade facilitation looks at operational improvements at the interface between business and government and associated transaction costs. Trade facilitation has become a key feature in supply chain security and customs modernisation programmes. Within the context of economic development it has also come to prominence in the Doha Development Round. However, it is an equally prominent feature in unilateral and bilateral initiatives that seek to improve the trade environment and enhance business competitiveness. Reference to trade facilitation is sometimes also made in the context of "better regulation". Some organisations promoting trade facilitation will emphasis the cutting of red tape in international trade as their main objective. Propagated ideas and concepts to reforming trade and customs procedures generally resonate around the following themes:

- Simple rules and procedures
- Avoidance of duplication
- Memoranda of Understanding (MoUs)
- Alignment of procedures and adherence to international conventions
- Trade consultation
- Transparent and operable rules and procedures
- Accommodation of business practices

- Operational flexibility
- Public-service standards and performance measures
- Mechanisms for corrections and appeals
- Fair and consistent enforcement
- Proportionality of legislation and control to risk
- Time-release measures
- Risk management and trader authorisations
- Standardisation of documents and electronic data requirements
- Automation
- International electronic exchange of trade data
- Single Window System

International trade law

International trade law includes the appropriate rules and customs for handling trade between countries or between private companies across borders. Over the past twenty years, it has become one of the fastest growing areas of international law.

Overview

International trade law should be distinguished from the broader field of international economic law. The latter could be said to encompass not only WTO law, but also law governing the international monetary system and currency regulation, as well as the law of international development.

The body of rules for transnational trade in the 21st century derives from medieval commercial laws called the *lex mercatoria* and *lex maritima* — respectively, "the law for merchants on land" and "the law for merchants on sea." Modern trade law (extending beyond bilateral treaties) began shortly after the Second World War, with the negotiation of a multilateral treaty to deal with trade in goods: the General Agreement on Tariffs and Trade (GATT).

International trade law is based on theories of economic liberalism developed in Europe and later the United States from the 18th century onwards.

World Trade Organization

In 1995, the World Trade Organization, a formal international organization to regulate trade, was established. It is the most important development in the history of international trade law.

The purposes and structure of the organization is governed by the *Agreement Establishing The World Trade Organization*, also known as the "Marrakesh Agreement". It does not specify the actual rules that govern international trade in specific areas. These are found in separate treaties, annexed to the Marrakesh Agreement.

Trade in goods

The GATT has been the backbone of international trade law throughout most of the twentieth century. It contains rules relating to "unfair" trading practices — dumping and subsidies.

Trade and Human Rights

The World Trade Organisation Trade Related Intellectual Property Rights (TRIPS) agreement required signatory nations to raise intellectual property rights (also known as intellectual monopoloy privileges. This arguably has had a negative impact on access to essential medicines in some nations.

Dispute settlement

Since there are no international governing judges (2004) the means of dispute resolution is determined by jurisdiction. Each individual country hears cases that are brought before them. Governments choose to be party to a dispute. And private citizens determine jurisdiction by the Forum Clause in their contract.

Besides forum, another factor in international disputes is the rate of exchange. With currency fluctuation ascending and descending over years, a lack of Commerce Clause can jeopardize trade between parties when one party becomes unjustly enriched through natural market fluctuations. By listing the rate of exchange expected over the contract life, parties can provide for changes in the market through reassessment of contract or division of exchange rate fluctuations.

Dumping (pricing policy)

In economics, "**dumping**" can refer to any kind of predatory pricing. However, the word is now generally used only in the context of international trade law, where dumping is defined as the act of a manufacturer in one country exporting a product to another country at a price which is either below the price it charges in its home market or is below its costs of production. The term has a negative connotation, but advocates of free markets see "dumping" as beneficial for consumers and believe that protectionism to prevent it would have *net* negative consequences. Advocates for workers and laborers however, believe that safeguarding businesses against predatory practices, such as dumping, help alleviate some of the harsher consequences of free trade between economies at different stages of development (see *protectionism*). The Bolkestein directive, for example, was accused in Europe of being a form of "social dumping," as it favored competition between workers, as exemplified by the Polish Plumber stereotype. While there are very few examples of a national scale dumping that succeeded in producing a national-level monopoly, there are several examples of dumping that produced a monopoly in regional markets for certain industries. Ron Chenow points to the example of regional oil monopolies in *Titan : The Life of John D. Rockefeller, Sr.* where Rockefeller receives a message from Colonel Thompson outlining an approved strategy where oil in one market, Cincinnati, would be sold at or below cost to drive competition's profits down and force them to exit the market. In another area where other independent businesses were already driven out, namely in Chicago, prices would be increased by a quarter.

A standard technical definition of dumping is the act of charging a lower price for a good in a foreign market than one charges for the same good in a domestic market. This is often referred to as selling at less than "fair value." Under the World Trade Organization (WTO) Agreement, dumping is condemned (but is not prohibited) if it causes or threatens to cause material injury to a domestic industry in the importing country.

Remedies and penalties

In United States, domestic firms can file an antidumping petition under the regulations determined by the United States Department of Commerce, which determines "less than fair value" and the International Trade Commission, which determines "injury". These proceedings operate on a timetable governed by U.S. law. The Department of Commerce has regularly found that products have been sold at less than fair value in U.S. markets. If the domestic industry is able to establish that it is being injured by the dumping, then antidumping duties are imposed on goods imported from the dumpers' country at a percentage rate calculated to counteract the dumping margin.

Related to antidumping duties are "countervailing duties." The difference is that countervailing duties seek to offset injurious subsidization while antidumping duties offset injurious dumping.

Some commentators have noted that domestic protectionism, and lack of knowledge regarding foreign cost of production, lead to the unpredictable institutional process surrounding investigation. Members of the WTO can file complaints against anti-dumping measures.

Anti-dumping actions

Legal issues

If a company exports a product at a price lower than the price it normally charges on its own home market, it is said to be "dumping" the product. Opinions differ as to whether or not this is unfair competition, but many governments take action against dumping in order to defend their domestic industries. The WTO agreement does not pass judgment. Its focus is on how governments can or cannot react to dumping—it disciplines anti-dumping actions, and it is often called the "Anti-Dumping Agreement". (This focuses only on the reaction to dumping contrasts with the approach of the Subsidies & Countervailing Measures Agreement.)

The legal definitions are more precise, but broadly speaking the WTO agreement allows governments to act against dumping where there is genuine ("material") injury to the competing domestic industry. In order to do that the government has to be able to show that dumping is taking place, calculate the extent of dumping (how much lower the export price is compared to the exporter’s home market price), and show that the dumping is causing injury or threatening to do so.

Definitions and degrees of dumping

While permitted by the WTO, General Agreement on Tariffs and Trade (GATT) (Article VI) allows countries the option of taking action against dumping. The Anti-Dumping Agreement clarifies and expands Article VI, and the two operate together. They allow countries to act in a way that would normally break the GATT principles of binding a tariff and not discriminating between trading partners—typically anti-dumping action means charging extra import duty on the particular product from the particular exporting country in order to bring its price closer to the “normal value” or to remove the injury to domestic industry in the importing country.

There are many different ways of calculating whether a particular product is being dumped heavily or only lightly. The agreement narrows down the range of possible options. It provides three methods to calculate a product’s “normal value”. The main one is based on the price in the exporter’s domestic market. When this cannot be used, two alternatives are available—the price charged by the exporter in another country, or a calculation based on the combination of the exporter’s production costs, other expenses and normal profit margins. And the agreement also specifies how a fair comparison can be made between the export price and what would be a normal price.

Calculating the extent of dumping on a product is not enough. Anti-dumping measures can only be applied if the dumping is hurting the industry in the importing country. Therefore, a detailed investigation has to be conducted according to specified rules first. The investigation must evaluate all relevant economic factors that have a bearing on the state of the industry in question. If the investigation shows dumping is taking place and domestic industry is being hurt, the exporting company can undertake to raise its price to an agreed level in order to avoid anti-dumping import duty.

Procedures in investigation and litigation

Detailed procedures are set out on how anti-dumping cases are to be initiated, how the investigations are to be conducted, and the conditions for ensuring that all interested parties are given an opportunity to present evidence. Anti-dumping measures must expire five years after the date of imposition, unless a review shows that ending the measure would lead to injury.

Anti-dumping investigations are to end immediately in cases where the authorities determine that the margin of dumping is, *de minimis,* or insignificantly small (defined as less than 2% of the export price of the product). Other conditions are also set. For example, the investigations also have to end if the volume of dumped imports is negligible (i.e., if the volume from one country is less than 3% of total imports of that product—although investigations can proceed if several countries, each supplying less than 3% of the imports, together account for 7% or more of total imports). The agreement says member countries must inform the Committee on Anti-Dumping Practices about all preliminary and final anti-dumping actions, promptly and in detail. They must also report on all investigations twice a year. When differences arise, members are encouraged to consult each other. They can also use the WTO’s dispute settlement procedure.

Actions in the European Union

European Union anti-dumping is under the purview of the European Council. It is governed by European Council regulation 384/96. However, implementation of anti-dumping actions (trade defence actions) is taken after voting by various committees with member state representation.

The bureaucratic entity responsible for advising member states on anti-dumping actions is the Directorate General Trade (DG Trade), based in Brussels. Community industry can apply to have an anti-dumping investigation begin. DG Trade first investigates the standing of the complainants. If they are found to represent at least 25% of community industry, the investigation will probably begin. The process is guided by quite specific guidance in the regulations. The DG Trade will make a recommendation to a committee known as the Anti-Dumping Advisory Committee, on which each member state has one vote. Member states abstaining will be treated as if they voted in favour of industrial protection, a voting system which has come under considerable criticism

As is implied by the criterion for beginning an investigation, EU anti-dumping actions are primarily considered part of a "trade defence" portfolio. Consumer interests and non-industry related interests ("community interests") are not emphasized during an investigation. An investigation typically looks for damage caused by dumping to community producers, and the level of tariff set is based on the damage done to community producers by dumping.

If consensus is not found, the decision goes to the European Council.

If imposed, duties last for five years theoretically. In practice they last at least a year longer, because expiry reviews are usually initiated at the end of the five years, and during the review process the status-quo is maintained.

Chinese economic situation

The dumping investigation essentially compares domestic prices of the accused dumping nation with prices of the imported product on the European market. However, several rules are applied to the data before the dumping margin is calculated. Most contentious is the concept of "analogue market". Some exporting nations are not granted "Market Economy Status" by the EU: China is a prime example. In such cases, the DG Trade is prevented from using domestic prices as the fair measure of the domestic price. A particular exporting industry may also lose market status if the DG Trade concludes that this industry receives government assistance. Other tests applied include the application of international accounting standards and bankruptcy laws.

The consequences of not being granted market economy status have a big impact on the investigation. For example, if China is accused of dumping widgets, the basic approach is to consider the price of widgets in China against the price of Chinese widgets in Europe. But China does not have market economy status, so Chinese domestic prices can not be used as the reference. Instead, the DG Trade must decide upon an analogue market: a market which does have market economy status, and which is similar enough to China. Brazil and Mexico have been used, but the USA is a popular analogue market. In this case, the price of widgets in the USA is regarded as the substitute for the price of widgets in China. This process of choosing an analogue market is subject to the influence of the complainant, which has led to some criticism that it is an inherent bias in the process.

However,China is one of the countries that has the cheapest labourforce. Criticizims have argued that it is quite unreasonable to compare China's goods price to the USA's as analogue. China is now developing to a more free and open market, unlike its planned-economy in the early 60s, the market in China is more willing to embrace the global competition. It is thus required to improve its market regulations and conquer the free trade barriers to improve the situation and produce a properly judged pricing level to assess the "dumping" behavior.

Agricultural support and dumping

European Union and Common Agricultural Policy

The Common Agricultural Policy of the European Union has often been accused of dumping though significant reforms were made as part of the Agreement on Agriculture at the Uruguay round of GATT negotiations in 1992 and in subsequent incremental reforms, notably the Luxembourg Agreement in 2003. Initially the CAP sought to increase European agricultural production and provide support to European farmers through a process of market intervention whereby a special fund - the European Agricultural Guidance and Guarantee Fund (EAGGF) - would buy up surplus agricultural produce if the price fell below a certain centrally determined level (the intervention level). Through this measure European farmers were given a 'guaranteed' price for their produce when sold in the European community. In addition to this internal measure a system of export reimbursements ensured that European produce sold outside of the European community would sell at or below world prices at no detriment to the European producer. This policy was heavily criticized as distorting world trade and since 1992 the policy has moved away from market intervention and towards direct payments to farmers regardless of production (a process of "decoupling"). Furthermore the payments are generally dependent on the farmer fulfilling certain environmental or animal welfare requirements so as to encourage responsible, sustainable farming in what is termed 'multifunctional' agricultural subsidies - that is, the social, environmental and other benefits from subsidies that do not include a simple increase in production.

Multinational corporation

A **multinational corporation** (**MNC**) or **transnational corporation** (**TNC**), also called **multinational enterprise** (**MNE**) is a corporation or enterprise that manages production or delivers services in more than one country. It can also be referred to as an ***international corporation***.

The first modern MNC is generally thought to be the Poor Knights of Christ and the Temple of Solomon, first endorsed by the pope in 1129. The key element of transnational corporations was present even back then: the British East India Company and Dutch East India Company were operating in different countries than the ones where they had their headquarters. Nowadays many corporations have offices, branches or manufacturing plants in different countries than where their original and main headquarter is located. This is the very definition of a transnational corporation. Having multiple operation points that all respond to one headquarter.

This often results in very powerful corporations that have budgets that exceed some national GDPs. Multinational corporations can have a powerful influence in local economies as well as the world economy and play an important role in international relations and globalization. The presence of such powerful players in the world economy is reason for much controversy.

Market imperfections

It may seem strange that a corporation can decide to do business in a different country, where it doesn't know the laws, local customs or business practices. Why is it not more efficient to combine assets of value overseas with local factors of production at lower costs by renting or selling them to local investors?

One reason is that the use of the market for coordinating the behaviour of agents located in different countries is less efficient than coordinating them by a multinational enterprise as an institution. The additional costs caused by the entrance in foreign markets are of less interest for the local enterprise. According to Hymer, Kindleberger and Caves, the existence of MNEs is reasoned by structural market imperfections for final products. In Hymer's example, there are considered two firms as monopolists in their own market and isolated from competition by transportation costs and other tariff and non-tariff barriers. If these costs decrease, both are forced to competition; which will reduce their profits. The firms can maximize their joint income by a merger or acquisition which will lower the competition in the shared market. Due to the transformation of two separated companies into one MNE the pecuniary externalities are going to be internalized. However, this doesn't mean that there is an improvement for the society. This could also be the case if there are few substitutes or limited licenses in a foreign market. The consolidation is often established by acquisition, merger or the vertical integration of the potential licensee into overseas manufacturing. This makes it easy for the MNE to enforce price discrimination schemes in various countries. Therefore Humyer considered the emergence of multinational firms as "an (negative) instrument for restraining competition between firms of different nations".Market imperfections had been considered by Hymer as structural and caused by the deviations from perfect competition in the final product markets. Further reasons are originated from the control of proprietary technology and distribution systems, scale economies, privileged access to inputs and product differentiation. In the absence of these factors, market are fully efficient.The transaction costs theories of MNEs had been developed simultaneously and independently by McManus (1972), Buckley & Casson (1976), Brown (1976) and Hennart (1977, 1982). All these authors claimed that market imperfections are inherent conditions in markets and MNEs are institutions which try to bypass these imperfections. The imperfections in markets are natural as the neoclassical assumptions like full knowledge and enforcement don't exist in real markets.

International power

Tax competition

Multinational corporations have played an important role in globalization. Countries and sometimes subnational regions must compete against one another for the establishment of MNC facilities, and the subsequent tax revenue, employment, and economic activity. To compete, countries and regional political districts sometimes offer incentives to MNCs such as tax breaks, pledges of governmental assistance or improved infrastructure, or lax environmental and labor standards enforcement. This process of becoming more attractive to foreign investment can be characterized as a race to the bottom, a push towards greater autonomy for corporate bodies, or both.

However, some scholars for instance the Columbia economist Jagdish Bhagwati, have argued that multinationals are engaged in a 'race to the top.' While multinationals certainly regard a low tax burden or low labor costs as an element of comparative advantage, there is no evidence to suggest that MNCs deliberately avail themselves of lax environmental regulation or poor labour standards. As Bhagwati has pointed out, MNC profits are tied to operational efficiency, which includes a high degree of standardization. Thus, MNCs are likely to tailor production processes in all of their operations in conformity to those jurisdictions where they operate (which will almost always include one or more of the US, Japan or EU) which has the most rigorous standards. As for labor costs, while MNCs clearly pay workers in, e.g. Vietnam, much less than they would in the US (though it is worth noting that higher American productivity—linked to technology—means that any comparison is tricky, since in America the same company would probably hire far fewer people and automate whatever process they performed in Vietnam with manual labour), it is also the case that they tend to pay a premium of between 10% and 100% on local labor rates. Finally, depending on the nature of the MNC, investment in any country reflects a desire for a long-term return. Costs associated with establishing plant, training workers, etc., can be very high; once established in a jurisdiction, therefore, many MNCs are quite vulnerable to predatory practices such as, e.g., expropriation, sudden contract renegotiation, the arbitrary withdrawal or compulsory purchase of unnecessary 'licenses,' etc. Thus, both the negotiating power of MNCs and the supposed 'race to the bottom' may be overstated, while the substantial benefits which MNCs bring (tax revenues aside) are often understated.

Market withdrawal

Because of their size, multinationals can have a significant impact on government policy, primarily through the threat of market withdrawal.For example, in an effort to reduce health care costs, some countries have tried to force pharmaceutical companies to license their patented drugs to local competitors for a very low fee, thereby artificially lowering the price. When faced with that threat, multinational pharmaceutical firms have simply withdrawn from the market, which often leads to limited availability of advanced drugs. In these cases, governments have been forced to back down from their efforts. Similar corporate and government confrontations have occurred when governments tried to force MNCs to make their intellectual property public in an effort to gain technology for local entrepreneurs. When companies are faced with the option of losing a core competitive technological advantage or withdrawing from a national market, they may choose the latter. This withdrawal often causes governments to change policy. Countries that have been the most successful in this type of confrontation with multinational corporations are large countries such as United States and Brazil , which have viable indigenous market competitors.

Lobbying

Multinational corporate lobbying is directed at a range of business concerns, from tariff structures to environmental regulations. There is no unified multinational perspective on any of these issues. Companies that have invested heavily in pollution control mechanisms may lobby for very tough environmental standards in an effort to force non-compliant competitors into a weaker position. Corporations lobby tariffs to restrict competition of foreign industries. For every tariff category that one multinational wants to have reduced, there is another multinational that wants the tariff raised. Even within the U.S. auto industry, the fraction of a company's imported components will vary, so some firms favor tighter import restrictions, while others favor looser ones. Says Ely Oliveira, Manager Director of the MCT/IR: This is very serious and is very hard and takes a lot of work for the owner.

Multinational corporations such as Wal-mart and McDonald's benefit from government zoning laws, to create barriers to entry.

Many industries such as General Electric and Boeing lobby the government to receive subsidies to preserve their monopoly.

Patents

Many multinational corporations hold patents to prevent competitors from arising. For example, Adidas holds patents on shoe designs, Siemens A.G. holds many patents on equipment and infrastructure and Microsoft benefits from software patents The pharmaceutical companies lobby international agreements to enforce patent laws on others.

Government power

In addition to efforts by multinational corporations to affect governments, there is much government action intended to affect corporate behavior. The threat of nationalization (forcing a company to sell its local assets to the government or to other local nationals) or changes in local business laws and regulations can limit a multinational's power. These issues become of increasing importance because of the emergence of MNCs in developing countries.

Micro-multinationals

Enabled by Internet based communication tools, a new breed of multinational companies is growing in numbers."How startups go global". http://money.cnn.com/2006/06/28/magazines/business2/startupsgoglobal.biz2/index.htm. These multinationals start operating in different countries from the very early stages. These companies are being called micro-multinationals. What differentiates micro-multinationals from the large MNCs is the fact that they are small businesses. Some of these micro-multinationals, particularly software development companies, have been hiring employees in multiple countries from the beginning of the Internet era. But more and more micro-multinationals are actively starting to market their products and services in various countries. Internet tools like Google, Yahoo, MSN, Ebay and Amazon make it easier for the micro-multinationals to reach potential customers in other countries.

Service sector micro-multinationals, like Indigo Design & Engineering Associates Pvt. Ltd. Facebook, Alibaba etc. started as dispersed virtual businesses with employees, clients and resources located in various countries. Their rapid growth is a direct result of being able to use the internet, cheaper telephony and lower traveling costs to create unique business opportunities

Criticism of multinationals

The rapid rise of multinational corporations has been a topic of concern among intellectuals, activists and laypersons who have seen it as a threat of such basic civil rights as privacy. They have pointed out that multinationals create false needs in consumers and have had a long history of interference in the policies of sovereign nation states. Evidence supporting this belief includes invasive advertising (such as billboards, television ads, adware, spam, telemarketing, child-targeted advertising, guerilla marketing), massive corporate campaign contributions in democratic elections, and endless global news stories about corporate corruption (Martha Stewart and Enron, for example). Anti-corporate protesters suggest that corporations answer only to shareholders, giving human rights and other issues almost no consideration.[15] Films and books critical of multinationals include *Surplus: Terrorized into Being Consumers*, *The Corporation*, *The Shock Doctrine*, *Downsize This* and others.

World Trade Organization

Location of the WTO headquarters in Geneva

The **World Trade Organization** (**WTO**) is an international organization designed by its founders to supervise and liberalize international capital trade. The organization officially commenced on January 1, 1995 under the Marrakesh Agreement, replacing the General Agreements on Tariffs and Trade (GATT), which commenced in 1947. The World Trade Organization deals with regulation of trade between participating countries; it provides a framework for negotiating and formalising trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements which are signed by representatives of member governments and ratified by their parliaments. Most of the issues that the WTO focuses on derive from previous trade negotiations, especially from the Uruguay Round (1986-1994). The organization is currently endeavouring to persist with a trade negotiation called the Doha Development Agenda (or Doha Round), which was launched in 2001 to enhance equitable participation of poorer countries which represent a majority of the world's population. However, the negotiation has been dogged by "disagreement between exporters of agricultural bulk commodities and countries with large numbers of subsistence farmers on the precise terms of a 'special safeguard measure' to protect farmers from surges in imports. At this time, the future of the Doha Round is uncertain."

The WTO has 153 members,

representing more than 95% of total world trade and 30 bservers, most seeking membership. The WTO is governed by a ministerial conference, meeting every two years; a general council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a director-general, who is appointed by the ministerial conference. The WTO's headquarters is at the Centre William Rappard, Geneva, Switzerland.

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

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

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

GATT rounds of negotiations

General Agreement on Tariffs and Trade

The GATT was the only multilateral instrument governing international trade from 1948 until the WTO was established in 1995. Despite attempts in the mid 1950s and

1960s to create some form of institutional mechanism for international trade, the GATT continued to operate for almost half a century as a semi-institutionalized multilateral treaty regime on a provisional basis.

From Geneva to Tokyo

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

WTO Ministerial Conference of 2001

Was held in Doha In Persian Gulf nation of Qatar. The Doha Development Round was launched at the conference. The conference also approved the joining of China, which became the 143rd member to join.

Fifth ministerial conference

WTO Ministerial Conference of 2003

The ministerial conference was held in Cancún, Mexico, aiming at forging agreement on the Doha round. An alliance of 22 southern states, the G20 developing nations (led by India, China[22] and Brazil), resisted demands from the North for agreements on the so-called "Singapore issues" and called for an end to agricultural subsidies within the EU and the US. The talks broke down without progress.

Sixth ministerial conference

For more details on this topic, see WTO Ministerial Conference of 2005.

The sixth WTO ministerial conference was held in Hong Kong from 13 December – 18 December 2005. It was considered vital if the four-year-old Doha Development Agenda negotiations were to move forward sufficiently to conclude the round in 2006. In this meeting, countries agreed to phase out all their agricultural export subsidies by the end of 2013, and terminate any cotton export subsidies by the end of 2006. Further concessions to developing countries included an agreement to introduce duty free, tariff free access for goods from the Least Developed Countries, following the Everything But Arms initiative of the European Union — but with up to 3% of tariff lines exempted. Other major issues were left for further negotiation to be completed by the end of 2010

Seventh ministerial conference

The WTO General Council, on 26 May 2009, agreed to hold a seventh WTO ministerial conference session in Geneva from 30 November–December 2009. A statement by chairman Amb. Mario Matus acknowledged that the prime purpose was to remedy a breach of protocol requiring two-yearly "regular" meetings, which had lapsed with the Doha Round failure in 2005, and that the "scaled-down" meeting would not be a negotiating session, but "emphasis will be on transparency and open discussion rather than on small group processes and informal negotiating structures".

Functions

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

- It oversees the implementation, administration and operation of the covered agreements.
- It provides a forum for negotiations and for settling disputes. Additionally, it is the WTO's duty to review and propagate the national trade policies, and to ensure the coherence and transparency of trade policies through surveillance in global economic policy-making. Another priority of the WTO is the assistance of developing, least-developed and low-income countries in transition to adjust to WTO rules and disciplines through technical cooperation and training. The WTO is also a center of economic research and analysis: regular assessments of the global trade picture in its annual publications and research reports on specific topics are produced by the organization. Finally, the WTO cooperates closely with the two other components of the Bretton Woods system, the IMF and the World Bank.

Principles of the trading system

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

1. **Non-Discrimination**. It has two major components: the most favored nation (MFN) rule, and the national treatment policy. Both are embedded in the main WTO rules on goods, services, and intellectual property, but their precise scope and nature differ across these areas. The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO members, i.e. a WTO member has to grant the most favorable conditions under which it allows trade in a certain product type to all other WTO members. "Grant someone a special favor and you have to do the same for all other WTO members." National treatment means that imported and locally-produced goods should be treated equally (at least after the foreign goods have entered the market) and was introduced to tackle non-tariff barriers to trade (e.g. technical standards, security standards et al. discriminating against imported goods).

2. **Reciprocity**. It reflects both a desire to limit the scope of free-riding that may arise because of the MFN rule, and a desire to obtain better access to foreign markets. A related point is that for a nation to negotiate, it is necessary that the gain from doing so be greater than the gain available from unilateral liberalization; reciprocal concessions intend to ensure that such gains will materialize.
3. **Binding and enforceable commitments**. The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a schedule (list) of concessions. These schedules establish "ceiling bindings": a country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures.
4. **Transparency**. The WTO members are required to publish their trade regulations, to maintain institutions allowing for the review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO. These internal transparency requirements are supplemented and facilitated by periodic country-specific reports (trade policy reviews) through the Trade Policy Review Mechanism (TPRM). The WTO system tries also to improve predictability and stability, discouraging the use of quotas and other measures used to set limits on quantities of imports.
5. **Safety valves**. In specific circumstances, governments are able to restrict trade. There are three types of provisions in this direction: articles allowing for the use of trade measures to attain noneconomic objectives; articles aimed at ensuring "fair competition"; and provisions permitting intervention in trade for economic reasons. Exceptions to the MFN principle also allow for preferential treatment of developing countries, regional free trade areas and customs unions. There are 11 committees under the jurisdiction of the Goods Council each with a specific task. All members of the WTO participate in the committees. The Textiles Monitoring Body is separate from the other committees but still under the jurisdiction of Goods Council. The body has its own chairman and only ten members. The body also has several groups relating to textiles.

Council for Trade-Related Aspects of Intellectual Property Rights

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

Council for Trade in Services

The Council for Trade in Services operates under the guidance of the General Council and is responsible for overseeing the functioning of the General Agreement on Trade in Services (GATS). It is open to all WTO members, and can create subsidiary bodies as required. The Service Council has three subsidiary bodies: financial services, domestic regulations, GATS rules and specific commitments.

Other committees

The General council has several different committees, working groups, and working parties.

Committees on

- Trade and Environment
- Trade and Development (Subcommittee on Least-Developed Countries)
- Regional Trade Agreements
- Balance of Payments Restrictions
- Budget, Finance and Administration

Working parties on

- Accession

Working groups on

- Trade, debt and finance
- Trade and technology transfer

Trade Negotiations Committee

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

Voting system

The WTO operates on a *one country, one vote* system, but actual votes have never been taken. Decision making is generally by consensus, and relative market size is the primary source of bargaining power. The advantage of consensus decision-making is that it encourages efforts to find the most widely acceptable decision. Main disadvantages include large time requirements and many rounds of negotiation to develop a consensus decision, and the tendency for final agreements to use ambiguous language on contentious points that makes future interpretation of treaties difficult.

In reality, WTO negotiations proceed not by consensus of all members, but by a process of informal negotiations between small groups of countries. Such negotiations are often called "Green Room" negotiations (after the colour of the WTO Director-General's Office in Geneva), or "Mini-Ministerials", when they occur in other countries. These processes have been regularly criticised by many of the WTO's developing country members which are often totally excluded from the negotiations.

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

Dispute settlement

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

The operation of the WTO dispute settlement process involves the DSB panels, the Appellate Body, the WTO Secretariat, arbitrators, independent experts and several specialized institution·

Accession and membership

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

Members and observers

The WTO has 153 members (almost all of the 123 nations participating in the Uruguay Round signed on at its foundation, and the rest had to get membership).The 27 states of the European Union are represented also as the European Communities. WTO members do not have to be full sovereign nation-members. Instead, they must be a customs territory with full autonomy in the conduct of their external commercial relations. Thus Hong Kong (as "Hong Kong, China" since 1997) became a GATT contracting party, and the Republic of China (ROC) (commonly known as Taiwan, whose sovereignty has been disputed by the People's Republic of China) acceded to the WTO in 2002 under the name of "Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu" (Chinese Taipei). A number of non-members (30) are observers at WTO proceedings and are currently negotiating their membership. As observers, Iran, Iraq and Russia are not yet members. With the exception of the Holy See, observers must start accession negotiations within five years of becoming observers. Some international intergovernmental organizations are also granted observer status to WTO bodies. 14 states and 2 territories so far have no official interaction with the WTO.

Agreements

The WTO oversees about 60 different agreements which have the status of international legal texts. Member countries must sign and ratify all WTO agreements on accession

Some of the important agreements

- **Agreement on Agriculture (AoA)**

The Agreement on Agriculture came into effect with the establishment of the WTO at the beginning of 1995. The AoA has three central concepts, or "pillars": domestic support, market access and export subsidies.

- **General Agreement on Trade in Services (GATS)**

The General Agreement on Trade in Services was created to extend the multilateral trading system to service sector, in the same way the General Agreement on Tariffs and Trade (GATT) provides such a system for merchandise trade. The Agreement entered into force in January 1995

- **Trade-Related Aspects of Intellectual Property Rights Agreement (TRIPs)**

The Agreement on Trade-Related Aspects of Intellectual Property Rights sets down minimum standards for many forms of intellectual property (IP) regulation. It was negotiated at the end of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in 1994.

- **Sanitary and Phyto-Sanitary (SPS) Agreement**

The Agreement on the Application of Sanitary and Phytosanitary Measures - also known as the SPS Agreement was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the beginning of 1995.

Under the SPS agreement, the WTO sets constraints on members' policies relating to food safety (bacterial contaminants, pesticides, inspection and labelling) as well as animal and plant health (imported pests and diseases).

- **Agreement on Technical Barriers to Trade (TBT)**

The Agreement on Technical Barriers to Trade is an international treaty of the World Trade Organization. It was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the end of 1994.

The object ensures that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade".

Criticism The stated aim of the WTO is to promote free trade and stimulate economic growth. Critics argue that free trade leads to a divergence instead of convergence of income levels within rich and poor countries (the rich get richer and the poor get poorer) .Martin Khor, Director of the Third World Network, argues that the WTO does not manage the global economy impartially, but in its operation has a systematic bias toward rich countries and multinational corporations, harming smaller countries which have less negotiation power. He argues that developing countries have not benefited from the WTO agreements of the Uruguay Round because, among other reasons, market access in industry has not improved; these countries have had no gains yet from the phasing-out of textile quotas; non-tariff barriers such as anti-dumping measures have increased; and domestic support and export subsidies for agricultural products in the rich countries remain high. Jagdish Bhagwati asserts, however, that there is greater tariff protection on manufacturers in the poor countries, which are also overtaking the rich nations in the number of anti-dumping filings.

Other critics claim that the issues of labor relations and environment are steadfastly ignored. Steve Charnovitz, former director of the Global Environment and Trade Study (GETS), believes that the WTO "should begin to address the link between trade and labor and environmental concerns." Further, labor unions condemn the labor rights record of developing countries, arguing that, to the extent the WTO succeeds at promoting globalization, the environment and labor rights suffer in equal measure On the other side, Khor responds that "if environment and labor were to enter the WTO system [...] it would be conceptually difficult to argue why other social and cultural issues should also not enter."Bhagwati is also critical towards "rich-country lobbies seeking on imposing their unrelated agendas on trade agreements." Therefore, both Bhagwati and Arvind Panagariya of Columbia University, have criticized the introduction of TRIPs into the WTO framework, fearing that such non-trade agendas might overwhelm the organization's function.

Other critics have characterized the decision making in the WTO as complicated, ineffective, unrepresentative and non-inclusive, and they have proposed the establishment of a small, informal steering committee (a "consultative board") that can be delegated responsibility for developing consensus on trade issues among the member countries.The Third World Network has called the WTO "the most non-transparent of international organisations", because "the vast majority of developing countries have very little real say in the WTO system"; the Network stresses that "civil society groups and institutions must be given genuine opportunities to express their views and to influence the outcome of policies and decisions."Certain non-governmental organizations, such as the World Federalist Movement, argue that democratic participation in the WTO could be enhanced through the creation of a parliamentary assembly, although other analysts have characterized this proposal as ineffective.Some libertarians and small-government conservatives, as well as think tanks such as the Ludwig von Mises Institute, oppose the World Trade Organization, seeing it as a bureaucratic and anti-capitalistic organization not promoting free trade, but political interventionism. The chairman of the Ludwig von Mises Institute, Llewellyn H Rockwell Jr, argued that

. . . the World Trade Organization says that the US must stop permitting US exporters to set up foreign subsidiaries that save as much as 30 percent in taxes they would otherwise pay. Now the US must either raise taxes by eliminating loopholes or face massive new sanctions that will seriously harm our export sector. [...] There's been a lot of talk recently about foreigners who hate our prosperity and civilization, and seek ways to inflict violence in retaliation. Well, here's another case in point, except these are not swarthy Islamic terrorists; they are diplomats and statesmen on nobody's list of suspicious characters.

References

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- McKenzie, Lionel W. (1954). "Specialization and Efficiency in World Production". *The Review of Economic Studies* **21** (3): 165–180.
- Samuelson, Paul (2001). "A Ricardo-Sraffa Paradigm Comparing the Gains from Trade in Inputs and Finished Goods". *Journal of Economic Literature* **39** (4): 1204–1214.

Course Name	: Marketing Principles

Course Description
The Course details the evolution and various concepts of Marketing principles, customer relationship Management, marketing ethics, account based marketing , marketing effectiveness, marketing mix, market research, brand management, sales promotion and competitive advertising in marketing.

Course Objectives
- To demonstrate a valid understanding of the principles and functions of marketing to students.
- To help students develop a better comparison between service & product marketing.
- To enable students in encountering with various marketing tools relevant for current market demands.
- To further help in promoting student's interest in marketing as a career in areas such as sales, retailing, advertising and physical distribution.

Course Content
Introduction Marketing
- Meaning of Marketing
- Evolution of Marketing
- Earlier approaches of marketing
- Contemporary approaches
- Principles of Marketing
- Market research
- Types of marketing research
- Service Marketing

Customer Relationship Management (CRM)
- Meaning of CRM
- Benefits of customer relationship management
- Types/variations of CRM
- Challenges of CRM

Marketing ethics
- Definition of marketing ethics
- Fundamental issues in the ethics of marketing
- Is marketing inherently evil
- Specific issues in marketing ethics
- Pricing ethics
- The use of as a marketing tactic
- Further issues in marketing ethics

Account-based Marketing
- Meaning of account- based marketing
- Overview of ABM
- Background and differences with traditional marketing
- The roles of sales and marketing teams
- Account-based marketing and the IT industry

- ABM programs frameworks

Marketing Effectiveness

- Meaning of Marketing effectiveness
- Dimensions of marketing effectiveness
- Factors driving the level of marketing effectiveness

Marketing Mix

- Origin of marketing mix
- Elements of the marketing mix
- Formal approach to customer-focused marketing mix

Market research

- Definition of market research
- History of market research
- Market research for business/planning
- Using segmentation in Customer Retention
- Process for tagging customers

Brand Management

- Meaning and application of brand management
- Principles of brand management
- Types of brands
- Functions of brands
- Brand architecture
- Online brand management

Advertising

- Meaning of advertising
- Types of advertising
- Criticism of advertising
- Advertising research

Sales Promotion

- Meaning of sales promotion
- Customer sales promotion techniques
- Trade sales promotion techniques
- Political issues in sales promotion
- The sales and marketing relationship
- Sales and marketing alignment and integration

Other related topics

- Marketing performance measurement and management
- Marketing strategy
- Marketing plan

Mode of delivery Face to face lectures

Assessment
Coursework 40%
Exams 60%
Total Mark 100%

MARKETING PRINCIPLES

Marketing mix" is a term that was first coined in the early 1950s by the president of the American Marketing Association during his address to the membership. About seven years later, another marketer proposed the concept of the 4Ps to provide a way to categorize the elements of an optimal marketing mix..

The 4Ps of the marketing mix are *product, price, place* and *promotion*. Each of these elements plays an important role in an effective marketing plan

The first P stands for **Product**which most often refers to the physical entity being sold. However, a product can also be a service, which does not have physical characteristics. Several elements play into creating a product to sell, including a name, quality, safety, packaging, service and support plans, and product extensions such as accessories or incremental services.Whether a product is a physical item or some sort of intangible service, it has a life cycle, or product life cycle (PLC).

The second P is for**Price**which is just what it sounds like the amount of money that is charged for someone to purchase the product. Some of the more common pricing strategies employed by marketers include bundling, providing a suggested retail price, providing volume discounts, and creating special pricing or sales. A number of different factors come into play when determining price, and they include; Competition; Cost of goods (what it costs to bring the product to market); Perceived value and Customer demand. An excellent example of customer demand's impact on pricing occurs when a new technology for a gaming system is introduced and people wait in line for hours to purchase the system and are willing to pay a premium price just to be one of the first to own the system.

The third P stands for**Place**which refers to how a product is distributed. It can also be referred to as a distribution channel and may include a physical store location, a catalog warehouse and distribution network, or an online store. In addition to being the location where a product can be acquired, place can also refer to inventory management, shipping or freight, order processing, and a plan to process returns.

Promotion is the last of the 4Ps and can have its own mix of tactics. Some examples of promotional tactics include advertising; Product sweepstakes or sales promotions; Personal selling and Public relations. Promotion can also entail some combining of the other components of the marketing mix as well depending upon the strategy. For example, advertisements feature product and price and often drive a customer to a certain location, or place, to make the purchase.

The Marketing mix is a set of four decisions which need to be taken before launching any new product. These variables are also known as the **4 P’s of marketing**.

These variables are never constant and may be changed over time. However, a change in one of the variables may cause a change in all the other variables as well. The variables are as follows

Product is the first thing you need, if you want to start a business, therefore Product is also the first variable in the marketing mix. Product decisions are the first decisions you need to take before making any marketing plan. A product can be divided into three parts. The core productthe augmented product and the tertiary product.Based on the decision made will in turn affect the other variables of the marketing mix. For example if you launch a car with is to have the highest quality. Thus the pricing, promotions and placing would have to be altered accordingly. Thus as long as you don’t know your product, you cannot decide any other variable of the marketing mix. However, if the product features are not fitting in the marketing mix, you can alter the product such that it finds a place for itself in the marketing mix.

Pricing of a product depends on a lot of different variables and hence it is constantly updated. Major consideration in pricing is the costing of the product, the advertising and marketing expenses, any price fluctuations in the market, distribution costs etc. Many of these factors can change separately. Thus the pricing has to be such that it can bear the brunt of changes for a certain period of time. However, if all these variables change, then the pricing of a product has to be increased and decreased accordingly.Along with the above factors, there are also other things which have to be taken in consideration when deciding on a pricing strategy. Competition can be the best example. Similarly, pricing also affects the targeting and positioning of a product. Pricing is used for sales promotions in the form of trade discounts.

Place is refers to the distribution channel of a product. If a product is a consumer product, it needs to be available as far and wide as possible. On the other hand, if the product is a*Premiumconsumer product*, it will be available only in select stores. Similarly, if the product is a business product, you need a team who interacts with businesses and makes the product available to them. Thus the place where the product is distributed depends on the product and pricing decisions. Distribution has a huge affect on the profitability of a product. Consider a company which has national distribution for its product. An increase in petrol rates will in fact bring

about drastic changes in the profitability of the company. Thus supply chain and logistics decisions are considered as very important costing decisions of the firm.
Promotionwhich is the last P in the marketing mix includes the complete integrated marketing communications which in turn includes advertising as well as sales promotions. Promotions are dependent a lot on the product and pricing decision. What is the budget for marketing and advertising? What stage is the product in? If the product is completely new in the market, it needs brand / product awareness promotions, whereas if the product is already existing then it will need brand recall promotions.Promotions also decide the segmentation targeting and positioning of the product. The right kind of promotions affect all the other three variables the product, price and place. If the promotions are effective, you might have to increase distribution points, you might get to increase the price because of the rising brand equity of the product, and the profitability might support you in launching even more products. Promotion is considered as marketing expenses and the same needs to be taken in consideration while deciding the costing of the product.
Thus as we see from the above explanations, all the four variables of marketing mix are inter related and affect each other. By increasing the pricing of the product, demand of the product might lessen, and lesser distribution points might be needed. Finally, the overall marketing mix can result in your customer base asking for some improvement in the product, and the same can be launched as the upgraded product.

DISCRIMINATION

Discrimination in simple words refers to treating different individuals or groups of people differently. In the same way in economics, price discrimination refers to charging different prices from different individual or groups of people for the same goods or services. Price discrimination can be done in monopoly where the seller of goods has the power of deciding the price of good or service.The purpose of price discrimination is generally to capture the market's consumer surplus. This surplus arises because, in a market with a single clearing price, some customers (the very low price elasticity segment) would have been prepared to pay more than the single market price. Price discrimination transfers some of this surplus from the consumer to the producer/marketer. On the other hand Market segmentation is a marketing strategy that involves dividing a broad target market into subsets of consumers who have common needs and applications for the relevant goods and services. Depending on the specific characteristics of the product, these subsets may be divided by criteria such as age and gender, or other distinctions, like location or income. Marketing campaigns can then be designed and implemented to target these specific customer segments.Market segmentation is the identification of portions of the market that are different from one another. Segmentation allows the firm to better satisfy the needs of its potential customers.

Market Trend

A market trend is a putative tendency of a financial market to move in a particular direction over time. These trends are classified as *secular* for long time frames, *primary* for medium time frames, and *secondary* for short time frames. The basic techniques of market trends include:

- Customer analysis
- Choice modeling
- Competitor’s analysis
- Risks analysis

- Product research
- Advertising the research
- Marketing mix modeling

Advertising

Advertising or advertizingis a form of communication used to encourage or persuade an audience (viewers, readers or listeners; sometimes a specific group of people) to continue or take some new action. Most commonly, the desired result is to drive consumer behavior with respect to a commercial offering, although political and ideological advertising is also common. The purpose of advertising may also be to reassure employees or shareholders that a company is viable or successful. Commercial advertisers often seek to generate increased consumption of their products or services through "branding," which involves the repetition of an image or product name in an effort to associate certain qualities with the brand in the minds of consumers. Non-commercial advertisers who spend money to advertise items other than a consumer product or service include political parties, interest groups, religious organizations and governmental agencies.

Advertising as described above has many different types as can be seen below:

Television advertising: The TV commercial is generally considered the most effective mass-market advertising format, as is reflected by the high prices TV networks charge for commercial airtime during popular TV events.). The majorities of television commercials feature a song or jingle that listeners soon relate to the product. Virtual advertisements may be inserted into regular television programming through computer graphics. It is typically inserted into otherwise blank backdropsor used to replace local billboards that are not relevant to the remote broadcast audience.

Infomercials Advertising: An infomercial is a long-format television commercial, typically five minutes or longer. The word "infomercial" is a portmanteau of the words "information" & "commercial". The main objective in an infomercial is to create an impulse purchase, so that the consumer sees the presentation and then immediately buys the product through the advertised toll-free telephone number or website. Infomercials describe, display, and often demonstrate products and their features, and commonly have testimonials from consumers and industry professionals.

Radio advertising: Radio advertising is a form of advertising via the medium of radio. Radio advertisements are broadcast as radio waves to the air from a transmitter to an antenna and a thus to a receiving device. Airtime is purchased from a station or network in exchange for airing the commercials. While radio has the limitation of being restricted to sound, proponents of radio advertising often cite this as an advantage. Radio is an expanding medium that can be found not only on air, but also online.

Online advertising: Online advertising is a form of promotion that uses the Internet and World Wide Web for the expressed purpose of delivering marketing messages to attract customers. Examples of online advertising include contextual ads that appear on search engine results pages, banner ads, in text ads, Rich Media Ads, Social network advertising and many others.

Covert advertising, also known as guerrilla advertising, is when a product or brand is embedded in entertainment and media. For example, in a film, the main character can use an item or other of a definite brand, as in the movie *Minority Report*, where Tom Cruise's character John Anderton owns a phone with the *Nokia* logo clearly written in the top corner, or his watch engraved with the *Bulgari* logo.

Press advertising: Press advertising describes advertising in a printed medium such as a newspaper, magazine, or trade journal. This encompasses everything from media with a very broad readership base, such as a major national newspaper or magazine, to more narrowly targeted media such as local newspapers and trade journals on very specialized topics. A form of press advertising is classified advertising, which allows private individuals or companies to purchase a small, narrowly targeted ad for a low fee advertising a product or service.
Billboards advertising: Billboards are large structures located in public places which display advertisements to passing pedestrians and motorists. Most often, they are located on main roads with a large amount of passing motor and pedestrian traffic; however, they can be placed in any location with large amounts of viewers, such as on mass transit vehicles and in stations, in shopping walls or office buildings, and in stadiums.
Mobile billboard advertising: Mobile billboards are generally vehicle mounted billboards or digital screens. These can be on dedicated vehicles built solely for carrying advertisements along routes preselected by clients, they can also be specially equipped cargo trucks or, in some cases, large banners strewn from planes. The billboards are often lighted; some being backlit, and others employing spotlights. Some billboard displays are static, while others change; for example, continuously or periodically rotating among a set of advertisements.
In-store advertising: In-store advertising is any advertisement placed in a retail store. It includes placement of a product in visible locations in a store, such as at eye level, at the ends of aisles and near checkout counters (Point Of Purchase display), eye-catching displays promoting a specific product, and advertisements in such places as shopping carts and in-store video displays.
Coffee cup advertising: Coffee cup advertising is any advertisement placed upon a coffee cup that is distributed out of an office, café, or drive-through coffee shop. This form of advertising was first popularized in Australia, and has begun growing in popularity in the United States, India, and parts of the Middle East.
Street advertising: This type of advertising first came to prominence in the UK by Street Advertising Services to create outdoor advertising on street furniture and pavements.
Sheltered Outdoor Advertising: This type of advertising opens the possibility of combining outdoor with indoor advertisement by placing large mobile, structures (tents) in public places on temporary bases. The large outer advertising space exerts a strong pull on the observe; the product is promoted indoor, where the creative decor can intensify the impression.
Celebrity branding: This type of advertising focuses upon using celebrity power, fame, money, popularity to gain recognition for their products and promote specific stores or products. Advertisers often advertise their products, for example, when celebrities share their favorite products or wear clothes by specific brands or designers. Celebrities are often involved in advertising campaigns such as television or print adverts to advertise specific or general products. For example the Samsung company uses Drogba, Essien and Mikel Obi (Chelsea players) to advertise their air conditioner.
Marketing strategy
Marketing strategy is a process that can allow an organization to concentrate its limited resources on the greatest opportunities to increase sales and achieve a sustainable competitive advantage. A marketing strategy should be centered around

the key concept that customer satisfaction is the main goal. Key part of the general corporate strategy

Marketing strategy is a method of focusing an organization's energies and resources on a course of action which can lead to increased sales and dominance of a targeted market niche. A marketing strategy combines product development, promotion, distribution, pricing, relationship management and other elements; identifies the firm's marketing goals, and explains how they will be achieved, ideally within a stated timeframe. Marketing strategy determines the choice of target market segments, positioning, marketing mix, and allocation of resources. It is most effective when it is an integral component of overall firm strategy, defining how the organization will successfully engage customers, prospects, and competitors in the market arena. Corporate strategies, corporate missions, and corporate goals. As the customer constitutes the source of a company's revenue, marketing strategy is closely linked with sales. A key component of marketing strategy is often to keep marketing in line with a company's overarching mission statement[4]. Basic theory: 1. Target Audience 2. Proposition / Key Element 3. Implementation Tactics and actions A marketing strategy can serve as the foundation of a marketing plan. A marketing plan contains a set of specific actions required to successfully implement a marketing strategy. For example: "Use a low cost product to attract consumers. Once our organization, via our low cost product, has established a relationship with consumers, our organization will sell additional, higher-margin products and services that enhance the consumer's interaction with the low-cost product or service." A strategy consists of a well thought out series of tactics to make a marketing plan more effective. Marketing strategies serve as the fundamental underpinning of marketing plans designed to fill market needs and reach marketing objectives[5]. Plans and objectives are generally tested for measurable results.

A marketing strategy often integrates an organization's marketing goals, policies, and action sequences (tactics) into a cohesive whole. Similarly, the various strands of the strategy , which might include advertising, channel marketing, internet marketing, promotion and public relations can be orchestrated. Many companies cascade a strategy throughout an organization, by creating strategy tactics that then become strategy goals for the next level or group. Each one group is expected to take that strategy goal and develop a set of tactics to achieve that goal. This is why it is important to make each strategy goal measurable. Marketing strategies are dynamic and interactive. They are partially planned and partially unplanned. See strategy dynamics. Types of strategies Marketing strategies may differ depending on the unique situation of the individual business. However there are a number of ways of categorizing some generic strategies. A brief description of the most common categorizing schemes is presented below: Strategies based on market dominance - In this scheme, firms are classified based on their market share or dominance of an industry. Typically there are four types of market dominance strategies: o Leader o Challenger o Follower o Nicher Porter generic strategies - strategy on the dimensions of strategic scope and strategic strength. Strategic scope refers to the market penetration while strategic strength refers to the firm‘s sustainable competitive advantage. The generic strategy framework (porter 1984) comprises two alternatives each with two alternative scopes. These are Differentiation and low-cost leadership each with a dimension of Focus-broad or narrow. o Product differentiation o Market segmentation Innovation strategies - This deals with the firm's rate of the new product development and business model innovation. It asks whether the company is on the cutting edge of technology and business innovation. There are three types: o Pioneers o Close followers o Late followers Growth strategies - In this scheme we ask the question, ―How should the firm grow?‖. There are a number of different ways of answering that question, but the most common gives four answers: o Horizontal integration o Vertical integration o Diversification o Intensification A more detailed scheme uses the categories [6]:

 Prospector
 Analyzer
 Defender
 Reactor
 Marketing warfare strategies - This scheme draws parallels between marketing strategies and military strategies. Strategic models Marketing participants often employ strategic models and tools to analyze marketing decisions. When beginning a strategic analysis, the 3Cs can be employed to get a broad understanding of the strategic environment. An Ansoff Matrix is also often used to convey an organization's strategic positioning of their marketing mix. The 4Ps can then be utilized to form a marketing plan to pursue a defined strategy. Marketing in Practice - The Kid The Consumer-Centric Business There are a many companies especially those in the Consumer Package Goods (CPG) market that adopt the theory of running their business centered around Consumer, Shopper & Retailer needs. Their Marketing departments spend quality time looking for "Growth Opportunities" in their categories by identifying relevant insights (both mindsets and behaviors) on their target Consumers, Shoppers and retail partners. These Growth Opportunities emerge from changes in market trends, segment dynamics changing and also internal brand or operational business challenges.The Marketing team can then prioritize these Growth Opportunities and begin to develop strategies to exploit the opportunities that could include new or adapted products, services as well as changes to the 7Ps. Real-life marketing primarily revolves around the application of a great deal of common-sense; dealing with a limited number of factors, in an environment of imperfect information and limited resources complicated by uncertainty and tight timescales. Use of classical marketing techniques, in these circumstances, is inevitably partial and uneven. Thus, for example, many new products will emerge from irrational processes and the rational development process may be used (if at all) to screen out the worst non-runners. The design of the advertising, and the packaging, will be the output of the creative minds employed; which management will then screen, often by 'gut-reaction', to ensure that it is reasonable. For most of their time, marketing managers use intuition and experience to analyze and handle the complex, and unique, situations being faced; without easy reference to theory. This will often be 'flying by the seat of the pants', or 'gut-reaction'; where the overall strategy, coupled with the knowledge of the customer which has been absorbed almost by a process of osmosis, will determine the quality of the marketing employed. This, almost instinctive management, is what is sometimes called 'coarse marketing'; to distinguish it from the refined, aesthetically pleasing, form favored by the theorists.

The four main fields of the Marketing mix. The marketing mix is generally accepted as the use and specification of the 'four Ps' describing the strategy position of a product in the marketplace. The 'marketing mix' is a set of controllable, tactical marketing tools that work together to achieve company's objectives. One version of the marketing mix originated in 1948 when James Culliton said that a marketing decision should be a result of something similar to a recipe. This version was used in 1953 when Neil Borden, in his American Marketing Association presidential address, took the recipe idea one step further and coined the term "marketing-mix". A prominent marketer, E. Jerome McCarthy, proposed a 4 P classification in 1960, which has seen wide use. The four Ps concept is explained in most marketing textbooks and classes. Four Ps Elements of the marketing mix are often referred to as 'the four Ps': Product - A tangible object or an intangible service that is mass produced or manufactured on a large scale with a specific volume of units. Intangible products are often service based like the tourism industry & the hotel industry or codes-based products like cellphone load and credits. Typical examples of a mass produced tangible object are the motor car and the disposable razor. A less obvious but ubiquitous mass produced service is a computer operating system. Price – The price is the amount a customer pays for the product. It is determined by a number of factors including market share, competition, material costs, product identity and the customer's perceived value of the product. The business may increase or decrease the price of product if other stores have the same product. Place – Place represents the location where a product can be purchased. It is often referred to as the distribution channel. It can include any physical store as well as virtual stores on the Internet. ' – Promotion represents all of the communications that a marketer may use in the marketplace. Promotion has four distinct elements - advertising, public relations, word of mouth and point of sale. A certain amount of crossover occurs when promotion uses the four principal elements together, which is common in film promotion. Advertising covers any communication that is paid for, from cinema commercials, radio and Internet adverts through print media and billboards. Public relations are where the communication is not directly paid for and includes press releases, sponsorship deals, exhibitions, conferences, seminars or trade fairs and events. Word of mouth is any apparently informal communication about the product by ordinary individuals, satisfied customers or people specifically engaged to create word of mouth momentum. Sales staff often plays an important role in word of mouth and Public Relations (see Product above). Broadly defined, optimizing the marketing mix is the primary responsibility of marketing. By offering the product with the right combination of the four Ps marketers can improve their results and marketing effectiveness. Making small changes in the marketing mix is typically considered to be a tactical change.Parm Bains says Making large changes in any of the four Ps can be considered strategic. For example, a large change in the price, say from $19.00 to $39.00 would be considered a strategic change in the position of the product. However a change of $130 to $129.99 would be considered a tactical change, potentially related to a promotional offer. The term 'marketing mix' however, does not imply that the 4P elements represent options. They are not trade-offs but are fundamental marketing issues that always need to be addressed. They are the fundamental actions that marketing requires whether determined explicitly or by default. [edit] Extended marketing mix There have been attempts to develop an 'extended marketing mix' to better accommodate specific aspects of marketing. For example, in the 1970s, Nickels and Jolson suggested the inclusion of packaging. In the 1980s Kotler proposed public opinion and political power and Booms and Bitner included three additional 'Ps' to accommodate trends towards a service or knowledge based economy: People – all people who directly or indirectly influence the perceived value of the product or service, including knowledge workers, employees, management and consumers. Process – procedures, mechanisms and flow of activities which lead to an exchange of value. Physical evidence – the direct sensory experience of a product or service that allows a customer to measure whether he or she has received value. Examples might include the way a customer is treated by a staff member, or the length of time a customer has to wait, or a cover letter from an insurance company, or the environment in which a product or service is delivered.

Four Cs

The Four Ps is also being replaced by the Four Cs model, consisting of consumer, cost, convenience, and communication. The Four Cs model is more consumer-oriented and fits better in the movement from mass marketing to niche marketing.[4][5] The product part of the Four Ps model is replaced by consumer or consumer models, shifting the focus to satisfying the consumer. Another C replacement for Product is Capability. By defining offerings as individual capabilities that when combined and focused to a specific industry, creates a custom solution rather than pigeon-holing a customer into a product. Pricing is replaced by cost, reflecting the reality of the total cost of ownership. Many factors affect cost, including but not limited to the customers cost to change or implement the new product or service and the customers cost for not selecting a competitors capability. Placement is replaced by the convenience function. With the rise of internet and hybrid models of purchasing, place is no longer relevant. Convenience takes into account the ease to buy a product, find a product, find information about a product, and several other considerations. Finally, the promotions feature is replaced by communication. Communications represents a broader focus than simply promotions. Communications can include advertising, public relations, personal selling, viral advertising, and any form of communication between the firm and the consumer.[6]

[edit] Four Cs in 7Cs compass model

A formal approach to this customer-focused marketing mix is known as 4C(Commodity, Cost, Channel, Communication) in 7Cs compass model. This system is basically the four Ps[7] renamed and reworded to provide a customer focus. The four Cs Model provides a demand/customer centric version alternative to the well-known four Ps supply side model (product, price, place, promotion) of marketing management. o Product→ Commodity o Price → Cost o Place → Channel o Promotion→ Communication The four elements of the 7Cs compass model are: 1.Commodity: the product for the consumers or citizens. 2.Cost: total marketing cost. 3.Channel: marketing channels. 4.Communication: not promotion, marketing communication. 7Cs Compass Model is in a customer oriented marketing mix. Framework of 7Cs compass model[8][9] 7Cs:(C1)Corporation (and Competitor), (C2)Commodity, (C3)Cost, (C4)Communication, (C5)Channel, (C6)Consumer, (C7)Circumstances Compass: o to Consumer: N = Needs, W = Wants, S = Security, E = Education o Circumstances: N = National and International, W=Weather, S = Social and Cultural, E = Economic (C1) Corporation(and competitor) is the core of 4Cs. 1) It is necessary to place more emphases on the organization of the companies; 2) It is necessary to execute marketing plans in conjunction with the company's objectives; 3) It is necessary to tackle the internal communication related problems like corporate communication or corporate identity system(CIS), etc. In the market, there are the companies of the same business, the competitors. But at the time of economics downturn, companies or corporations produce the convenient (C2)―commodities‖ for the consumers or citizens with the consideration of the total marketing(C3) ―cost‖, and first of all gain their consents through the sufficient (C5)―communications‖ and then their confidences by selecting the effective(C4) ―channels‖ in conjunction with the uncontrollable external circumstances. This is the way to survive in the period of low growth economics. (C6) Consumer Consumers are those people encircling the companies. Instead of just the customers of 4P marketing model, they are the ordinary citizens nurtured by the motto of the consumerism. However of course they are also including the customers and the potential customers. four directions marked on the compass: the factors related to the consumer can be explained by the first characters of four directions marked on the Compass.(N,W,S,E) N = Needs: companies can offer more alternatives to meet the various needs of the consumers. W = Wants: the substantiated needs to expect the accordingly commodities. S = Security: the safety of the commodities, the safety of the production process and the adequate after-sell warranty. E = Education: consumer right to know the information of the commodities.

(C7)Circumstances Besides the customers, there are also various uncontrollable external environmental factors encircling the companies. The same as the factors of the consumers, they can also be explained the first character of the four directions marked on the compass. (N,W,S,E) N= National and International Circumstances The National Circumstances are related to politic and law. International environment now also becomes important. W=Weather For most of the natural disasters, the companies can do little but try to predict when they will happen and adjust the marketing plans. S=Social and Cultural Circumstances When exploring a new oversea market, it is essential to study the social circumstances of that nation. E=Economic Circumstances: economics climate is changing due to many other uncontrollable factors like energy, resources, international income and expense, financial circumstances and economic growth etc. [edit] References

Strategic management

Strategic management Strategic management Strategic management Strategic managementStrategic managementStrategic management From Wikipedia, the free encyclopedia Jump to: navigation, search

This article may need to be rewritten entirely to comply with Wikipedia's quality standards. You can help. The discussion page may contain suggestions. (March 2009) Strategic or institutional management is the conduct of drafting, implementing and evaluating cross-functional decisions that will enable an organization to achieve its long-term objectives.[1] It is the process of specifying the organization's mission, vision and objectives, developing policies and plans, often in terms of projects and programs, which are designed to achieve these objectives, and then allocating resources to implement the policies and plans, projects and programs. A balanced scorecard is often used to evaluate the overall performance of the business and its progress towards objectives. Strategic management is a level of managerial activity under setting goals and over Tactics. Strategic management provides overall direction to the enterprise and is closely related to the field of Organization Studies. In the field of business administration it is useful to talk about "strategic alignment" between the organization and its environment or "strategic consistency". According to Arieu (2007), "there is strategic consistency when the actions of an organization are consistent with the expectations of management, and these in turn are with the market and the context." ―Strategic management is an ongoing process that evaluates and controls the business and the industries in which the company is involved; assesses its competitors and sets goals and strategies to meet all existing and potential competitors; and then reassesses each strategy annually or quarterly [i.e. regularly] to determine how it has been implemented and whether it has succeeded or needs replacement by a new strategy to meet changed circumstances, new technology, new competitors, a new economic environment., or a new social, financial, or political environment.‖]

A price tag for a product on sale.

A sale is the pinnacle activity involved in selling products or services in return for money or other compensation. It is an act of completion of a commercial activity.[1] A sale is completed by the seller, the owner of the goods. It starts with consent (or agreement) to an acquisition or appropriation or request followed by the passing of title (property or ownership) in the item and the application and due settlement of a price, the douche of or any claim upon the item. The purchaser, though a party to the sale, does not execute the sale, only the seller does that. To be precise the sale completes prior to the payment and gives rise to the obligation of payment. If the seller completes the first two above stages (consent and passing ownership) of the sale prior to settlement of the price, the sale is still valid and gives rise to an obligation to pay.

A beach salesman selling necklaces The sale can be made through:[2] Direct sales, involving person to person contact o Buying Facilitation Method Pro forma sales Agency-based o Sales agents (real estate, manufacturing) o Sales outsourcing through direct branded representation o Transaction sales o Consultative sales o Complex sales o Consignment o Telemarketing or telesales o Retail or consumer Traveling salesman o Door-to-door o To tourists on crowded beach Request for proposal – An invitation for suppliers, through a bidding process, to submit a proposal on a specific product or service. An RFP is usually part of a complex sales process, also known as enterprise sales. Business-to-business – Business-to-business sales are much more relationship based owing to the lack of emotional attachment to the products in question. Industrial/Professional Sales is selling from one business to another Electronic o Web – Business-to-business and business-to-consumer o Electronic Data Interchange (EDI) – A set of standard for structuring information to be electronically exchanged between and within businesses Indirect, human-mediated but with indirect contact o Mail-order Sales Methods: o Selling technique o SPIN Selling o Consultative selling o Sales enablement o Solution selling o Conceptual Selling o Strategic Selling

o Sales Negotiation o Reverse Selling o Paint-the-Picture o Large Account Management Process [edit] Sales agents Agents in the sales process can be defined as representing either side of the sales process for example: Sales broker or Seller agency or seller agent This is a traditional role where the salesman represents a person or company on the selling end of the deal.[3] Buyers broker or Buyer brokerage This is where the salesman represents the consumer making the purchase. This is most often applied in large transactions. Disclosed dual agent This is where the salesman represents both parties in the sale and acts as a mediator for the transaction. The role of the salesman here is to over see that both parties receive an honest and fair deal, and is responsible to both. Transaction broker This is where the salesperson doesn't represent either party, but handles the transaction only. This is where the seller owes no responsibility to either party getting a fair or honest deal, just that all of the papers are handled properly. Sales Outsourcing This is direct branded representation where the sales reps are recruited, hired, and managed by an external entity but hold quotas, represent themselves as the brand of the client, and report all activities (through their own sales management channels) back to the client. It is akin to a virtual extension of a sales force. (see Sales Outsourcing entry) Sales Managers It is the goal of a qualified and talented sales manager to implement various sales strategies and management techniques in order to facilitate improved profits and increased sales volume. They are also responsible for coordinating the sales and marketing department as well as oversight concerning the fair and honest execution of the sales process by his agents.[4] Salesmen The primary function of professional sales is to generate and close leads, educate prospects, fill needs and satisfy wants of consumers appropriately, and therefore turn prospective customers into actual ones. The successful questioning to understand a customer's goal and requirements relevant to the product, the further creation of a valuable solution by communicating the necessary information that encourages a buyer to achieve their goal at an economic cost is the responsibility of the salesperson or the sales engine (e.g. internet, vending machine etc). A good salesman should never miss sell or over evaluate the customers requirements. [edit] The sales and marketing relationship Marketing and sales are very different, but have the same goal. Marketing improves the selling environment and plays a very important role in sales. If the marketing department generates a potential customers list, it can be beneficial for sales. The marketing department's goal is to increase the number of interactions between potential customers and company, which includes the sales team using promotional techniques such as advertising, sales promotion, publicity, and public relations, creating new sales channels, or creating new products (new product development), among other things. It also includes bringing the potential customer to the company's website for more information, or to contact the company for more information, or interact with the company via social media such as Twitter, Facebook, a blog, etc. The relatively new field of sales process engineering views "sales" as the output of a larger system, not just that of one department. The larger system includes many functional areas within an organization. From this perspective, sales and marketing (among others, such as customer service) are labels for a number of processes whose inputs and outputs supply one another to varying degrees. Considered in this way, to improve the "output" (namely, sales) the broader sales process needs to be studied and improved as would any system, since the component functional areas interact and are interdependent[5]. In most large corporations, the marketing department is structured in a similar fashion to the sales department[citation needed] and the managers of these teams must coordinate efforts in order to drive profits and business success. For example, an "inbound" focused campaign seeks to drive more customers "through the door" giving the sales department a better chance of selling their product to the consumer. A good marketing program would address any potential downsides as well. The Sales department's goal would be to improve the interaction between the customer and the sales facility or mechanism (example, web site) and/or salesperson. Sales management would break down the selling process and then increase the effectiveness of the discrete processes as well as the interaction between processes. For example, in many out-bound sales environments, the typical process is out bound calling, the sales pitch, handling objections, opportunity identification, and the close. Each step of the process has sales-related issues, skills, and training needs as well as marketing solutions to improve each discrete step, as well as the whole process. One further common complication of marketing involves the inability to measure results for a great deal of marketing initiatives. In essence, many marketing and advertising executives often lose sight of the objective of sales/revenue/profit, as they focus on establishing a creative/innovative program, without concern for the top or bottom lines. Such is a fundamental pitfall of marketing for marketing's sake. Many companies find it challenging to get marketing and sales on the same page. Both departments are different in nature, but handle very similar concepts and have to work together for sales to be successful. Building a good relationship between the two that encourages communication can be the key to success even in a down economy.[6]

Marketing potentially negates need for sales Some sales authors and consultants contend that an expertly planned and executed marketing strategy may negate the need for outside sales entirely. They suggest that by effectively bringing more customers "through the door" and enticing them to contact you, sales organizations can dramatically improve their results, efficiency, profitability, and allow salespeople to provide a drastically higher level of customer service and satisfaction, instead of spending the majority of their working hours searching for someone to sell to. [7] While this theory is present in a few marketing consulting companies the practical and realistic application of this principle has not been widely proven in the market and sales forces worldwide continue to be responsible for developing business as well as closing it. Some marketing consulting firms postulate that each selling opportunity at each enterprise lies on a continuum of numbers of people involved, necessary degree of face-to-face interaction, overhead, and through-put time, to name a few dimensions. The number of people involved in actual face-to-face selling at, say, a clothing store is probably vastly different than at an on-line book-seller. [edit] Industrial marketing The idea that marketing can potentially eliminate the need for sales people is entirely dependent on context. For example, this may be possible in some B2C situations however, for many B2B organisations (for example industrial organisations) this is mostly impossible. Another dimension is the value of the goods being sold. Fast Moving Consumer Goods (FMCG) require no sales people at the point of sale to get them to jump off the supermarket shelf and into the customer's trolley. However, the purchase of large mining equipment worth millions of dollars will require a sales person to manage the sales process. Particularly in the face of competitors. [edit] Sales and marketing alignment and integration Another key area of conversation that has arisen is the need for alignment and integration between corporate sales and marketing functions. According to a report from the Chief Marketing Officer (CMO) Council, only 40 percent of companies have formal programs, systems or processes in place to align and integration between the two critical functions. Traditionally, these two functions, as referenced above, has been largely segmented and left in siloed areas of tactical responsibility. In Glen Petersen‘s book, ―The Profit Maximization Paradox,‖ the changes in the competitive landscape between the 1950s and today are so dramatic that the complexity of choice, price and opportunities for the customer forced this seemingly simple and integrated relationship between sales and marketing to change forever. Petersen goes on to highlight that salespeople are spending approximately 40 percent of their time preparing customer-facing deliverables while leveraging less than 50 percent of the materials created by marketing, adding to the perception that marketing is out of touch with the customer, and sales is resistant to messaging and strategy. Internet applications, commonly referred to as Sales 2.0 tools, have also increasingly been created to help align the goals and responsibilities of marketing and sales departments.[8] [edit] Scoring Sales Every good sales team needs a way to score how well their deals have performed. Common ways of scoring include: Telemarketing CRM Software Funnel Scorecard Sales Lead Scoring [edit] See also Marketing plan

Marketing Key concepts Product • Pricing • Promotion Distribution • Service • Retail Brand management Account-based marketing Marketing ethics Marketing effectiveness Market research Market segmentation Marketing strategy Marketing management Market dominance Promotional content Advertising • Branding Direct marketing • Personal Sales Product placement • Publicity Sales promotion • Sex in advertising Underwriting Promotional media Printing • Publication • Broadcasting Out-of-home • Internet marketing Point of sale • Novelty items Digital marketing • In-game In-store demonstration • Word of mouth This box: view • talk • edit A marketing plan is a written document that details the necessary actions to achieve one or more marketing objectives. It can be for a product or service, a brand, or a product line. Marketing plans cover between one and five years. A marketing plan may be part of an overall business plan. Solid marketing strategy is the foundation of a well-written marketing plan. While a marketing plan contains a list of actions, a marketing plan without a sound strategic foundation is of little use.

1 The marketing planning process

The marketing process model based on the publications of Philip Kotler. It consists of 5 steps, beginning with the market & environment research. After fixing the targets and setting the strategies, they will be realised by the marketing mix in step 4. The last step in the process is the marketing controlling. In most organizations, "strategic planning" is an annual process, typically covering just the year ahead. Occasionally, a few organizations may look at a practical plan which stretches three or more years ahead. To be most effective, the plan has to be formalized, usually in written form, as a formal "marketing plan." The essence of the process is that it moves from the general to the specific; from the overall objectives of the organization down to the individual action plan for a part of one marketing program. It is also an interactive process, so that the draft output of each stage is checked to see what impact it has on the earlier stages - and is amended.. [edit] Marketing planning aims and objectives

Behind the corporate objectives, which in themselves offer the main context for the marketing plan, will lay the "corporate mission"; which in turn provides the context for these corporate objectives. In a sales-oriented organization, marketing planning function designs incentive pay plans to not only motivate and reward frontline staff fairly but also to align marketing activities with corporate mission. This "corporate mission" can be thought of as a definition of what the organization is; of what it does: "Our business is ...". This definition should not be too narrow, or it will constrict the development of the organization; a too rigorous concentration on the view that "We are in the business of making meat-scales," as IBM was during the early 1900s, might have limited its subsequent development into other areas. On the other hand, it should not be too wide or it will become meaningless; "We want to make a profit" is not too helpful in developing specific plans. Abell suggested that the definition should cover three dimensions: "customer groups" to be served, "customer needs" to be served, and "technologies" to be utilized [1]. Thus, the definition of IBM's "corporate mission" in the 1940s might well have been: "We are in the business of handling accounting information [customer need] for the larger US organizations [customer group] by means of punched cards [technology]." Perhaps the most important factor in successful marketing is the "corporate vision." Surprisingly, it is largely neglected by marketing textbooks; although not by the popular exponents of corporate strategy - indeed, it was perhaps the main theme of the book by Peters and Waterman, in the form of their "Superordinate Goals." "In Search of Excellence" said: "Nothing drives progress like the imagination. The idea precedes the deed." [2] If the organization in general, and its chief executive in particular, has a strong vision of where its future lies, then there is a good chance that the organization will achieve a strong position in its markets (and attain that future). This will be not least because its strategies will be consistent; and will be supported by its staff at all levels. In this context, all of IBM's marketing activities were underpinned by its philosophy of "customer service"; a vision originally promoted by the charismatic Watson dynasty. The emphasis at this stage is on obtaining a complete and accurate picture. A "traditional" - albeit product-based - format for a "brand reference book" (or, indeed, a "marketing facts book") was suggested by Godley more than three decades ago: 1. Financial data—Facts for this section will come from management accounting, costing and finance sections. 2. Product data—From production, research and development. 3. Sales and distribution data - Sales, packaging, distribution sections. 4. Advertising, sales promotion, merchandising data - Information from these departments. 5. Market data and miscellany - From market research, who would in most cases act as a source for this information. His sources of data, however, assume the resources of a very large organization. In most organizations they would be obtained from a much smaller set of people (and not a few of them would be generated by the marketing manager alone). It is apparent that a marketing audit can be a complex process, but the aim is simple: "it is only to identify those existing (external and internal) factors which will have a significant impact on the future plans of the company." It is clear that the basic material to be input to the marketing audit should be comprehensive. Accordingly, the best approach is to accumulate this material continuously, as and when it becomes available; since this avoids the otherwise heavy workload involved in collecting it as part of the regular, typically annual, planning process itself - when time is usually at a premium. Even so, the first task of this annual process should be to check that the material held in the current facts book or facts files actually is comprehensive and accurate, and can form a sound basis for the marketing audit itself. The structure of the facts book will be designed to match the specific needs of the organization, but one simple format - suggested by Malcolm McDonald - may be applicable in many cases. This splits the material into three groups: 1. Review of the marketing environment. A study of the organization's markets, customers, competitors and the overall economic, political, cultural and technical environment; covering developing trends, as well as the current situation. 2. Review of the detailed marketing activity. A study of the company's marketing mix; in terms of the 7 Ps - (see below) 3. Review of the marketing system. A study of the marketing organization, marketing research systems and the current marketing objectives and strategies. The last of these is too frequently ignored. The marketing system itself needs to be regularly questioned, because the validity of the whole marketing plan is reliant upon the accuracy of the input from this system, and `garbage in, garbage out' applies with a vengeance. o Portfolio planning. In addition, the coordinated planning of the individual products and services can contribute towards the balanced portfolio. 80:20 rule. To achieve the maximum impact, the marketing plan must be clear, concise and simple. It needs to concentrate on the 20 percent of products or services, and on the 20 percent of customers, which will account for 80 percent of the volume and 80 percent of the profit. 7 P's: Product, Place, Price and Promotion, Physical Environment, People, Process. The 7 P's can sometimes divert attention from the customer, but the framework they offer can be very useful in building the action plans. It is only at this stage (of deciding the marketing objectives) that the active part of the marketing planning process begins'. This next stage in marketing planning is indeed the key to the whole marketing process. The "marketing objectives" state just where the company intends to be; at some specific time in the future. James Quinn succinctly defined objectives in general as: Goals (or objectives) state what is to be achieved and when results are to be accomplished, but they do not state 'how' the results are to be achieved.[3] They typically relate to what products (or services) will be where in what markets (and must be realistically based on customer behavior in those markets). They are essentially about the match between those "products" and "markets." Objectives for pricing, distribution, advertising and so on are at a lower level, and should not be confused with marketing objectives. They are part of the marketing strategy needed to achieve marketing objectives. To be most effective, objectives should be capable of measurement and therefore "quantifiable." This measurement may be in terms of sales volume, money value, market share, percentage penetration of distribution outlets and so on. An example of such a measurable marketing objective might be "to enter the market with product Y and capture 10 percent of the market by value within one year." As it is quantified it can, within limits, be unequivocally monitored; and corrective action taken as necessary. The marketing objectives must usually be based, above all, on the organization's financial objectives; converting these financial measurements into the related marketing measurements.He went on to explain his view of the role of "policies," with which strategy is most often confused: "Policies are rules or guidelines that express the 'limits' within which action should occur."Simplifying somewhat, marketing strategies can be seen as the means, or "game plan," by which marketing objectives will be achieved and, in the framework that we have chosen to use, are generally concerned with the 8 P's. Examples are: 1. Price - The amount of money needed to buy products 2. Product - The actual product 3. Promotion (advertising)- Getting the product known 4. Placement - Where the product is located 5. People - Represent the business 6. Physical environment - The ambiance, mood, or tone of the environment 7. Process - How do people obtain your product 8. Packaging - How the product will be protected (Note: At GCSE the 4 P's are Place, Promotion, Product and Price and the "secret" 5th P is Packaging, but which applies only to physical products, not services usually, and mostly those sold to individual consumers) In principle, these strategies describe how the objectives will be achieved. The 7 P's are a useful framework for deciding how the company's

resources will be manipulated (strategically) to achieve the objectives. It should be noted, however, that they are not the only framework, and may divert attention from the real issues. The focus of the strategies must be the objectives to be achieved - not the process of planning itself. Only if it fits the needs of these objectives should you choose, as we have done, to use the framework of the 7 P's. The strategy statement can take the form of a purely verbal description of the strategic options which have been chosen. Alternatively, and perhaps more positively, it might include a structured list of the major options chosen. One aspect of strategy which is often overlooked is that of "timing." Exactly when it is the best time for each element of the strategy to be implemented is often critical. Taking the right action at the wrong time can sometimes be almost as bad as taking the wrong action at the right time. Timing is, therefore, an essential part of any plan; and should normally appear as a schedule of planned activities.Having completed this crucial stage of the planning process, you will need to re-check the feasibility of your objectives and strategies in terms of the market share, sales, costs,
profits and so on which these demand in practice. As in the rest of the marketing discipline, you will need to employ judgment, experience, market research or anything else which helps you to look at your conclusions from all possible angles. [edit] Detailed plans and programs At this stage, you will need to develop your overall marketing strategies into detailed plans and program. Although these detailed plans may cover each of the 7 P's, the focus will vary, depending upon your organization's specific strategies. A product-oriented company will focus its plans for the 7 P's around each of its products. A market or geographically oriented company will concentrate on each market or geographical area. Each will base its plans upon the detailed needs of its customers, and on the strategies chosen to satisfy these needs. Again, the most important element is, indeed, that of the detailed plans; which spell out exactly what programs and individual activities will take place over the period of the plan (usually over the next year). Without these specified - and preferably quantified - activities the plan cannot be monitored, even in terms of success in meeting its objectives.It is these programs and activities which will then constitute the "marketing" of the organization over the period. As a result, these detailed marketing programs are the most important, practical outcome of the whole planning process. These plans therefore be: Clear - They should be an unambiguous statement of 'exactly' what is to be done. Quantified - The predicted outcome of each activity should be, as far as possible, quantified; so that its performance can be monitored. Focused - The temptation to proliferate activities beyond the numbers which can be realistically controlled should be avoided. The 80:20 Rule applies in this context too. Realistic - They should be achievable. Agreed - Those who are to implement them should be committed to them, and agree that they are achievable. The resulting plans should become a working document which will guide the campaigns taking place throughout the organization over the period of the plan. If the marketing plan is to work, every exception to it (throughout the year) must be questioned; and the lessons learned, to be incorporated in the next year's planning. [edit] Content of the marketing plan A marketing plan for a small business typically includes Small Business Administration Description of competitors, including the level of demand for the product or service and the strengths and weaknesses of competitors 1. Description of the product or service, including special features 2. Marketing budget, including the advertising and promotional plan 3. Description of the business location, including advantages and disadvantages for marketing 4. Pricing strategy 5. Market Segmentation

[edit] Medium-sized and large organizations The main contents of a marketing plan are:[4] 1. Executive Summary 2. Situational Analysis 3. Opportunities / Issue Analysis - SWOT Analysis 4. Objectives 5. Strategy 6. Action Program (the operational marketing plan itself for the period under review) 7. Financial Forecast 8. Controls In detail, a complete marketing plan typically includes:[4] 1. Title page 2. Executive Summary 3. Current Situation - Macroenvironment[5] o economy o legal o government o technology o ecological o sociocultural o supply chain 4. Current Situation - Market Analysis o market definition o market size o market segmentation o industry structure and strategic groupings o Porter 5 forces analysis o competition and market share o competitors' strengths and weaknesses o market trends 5. Current Situation - Consumer Analysis [6] o nature of the buying decision o participants o demographics o psychographics o buyer motivation and expectations o loyalty segments 6. Current Situation - Internal o company resources financial people time
 skills o objectives mission statement and vision statement corporate objectives financial objective marketing objectives long term objectives description of the basic business philosophy o corporate culture 7. Summary of Situation Analysis o external threats o external opportunities o internal strengths o internal weaknesses o Critical success factors in the industry o our sustainable competitive advantage 8. Marketing research o information requirements o research methodology o research results 9. Marketing Strategy - Product[7] o product mix o product strengths and weaknesses perceptual mapping o product life cycle management and new product development o Brand name, brand image, and brand equity o the augmented product o product portfolio analysis B.C.G. Analysis contribution margin analysis G.E. Multi Factoral analysis Quality Function Deployment 10. Marketing Strategy [8][9] - segmented marketing actions and market share objectives o by product, o by customer segment, o by geographical market, o by distribution channel. 11. Marketing Strategy - Price o pricing objectives o pricing method (eg.: cost plus, demand based, or competitor indexing) o pricing strategy (eg.: skimming, or penetration) o discounts and allowances o price elasticity and customer sensitivity o price zoning o break even analysis at various prices 12. Marketing Strategy - promotion
o promotional goals o promotional mix o advertising reach, frequency, flights, theme, and media o sales force requirements, techniques, and management o sales promotion o publicity and public relations o electronic promotion (eg.: Web, or telephone) o word of mouth marketing (buzz) o viral marketing 13. Marketing Strategy - Distribution o geographical coverage o distribution channels o physical distribution and logistics o electronic distribution 14. Implementation o personnel requirements assign responsibilities give incentives training on selling methods o financial requirements o management information systems requirements o month-by-month agenda PERT or critical path analysis o monitoring results and benchmarks o adjustment mechanism o contingencies (What if's) 15. Financial Summary o assumptions o pro-forma monthly income statement o contribution margin analysis o breakeven analysis o Monte Carlo method o ISI: Internet Strategic Intelligence 16. Scenarios o Prediction of Future Scenarios o Plan of Action for each Scenario 17. Appendix o pictures and specifications of the new product o results from research already completed [edit] Measurement of progress The final stage of any marketing planning process is to establish targets (or standards) so that progress can be monitored. Accordingly, it is important to put both quantities and

timescales into the marketing objectives (for example, to capture 20 percent by value of the market within two years) and into the corresponding strategies.

Changes in the environment mean that the forecasts often have to be changed. Along with these, the related plans may well also need to be changed. Continuous monitoring of performance, against predetermined targets, represents a most important aspect of this. However, perhaps even more important is the enforced discipline of a regular formal review. Again, as with forecasts, in many cases the best (most realistic) planning cycle will revolve around a quarterly review. Best of all, at least in terms of the quantifiable aspects of the plans, if not the wealth of backing detail, is probably a quarterly rolling review - planning one full year ahead each new quarter. Of course, this does absorb more planning resource; but it also ensures that the plans embody the latest information, and - with attention focused on them so regularly - forces both the plans and their implementation to be realistic. Plans only have validity if they are actually used to control the progress of a company: their success lies in their implementation, not in the writing'. [edit] Performance analysis The most important elements of marketing performance, which are normally tracked, are: [edit] Sales analysis Most organizations track their sales results; or, in non-profit organizations for example, the number of clients. The more sophisticated track them in terms of 'sales variance' - the deviation from the target figures - which allows a more immediate picture of deviations to become evident. `Micro-analysis', which is a nicely pseudo-scientific term for the normal management process of investigating detailed problems, then investigates the individual elements (individual products, sales territories, customers and so on) which are failing to meet targets. [edit] Market share analysis Few organizations track market share though it is often an important metric. Though absolute sales might grow in an expanding market, a firm's share of the market can decrease which bodes ill for future sales when the market starts to drop. Where such market share is tracked, there may be a number of aspects which will be followed: overall market share segment share - that in the specific, targeted segment relative share -in relation to the market leaders annual fluctuation rate of market share [edit] Expense analysis The key ratio to watch in this area is usually the `marketing expense to sales ratio'; although this may be broken down into other elements (advertising to sales, sales administration to sales, and so on).

[edit] Financial analysis The "bottom line" of marketing activities should at least in theory, be the net profit (for all except non-profit organizations, where the comparable emphasis may be on remaining within budgeted costs). There are a number of separate performance figures and key ratios which need to be tracked: gross contribution<>net profit gross profit<>return on investment net contribution<>profit on sales There can be considerable benefit in comparing these figures with those achieved by other organizations (especially those in the same industry); using, for instance, the figures which can be obtained (in the UK) from `The Centre for Interfirm Comparison'. The most sophisticated use of this approach, however, is typically by those making use of PIMS (Profit Impact of Management Strategies), initiated by the General Electric Company and then developed by Harvard Business School, but now run by the Strategic Planning Institute. The above performance analyses concentrate on the quantitative measures which are directly related to short-term performance. But there are a number of indirect measures, essentially tracking customer attitudes, which can also indicate the organization's performance in terms of its longer-term marketing strengths and may accordingly be even more important indicators. Some useful measures are: market

research - including customer panels (which are used to track changes over time) lost business - the orders which were lost because, for example, the stock was not available or the product did not meet the customer's exact requirements customer complaints - how many customers complain about the products or services, or the organization itself, and about what [edit] Use of marketing plans A formal, written marketing plan is essential; in that it provides an unambiguous reference point for activities throughout the planning period. However, perhaps the most important benefit of these plans is the planning process itself. This typically offers a unique opportunity, a forum, for information-rich and productively focused discussions between the various managers involved. The plan, together with the associated discussions, then provides an agreed context for their subsequent management activities, even for those not described in the plan itself. [edit] Budgets as managerial tools The classic quantification of a marketing plan appears in the form of budgets. Because these are so rigorously quantified, they are particularly important. They should, thus, represent an unequivocal projection of actions and expected results. What is more, they should be capable of being monitored accurately; and, indeed, performance against budget is the main (regular) management review process.
The purpose of a marketing budget is, thus, to pull together all the revenues and costs involved in marketing into one comprehensive document. It is a managerial tool that balances what is needed to be spent against what can be afforded, and helps make choices about priorities. It is then used in monitoring performance in practice. The marketing budget is usually the most powerful tool by which you think through the relationship between desired results and available means. Its starting point should be the marketing strategies and plans, which have already been formulated in the marketing plan itself; although, in practice, the two will run in parallel and will interact. At the very least, the rigorous, highly quantified, budgets may cause a rethink of some of the more optimistic elements of the plans.

Specific types of distribution

The Distribution Channel Chain of intermediaries, each passing the product down the chain to the next organization, before it finally reaches the consumer or end-user. This process is known as the 'distribution chain' or the 'channel.' Each of the elements in these chains will have their own specific needs, which the producer must take into account, along with those of the all-important end-user. [edit] Channels A number of alternate 'channels' of distribution may be available: Distributor, who sells to retailers Retailer (also called dealer or reseller), who sells to end customers
 Advertisement typically used for consumption goods Distribution channels may not be restricted to physical products alone. They may be just as important for moving a service from producer to consumer in certain sectors, since both direct and indirect channels may be used. Hotels, for example, may sell their services (typically

rooms) directly or through travel agents, tour operators, airlines, tourist boards, centralized reservation systems, etc. There have also been some innovations in the distribution of services. For example, there has been an increase in franchising and in rental services - the latter offering anything from televisions through tools. There has also been some evidence of service integration, with services linking together, particularly in the travel and tourism sectors. For example, links now exist between airlines, hotels and car rental services. In addition, there has been a significant increase in retail outlets for the service sector. Outlets such as estate agencies and building society offices are crowding out traditional grocers from major shopping areas. [edit] Channel members Distribution channels can thus have a number of levels. Kotler defined the simplest level, that of a direct contact with no intermediaries involved, as the 'zero-level' channel. The next level, the 'one-level' channel, features just one intermediary; in consumer goods a retailer, for industrial goods a distributor. In small markets (such as small countries) it is practical to reach the whole market using just one- and zero-level channels. In large markets (such as larger countries) a second level, a wholesaler for example, is now mainly used to extend distribution to the large number of small, neighborhood retailers or dealers. In Japan the chain of distribution is often complex and further levels are used, even for the simplest of consumer goods. In Bangladesh Telecom Operators are using different Chains of Distribution, especially 'second level'. In IT and Telecom industry levels are named "tiers". A one tier channel means that vendors IT product manufacturers (or software publishers) work directly with the dealers. A one tier / two tier channel means that vendors work directly with dealers and with distributors who sell to dealers. But the most important is the distributor or wholesaler. [edit] The internal market Many of the marketing principles and techniques which are applied to the external customers of an organization can be just as effectively applied to each subsidiary's, or each department's, 'internal' customers.
In some parts of certain organizations this may in fact be formalized, as goods are transferred between separate parts of the organization at a `transfer price'. To all intents and purposes, with the possible exception of the pricing mechanism itself, this process can and should be viewed as a normal buyer-seller relationship. The fact that this is a captive market, resulting in a `monopoly price', should not discourage the participants from employing marketing techniques. Less obvious, but just as practical, is the use of `marketing' by service and administrative departments; to optimize their contribution to their `customers' (the rest of the organization in general, and those parts of it which deal directly with them in particular). In all of this, the lessons of the non-profit organizations, in dealing with their clients, offer a very useful parallel. But in spite of this many, organizations prefer not to operate at a 'transfer' price because costs gradually increase as they undergo the distribution process. [edit] Channel decisions Channel strategy o Gravity o Push and Pull strategy Product (or service)<>Cost<>Consumer location [edit] Managerial concerns The channel decision is very important. In theory at least, there is a form of trade-off: the cost of using intermediaries to achieve wider distribution is supposedly lower. Indeed, most consumer goods manufacturers could never justify the cost of selling direct to their consumers, except by mail order. Many suppliers seem to assume that once their product has been sold into the channel, into the beginning of the distribution chain, their job is finished. Yet that distribution chain is merely assuming a part of the supplier's responsibility; and, if they have any aspirations to be market-oriented, their job should really be extended to managing all the processes involved in that chain, until the product or service

arrives with the end-user. This may involve a number of decisions on the part of the supplier: Channel membership Channel motivation Monitoring and managing channels [edit] Channel membership 1. Intensive distribution - Where the majority of resellers stock the 'product' (with convenience products, for example, and particularly the brand leaders in consumer goods markets) price competition may be evident. 2. Selective distribution - This is the normal pattern (in both consumer and industrial markets) where 'suitable' resellers stock the product. 3. Exclusive distribution - Only specially selected resellers or authorized dealers (typically only one per geographical area) are allowed to sell the 'product'.

 Channel motivation It is difficult enough to motivate direct employees to provide the necessary sales and service support. Motivating the owners and employees of the independent organizations in a distribution chain requires even greater effort. There are many devices for achieving such motivation. Perhaps the most usual is `incentive': the supplier offers a better margin, to tempt the owners in the channel to push the product rather than its competitors; or a competition is offered to the distributors' sales personnel, so that they are tempted to push the product. Dent defines this incentive as a Channel Value Proposition or business case, with which the supplier sells the channel member on the commercial merits of doing business together. He describes this as selling business models not products.

 Monitoring and managing channels In much the same way that the organization's own sales and distribution activities need to be monitored and managed, so will those of the distribution chain. In practice, many organizations use a mix of different channels; in particular, they may complement a direct salesforce, calling on the larger accounts, with agents, covering the smaller customers and prospects.

Internet marketing, also referred to as i-marketing, web marketing, online marketing, or eMarketing, is the marketing of products, or, services over the Internet. The Internet has brought media to a global audience. The interactive nature of Internet marketing, both, in terms of providing instant response and eliciting responses, is a unique quality of the medium. Internet marketing is sometimes considered to have a broader scope because it not only refers to, such as, the Internet, e-mail, and wireless media, but also it includes management of digital customer data and electronic customer relationship management (ECRM) systems. Internet marketing ties together creative and technical aspects of the Internet including design, development, advertising, and sales. Internet marketing also refers to the placement of media along different stages of the customer engagement cycle through search engine marketing (SEM), search engine optimization (SEO), banner ads on specific websites, e-mail marketing, and Web 2.0 strategies. In 2008 The New York Times, working with comScore, published an initial estimate to quantify the user data collected by large Internet-based companies. Counting four types of interactions with company websites in addition to the hits from advertisements served from advertising networks, the authors found the potential for collecting data upward of 2,500 times on average per user per month.

 1 Business models
o 1.1 One-to-one approach
o 1.2 Appeal to specific interests
o 1.3 Geo targeting
 1.3.1 Different content by choice
 1.3.2 Automated different content
 2 Advantages

 3 Limitations
 4 Security concerns
 5 Broadband-induced trends
 6 Effects on industries

Business models Internet marketing is associated with several business models: e-commerce — this is where goods are sold directly to consumers (B2C) or businesses (B2B) Publishing — this is the sale of advertising lead-based websites — this is an organization that generates value by acquiring sales leads from its website affiliate marketing — this is process in which a product or service developed by one person is sold by other active seller for a share of profits. The owner of the product normally provide some marketing material (sales letter, affiliate link, tracking facility). local internet marketing - this is the process of a locally based company traditionally selling belly to belly and utilizing the Internet to find and nurture relationships, later to take those relationships offline. There are many other business models based on the specific needs of each person or the business that launches an Internet marketing campaign. [edit] One-to-one approach The targeted user is typically browsing the Internet alone therefore the marketing messages can reach them personally. This approach is used in search marketing, where the advertisements are based on search engine keywords entered by the user. And now with the advent of Web 2.0 tools, many users can interconnect as "peers." Appeal to specific interests
Internet marketing and geo marketing places an emphasis on marketing that appeals to a specific behaviour or interest, rather than reaching out to a broadly-defined demographic. "On- and Off-line" marketers typically segment their markets according to age group, gender, geography, and other general factors. Marketers have the luxury of targeting by activity and geolocation. For example, a kayak company can post advertisements on kayaking and canoeing websites with the full knowledge that the audience has a related interest. Internet marketing differs from magazine advertisements, where the goal is to appeal to the projected demographic of the periodical, but rather the advertiser has knowledge of the target audience—people who engage in certain activities (e.g., uploading pictures, contributing to blogs)— so the company does not rely on the expectation that a certain group of people will be interested in its new product or service. [edit] Geo targeting Geo targeting (in internet marketing) and geo marketing are the methods of determining the geolocation (the physical location) of a website visitor with geolocation software, and delivering different content to that visitor based on his or her location, such as country, region/state, city, metro code/zip code, organization, Internet Protocol (IP) address, ISP or other criteria. [edit] Different content by choice A typical example for different content by choice in geo targeting is the FedEx website at FedEx.com where users have the choice to select their country location first and are then presented with a different site or article content depending on their selection. [edit] Automated different content With automated different content in Internet marketing and geomarketing, the delivery of different content based on the geographical geolocation and other personal information is automated. [edit] Advantages Internet marketing is relatively inexpensive when compared to the ratio of cost against the reach of the target audience. Companies can reach a wide audience for a small fraction of traditional advertising budgets. The nature of the medium allows consumers to research and purchase products and services at their own convenience. Therefore, businesses have the advantage of appealing to consumers in a medium that can

bring results quickly. The strategy and overall effectiveness of marketing campaigns depend on business goals and cost-volume-profit (CVP) analysis. Internet marketers also have the advantage of measuring statistics easily and inexpensively. Nearly all aspects of an Internet marketing campaign can be traced, measured, and tested. The advertisers can use a variety of methods: pay per impression, pay per click, pay per play, or pay per action. Therefore, marketers can determine which messages or offerings are more appealing
to the audience. The results of campaigns can be measured and tracked immediately because online marketing initiatives usually require users to click on an advertisement, visit a website, and perform a targeted action. Such measurement cannot be achieved through billboard advertising, where an individual will at best be interested, then decide to obtain more information at a later time. Internet marketing as of 2007 is growing faster than other types of media.[citation needed] Because exposure, response, and overall efficiency of Internet media are easier to track than traditional off-line media—through the use of web analytics for instance—Internet marketing can offer a greater sense of accountability for advertisers. Marketers and their clients are becoming aware of the need to measure the collaborative effects of marketing (i.e., how the Internet affects in-store sales) rather than siloing each advertising medium. The effects of multichannel marketing can be difficult to determine, but are an important part of ascertaining the value of media campaigns. [edit] Limitations Internet marketing requires customers to use newer technologies rather than traditional media. Low-speed Internet connections are another barrier. If companies build large or overly-complicated websites, individuals connected to the Internet via dial-up connections or mobile devices experience significant delays in content delivery. From the buyer's perspective, the inability of shoppers to touch, smell, taste or "try on" tangible goods before making an online purchase can be limiting. However, there is an industry standard for e-commerce vendors to reassure customers by having liberal return policies as well as providing in-store pick-up services. A survey of 410 marketing executives listed the following barriers to entry for large companies looking to market online: insufficient ability to measure impact, lack of internal capability, and difficulty convincing senior management.[2] [edit] Security concerns Information security is important both to companies and consumers that participate in online business. Many consumers are hesitant to purchase items over the Internet because they do not trust that their personal information will remain private. Encryption is the primary method for implementing privacy policies. Recently some companies that do business online have been caught giving away or selling information about their customers. Several of these companies provide guarantees on their websites, claiming that customer information will remain private. Some companies that purchase customer information offer the option for individuals to have their information removed from the database, also known as opting out. However, many customers are unaware if and when their information is being shared, and are unable to stop the transfer of their information between companies if such activity occurs.
Another major security concern that consumers have with e-commerce merchants is whether or not they will receive exactly what they purchase. Online merchants have attempted to address this concern by investing in and building strong consumer brands (e.g., Amazon.com, eBay, Overstock.com), and by leveraging merchant/feedback rating systems and e-commerce bonding solutions. All of these solutions attempt to assure consumers that their transactions will be free of problems because the merchants can be trusted to provide reliable products and

services. Additionally, the major online payment mechanisms (credit cards, PayPal, Google Checkout, etc.) have also provided back-end buyer protection systems to address problems if they actually do occur. [edit] Broadband-induced trends Online advertising techniques have been dramatically affected by technological advancements in the telecommunications industry. In fact, many firms are embracing a new paradigm that is shifting the focus of online advertising from simple text ads to rich multimedia experiences. As a result, advertisers can more effectively engage in and manage online branding campaigns, which seek to shape consumer attitudes and feelings towards specific products. The critical technological development fueling this paradigm shift is Broadband. In March 2005, roughly half of all American homes were equipped with broadband technology. By May 2008, broadband technologies had spread to more than 90% of all residential Internet connections in the United States. When one considers a Nielsen‘s study conducted in June 2008, which estimated the number of U.S. Internet users as 220,141,969, one can calculate that there are presently about 199 million people in the United States utilizing broadband technologies to surf the Web. As a result, all 199 million members of this burgeoning market have the ability to view TV-like advertisements with the click of a mouse. And to be sure, online advertisers are working feverishly to design rich multimedia content that will engender a ―warm-fuzzy‖ feeling when viewed by their target audience. As connection speeds continue to increase, so will the frequency of online branding campaigns. [edit] Effects on industries Internet marketing has had a large impact on several previously retail-oriented industries including music, film, pharmaceuticals, banking, flea markets, as well as the advertising industry itself. Internet marketing is now overtaking radio marketing in terms of market share.[3] In the music industry, many consumers have been purchasing and downloading music (e.g., MP3 files) over the Internet for several years in addition to purchasing compact discs. By 2008 Apple Inc.'s iTunes Store has become the largest music vendor in the United States.[4] The number of banks offering the ability to perform banking tasks online has also increased. Online banking is believed to appeal to customers because it is more convenient than visiting bank branches. Currently over 150 million U.S. adults now bank online, with increasing Internet connection speed being the primary reason for fast growth in the online banking industry.[citation
needed] Of those individuals who use the Internet, 44 percent now perform banking activities over the Internet.[citation needed] Internet auctions have gained popularity. Unique items that could only previously be found at flea markets are being sold on eBay. Specialized e-stores sell items ranging from antiques to movie props.[5][6] As the premier online reselling platform, eBay is often used as a price-basis for specialized items. Buyers and sellers often look at prices on the website before going to flea markets; the price shown on eBay often becomes the item's selling price. It is increasingly common for flea market vendors to place a targeted advertisement on the Internet for each item they are selling online, all while running their business out of their homes. The effect on the advertising industry itself has been profound. In just a few years, online advertising has grown to be worth tens of billions of dollars annually.

Promotion (marketing)

It has been suggested that this article or section be merged into Promotional mix. (Discuss) Marketing Key concepts Product • Pricing • Promotion Distribution • Service • Retail Brand management Account-based marketing Marketing ethics Marketing effectiveness Market research Market segmentation Marketing strategy

Marketing management Market dominance Promotional content Advertising • Branding Direct marketing • Personal Sales Product placement • Publicity Sales promotion • Sex in advertising Underwriting Promotional media Printing • Publication • Broadcasting Out-of-home • Internet marketing Point of sale • Novelty items Digital marketing • In-game In-store demonstration • Word of mouth This box: view • talk • edit

Wikibooks has a book on the topic of Marketing Promotion involves disseminating information about a product, product line, brand, or company. It is one of the five key aspects of the marketing mix. (The other four elements are product marketing, pricing, pay role and distribution.) Promotion is generally sub-divided into two parts: Above the line promotion: Promotion in the media (e.g. TV, radio, newspapers, Internet and Mobile Phones) in which the advertiser pays an advertising agency to place the ad Below the line promotion: All other promotion. Much of this is intended to be subtle enough for the consumer to be unaware that promotion is taking place. E.g. sponsorship, product placement, endorsements, sales promotion, merchandising, direct mail, personal selling, public relations, trade shows The specification of these four variables creates a promotional mix or promotional plan. A promotional mix specifies how much attention to pay to each of the four subcategories, and how much money to budget for each. A promotional plan can have a wide range of objectives, including: sales increases, new product acceptance, creation of brand equity, positioning, competitive retaliations, or creation of a corporate image. The term "promotion" is usually an "in" expression used internally by the marketing company, but not normally to the public or the market - phrases like "special offer" are more common. An example of a fully integrated, long-term, large-scale promotion are My Coke Rewards and Pepsi Stuff. [edit] Notes

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Market segment Market segmentMarket segment Market segment Market segment Market segment From Wikipedia, the free encyclopedia (Redirected from Market Segmentation) Jump to: navigation, search A Business market segment is a group of people or organizations sharing one or more characteristics that cause them to have similar product and/or service needs. A true market segment meets all of the following criteria: it is distinct from other segments (different segments have different needs), it is homogeneous within the segment (exhibits common needs); it responds similarly to a market stimulus, and it can be reached by a market intervention. The term is also used when consumers with identical product and/or service needs are divided up into groups so they can be charged different amounts. These can broadly be viewed as 'positive' and 'negative' applications of the same idea, splitting up the market into smaller groups.

"**Positive" market segmentation**

Market segmenting is the process that a company divides the market into distinct groups who have distinct needs, wants, behavior or who might want different products & services Broadly, markets can be divided according to a number of general criteria, such as by industry or public versus private although industrial market segmentation is quite different from consumer market segmentation, both have similar objectives. All of these methods of segmentation are merely proxies for true segments, which don't always fit into convenient demographic boundaries. Consumer-based market segmentation can be performed on a product specific basis, to provide a close match between specific products and individuals. However, a number of generic market segment systems also exist, e.g. the Nielsen Claritas PRIZM system provides a broad segmentation of the population of the United States based on the statistical analysis of household and geodemographic data. The process of segmentation is distinct from targeting (choosing which segments to address) and positioning (designing an appropriate marketing mix for each segment). The overall intent is to identify groups of similar customers and potential customers; to prioritize the groups to address; to understand their behavior; and to respond with appropriate marketing strategies that satisfy the different preferences of each chosen segment. Revenues are thus improved. Improved segmentation can lead to significantly improved marketing effectiveness. Distinct segments can have different industry structures and thus have higher or lower attractiveness (Michael Porter). With the right segmentation, the right lists can be purchased, advertising results can be improved and customer satisfaction can be increased leading to better reputation.

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Course Name: INTERNATIONAL BUSINESS STRATEGY

Introduction

Warfare (Marketing warfare) strategies are a type of strategies, used in business and marketing, that try to draw parallels between business and warfare, and then apply the principles of military strategy to business situations, with competing firms considered as analogous to sides in a military conflict, and market share considered as analogous to the territory which is being fought over. The four marketing warfare can be seen as follows:

The first strategy is the offensive marketing warfare strategies which is a type of marketing warfare strategy designed to obtain an objective, usually market share, from a target competitor. In addition to market share, an offensive strategy could be designed to obtain key customers, high margin market segments, or high loyalty market segments. There are four fundamental principles involved: (1)Assess the strength of the target competitor. Consider the amount of support that the target might muster from allies. Choose only one target at a time. (2) Find a weakness in the target's position; attack at this point. Consider how long it will take for the target to realign their resources so as to reinforce this weak spot. (3) Launch the attack on as narrow a front as possible. Whereas a defender must defend all their borders, an attacker has the advantage of being able to concentrate their forces at one place. (4) Launch the attack quickly. The element of surprise is worth more than a thousand tanks. The main types of offensive marketing warfare strategies are frontal attack; envelopment Strategy (also called encirclement strategy) - leapfrog strategy and flanking attack.

The second strategy is the flanking marketing warfare strategies which is a type of marketing warfare strategy designed to minimize confrontational losses. The fundamental principles involved are (1) Avoid areas of likely confrontation. A flanking move always occurs in an uncontested area. (2) Make your move quickly and stealth fully. The element of surprise is worth more than a thousand tanks. (3) Make moves that the target will not find threatening enough to respond decisively to. Flanking strategies can be either offensive or defensive: Flanking Attack (offensive) is designed to pressure the flank of the enemy line so the flank turns inward and the Flanking Position (defensive) involves the re-deployment of your resources to deter a flanking attack

The third strategy is the defensive marketing warfare strategies which is a type of marketing warfare strategy designed to protect a company's market share, profitability, product positioning, or mind share. It has five fundamental principles which are a) always counter an attack with equal or greater force; (b) defend every important market; (c) be forever vigilant in scanning for potential attackers. Assess the strength of the competitor. Consider the amount of support that the attacker might muster from allies; (d) the best defense is to attack yourself. Attack your weak spots and rebuild yourself anew and (e) defensive strategies should be the exclusive domain of the market leader.

And the last strategy is the guerrilla marketing warfare strategy which is an attack, retreat, hide, then do it again, and again, until the competitor moves on to other markets. Guerrilla Marketing Warfare Tactics are often the best, most cost effective methods to reach consumers. Often Guerrilla tactics are used against a company by advertising to their competitors' customers directly for the most impact. It employs the following principles: Deterrence Strategieswhich is a battle won in the minds of the enemy. You convince the competitor that it would be prudent to keep out of your markets;Pre-emptive strike which is attack before you are attacked; Frontal Attack which is a direct head-on confrontation; Flanking Attack which is attack the competitor’s flank and Sequential Strategies which a strategy that consists of a series of sub-strategies that must all be successfully carried out in the right order.

Strategy

Strategic plan is an organization's process of defining its strategy, or direction, and making decisions on allocating its resources to pursue this strategy. In order to determine the direction of the organization, it is necessary to understand its current position and the possible avenues through which it can pursue a particular course of action. There are many reasons why strategic plan fails as can be seen below.

The first reason why a strategic plan fails is the failure to overcome organization hurdles. These can be classified as cognitive, motivational, resource and political hurdles. Even if the general managers has a good intention and are motivated to bring your business up, if they lack the skills to do so then there is a chance that their proposed plans contain a lot of loopholes. The same goes for a group of skilled managers who simply lack the motivation to help. But even if there is a group of skilled and highly motivated individuals but lack the budget or resources to put the plans into actions, then nothing will be achieved. Influence of politics can also contribute to a business plans failure.

Another reason why strategic plan fails is the management's failure to understand its customers. They should learn the reason why the customers buy their products. Is it really important in their lifestyle? Is there a credible data to back up all these and confirm a precise conclusion on how to best market the products to the target customers. The products should always be beneficial to the consumers, otherwise there is no use buying it.

Failure to predict market and environmental changes and how it reacts to stimuli is also a possible reason why plan fails. The management should always be aware of how the competition is faring and if it's possible to compete with the prices. Government intervention should also be considered and how it could impact the marketing status of the goods.

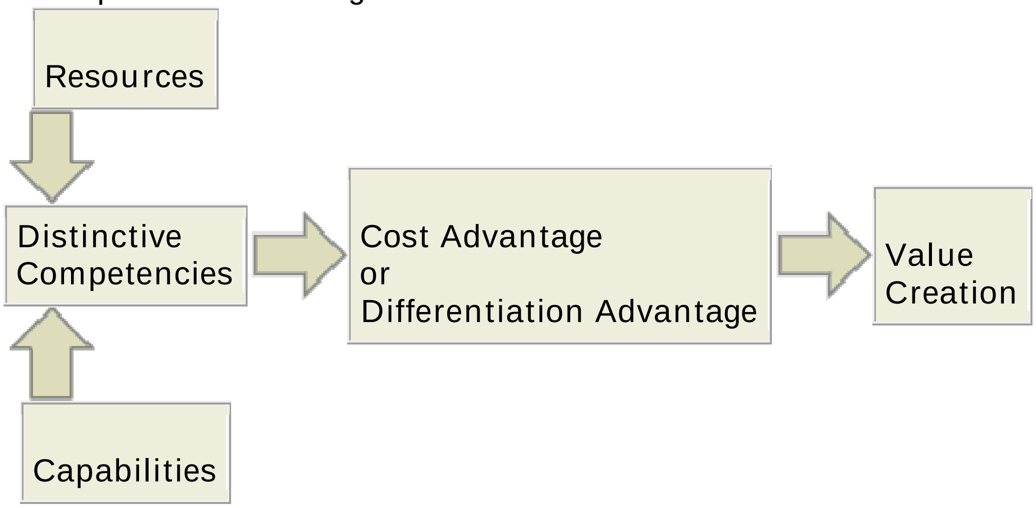
Overconfidence with the current resources can also lead to plan failure. Careful assessment of the staff, their skills, the equipment and current processes should be done to assure their capability of adapting to new strategies. Also, failure to adapt to new employment and managerial practices can severe relationships between the management and its staff and this can affect a business plan's success rate. This could lead to lack of coordination and commitment among members of the team.

Poor communications seems to take many forms. Apparently, some groups like to develop strategic plans, and then hide them under a rock. But they don't do it on purpose. "The failure to communicate the vision and strategic objectives to stakeholders" may mean that the developers of the strategy aren't getting out enough information for folks to understand what they're supposed to do with it. "New initiatives or objectives are outlined but not communicated throughout the organization as to how the new objectives should look and feel, what steps to take, time-frame, etc. Poor communications among team members responsible for decisions in implementation; Expectations and opinions are not shared openly, thoroughly, and effectively." Communication is also much more than words and pictures. Communication is also delivered through demonstration. "The management team does not follow the strategy themselves

Competitive Advantage

Competitive advantage is defined as the strategic advantage one business entity has over its rival entities within its competitive industry. Achieving competitive advantage strengthens and positions a business better within the business environment. A competitive advantage exists when the firm is able to deliver the same benefits as competitors but at a lower cost (cost advantage), or deliver benefits that exceed those of competing products (differentiation advantage). Thus, a competitive advantage enables the firm to create superior value for its customers and superior profits for itself. It can be illustrated as below

A Model of Competitive Advantage



A well-designed global strategy can help a firm to gain a competitive advantage. This advantage can arise from the following sources:

•Efficiency which leads to economies of scale from access to more customers and markets; exploit another country's resources - labor, raw materials; extend the product life cycle that is older products can be sold in lesser developed countries; operational flexibility that is shift production as costs, exchange rates, etc.change over time.

•Strategicwhich is a first mover advantage and only provider of a product to a market making a cross subsidization between countries and transfer price

•Risk is a diversify macroeconomic risks (business cycles not perfectly correlatedamong countries) advantage. It diversify operational risks (labor problems, earthquakes, wars)

•Learningwhich is the advantage of broadening learning opportunities due to diversity of operatingenvironments.

•Reputationwhich is the advantage of crossover customers between markets - reputation and brands

In finance, diversification means reducing risk by investing in a variety of assets. If the asset values do not move up and down in perfect synchrony, a diversified portfolio will have less risk than the weighted average risk of its constituent assets, and often less risk than the least risky of its constituents. Therefore, any risk-averse investor will diversify to at least some extent, with more risk-averse investors diversifying more completely than less risk-averse investors. The three types of diversification include:

The **concentric diversifications**which specify that there exists similarities between the industries in terms of the technological standpoint. It is through this that the firm may compare and apply its technological knowhow to an advantage. This is through a careful change or alteration in the marketing strategy performed by the business. This strategy aims to increase the market value of a particular product and therefore gain a higher profit.

The **horizontal diversification** tackles products or services that are in a sense, not related technologically to certain products but still pique the interest of current customers. This strategy is more effective is the current clientele is loyal to the existing products or services, and if the new additions are well priced and adequately promoted. The newest additions are marketed in the same way that the previous ones were which may cause instability. This is because the strategy increases the new products' dependence on an existing one. This integration normally occurs when a new business is introduced, however unrelated to the existing.

Conglomerate or lateral diversification is where the company or business promotes products or services with no relation commercially or technologically to the existing products or services, however still interest a number of customers. This type of diversification is unique to the current business and may prove quite risky. However, it may also prove very successful since it independently aims to improve on the profit the company accumulates with regards to the new product or service.

Diversification

Diversification as already explained above is associated with many risks; The Capital Asset Pricing Model introduced the concepts of diversifiable and non-diversifiable risk. Synonyms for diversifiable risk are idiosyncratic risk, unsystematic risk, and security-specific risk.

Systematic Risk -This influences a large number of assets. A significant political event, for example, could affect several of the assets in your portfolio. It is virtually impossible to protect yourself against this type of risk.

Unsystematic Risk is sometimes referred to as "specific risk". This kind of risk affects a very small number of assets. An example is news that affects a specific stock such as a sudden strike by employees. Diversification is the only way to protect you from unsystematic risk.

Credit or Default Risk is the risk that a company or individual will be unable to pay the contractual interest or principal on its debt obligations. This type of risk is of particular concern to investors who hold bonds in their portfolios. Government bonds, especially those issued by the federal government, have the least amount of default risk and the lowest returns, while corporate bonds tend to have the highest amount of default risk but also higher interest rates. Bonds with a lower chance of default are considered to be investment grade, while bonds with higher chances are considered to be junk bonds.

Country Risk refers to the risk that a country won't be able to honor its financial commitments. When a country defaults on its obligations, this can harm the performance of all other financial instruments in that country as well as other countries it has relations with. Country risk applies to stocks, bonds, mutual funds, options and futures that are issued within a particular country. This type of risk is most often seen in emerging markets or countries that have a severe deficit.

Foreign-Exchange Risk - When investing in foreign countries you must consider the fact that currency exchange rates can change the price of the asset as well. Foreign-exchange risk applies to all financial instruments that are in a currency other than your domestic currency. As an example, if you are a resident of America and invest in some Canadian stock in Canadian dollars, even if the share value appreciates, you may lose money if the Canadian dollar depreciates in relation to the American dollar.

Interest Rate Risk is the risk that an investment's value will change as a result of a

change in interest rates. This risk affects the value of bonds more directly than stocks.
Political Risk represents the financial risk that a country's government will suddenly change its policies. This is a major reason why developing countries lack foreign investment.
Market Risk is the most familiar of all risks also referred to as volatility; market risk is the day-to-day fluctuations in a stock's price. Market risk applies mainly to stocks and options. As a whole, stocks tend to perform well during a bull market and poorly during a bear market - volatility is not so much a cause but an effect of certain market forces. Volatility is a measure of risk because it refers to the behavior, or "temperament", of your investment rather than the reason for this behavior. Because market movement is the reason why people can make money from stocks, volatility is essential for returns, and the more unstable the investment the more chance there is that it will experience a dramatic change in either direction.

International trade

International trade is exchange of capital, goods, and services across international borders or territorie In most countries, it represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history (see Silk Road, Amber Road), 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 on the international trade system. Increasing international trade is crucial to the continuance of globalization. International trade is a major source of economic revenue for any nation that is considered a world power. Without international trade, nations would be limited to the goods and services produced within their own borders.

International trade is in principle not different from domestic trade as the motivation and the behavior of parties involved in a trade does not change fundamentally depending on whether trade is across a border or not. The main difference is that international trade is typically more costly than domestic trade. The reason is that a border typically imposes additional costs such as tariffs, time costs due to border delays and costs associated with country differences such as language, the legal system or a different culture.

International trade uses a variety of currencies, the most important of which are held as foreign reserves by governments and central banks. Here the percentage of global cumulative reserves held for each currency between 1995 and 2005 are shown: the US dollar is the most sought-after currency, with the Euro in strong demand as well.

Another difference between domestic and international trade is that factors of production such as capital and labor are typically more mobile within a country than across countries. Thus international trade is mostly restricted to trade in goods and services, and only to a lesser extent to trade in capital, labor or other factors of production. Then trade in goods and services can serve as a substitute for trade in factors of production. Instead of importing the factor of production a country can import goods that make intensive use of the factor of production and are thus embodying the respective factor. An example is the import of labor-intensive goods by the United States from China. Instead of importing Chinese labor the United States is importing goods from China that were produced with Chinese labor. International trade is also a branch of economics, which, together with international finance, forms the larger branch of international economics.

Models used to predict trade patterns

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. The main merit of Ricardin model is that it assumes technology differences between countries. The Ricardian model makes the following assumptions:

6. Labor is the only primary input to production (labor is considered to be the ultimate source of value).
7. Constant Marginal Product of Labor (MPL) (Labor productivity is constant, constant returns to scale, and simple technology.)
8. Limited amount of labor in the economy
9. Labor is perfectly mobile among sectors but not internationally.
10. Perfect competition (price-takers).

The Ricardian model measures in the short-run, therefore technology differs internationally. This supports the fact that countries follow their comparative advantage and allows for specialization.

Modern development of the Ricardian model

The Ricardian trade model was studied by Graham, Jones, McKenzie and others. All the theories excluded intermediate goods, or traded input goods such as materials and capital goods. McKenzie(1954), Jones(1961) and Samuelson(2001)emphasised that condiderable gains from trade would be lost once intermediate goods were excluded from trade. In a famous comment McKenzie 1954 pointed that "A moment's consideration will convince one that Lancashire would be unlikely to produce cotton cloth if the cotton had to be grown in England.

Recently, the theory was extended to the case that includes traded intermediates.Thus the "labor only" assumption (#1 above) was removed from the theory. Thus the new Ricardian theory, or the Ricardo-Sraffa model, as it is sometimes named, theoretically includes capital goods such as machines and materials, which are traded across countries. In the time of global trade, this assumption is much more realistic than the Heckscher-Ohlin model, which assumes that capital is fixed inside the country and does not move internatioally.

Heckscher-Ohlin model

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 a capital abundance.

The H-O model makes the following core assumptions:

7. Labor and capital flow freely between sectors
8. The production of shoes is labor intensive and computers is capital intensive
9. The amount of labor and capital in two countries differ (difference in endowments)
10. free trade
11. technology is the same across countries (long-term)
12. Tastes are the same.

The problem with the H-O theory is that it excludes the trade of capital goods (including materials and fuels). In the H-O theory, labor and capital are fixed entities endowed to each country. In a modern economy, capital goods are traded internationally. Gains from trade of intermediate goods are considerable, as it was emphasized by Samuelson (2001).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. This theory differs from the theories of comparative advantage and absolute advantage since these theory focuses on the productivity of the production process for a particular good. On the contrary, the Heckscher-Ohlin theory states that a country should specialise production and export using the factors that are most abundant, and thus the cheapest. Not produce, as earlier theories stated, the goods it produces most efficiently.

Reality and Applicability of the Heckscher-Ohlin Model

The Heckscher-Ohlin theory is preferred to the Ricardo theory by many economists, because it makes fewer simplifying assumptions. In 1953, Wassily Leontief published a study, where he tested the validity of the Heckscher-Ohlin theory The study showed that the U.S was more abundant in capital compared to other countries, therefore the U.S would export capital- intensive goods and import labour-intensive goods. Leontief found out that the U.S's export was less capital intensive than import.

After the appearance of Leontief's paradox, many researchers tried to save the Heckscher-Ohlin theory, either by new methods of measurement, or either by new interpretations. Leamer emphasized that Leontief did not interpret HO theory properly and claimed that with a right interpretation paradox did not occur. Brecher and Choudri found that, if Leamer was right, the American workers consumption per head should be lower than the workers world average consumption.

Many other trials followed but most of them failed. Many of famous textbook writers, including Krugman and Obstfeld and Bowen, Hollander and Viane, are negative about the validity of H-O model. After examining the long history of empirical research, Bowen, Hollander and Viane concluded: "Recent tests of the factor abundance theory [H-O theory and its developed form into many-commodity and many-factor case] that directly examine the H-O-V equations also indicate the rejection of the theory."Heckscher-Ohlin theory is not well adapted to the analyze South-North trade problems. The assumptions of HO are less realistic with respect to N-S than N-N (or S-S) trade. Income differences between North and South is the one that third world cares most. The factor price equalization [a consequence of HO theory] has not shown much sign of realization. HO model assumes identical production functions between countries. This is highly unrealistic. Technological gap between developed and developing countries is the main concern of the poor countries.

Specific factors model

In this model, labor mobility between industries is possible while capital is immobile between industries in the short-run. Thus, this model can be interpreted as a 'short run' version of the Heckscher-Ohlin model. 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 (i.e. labor and capital) are likely to have opposing agendas when lobbying for controls over immigration of labor. Conversely, both owners of capital and labor 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.

New Trade Theory

New Trade theory tries to explain several facts about trade, which the two main models above have difficulty with. These include the fact that most trade is between countries with similar factor endowment and productivity levels, and the large amount of multinational production(i.e.foreign direct investment) which exists. In one example of this framework, the economy exhibits monopolistic competition and increasing returns to scale.

Gravity model

Gravity model of trade

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 for international trade

This belief became the dominant thinking among western nations since then. In the years since the Second World War, controversial multilateral treaties like the General Agreement on Tariffs and Trade (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 nations, 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.

Risk in international trade

Companies doing business across international borders face many of the same risks as would normally be evident in strictly domestic transactions. For

example, Buyer insolvency (purchaser cannot pay);

- Non-acceptance (buyer rejects goods as different from the agreed upon specifications);
- Credit risk (allowing the buyer to take possession of goods prior to payment);
- Regulatory risk (e.g., a change in rules that prevents the transaction);

- Intervention (governmental action to prevent a transaction being completed);
- Political risk (change in leadership interfering with transactions or prices); and
- War and Acts of God.

In addition, international trade also faces the risk of unfavorable exchange rate movements (and, the potential benefit of favorable movements).

2. Borders

Borders define geographic boundaries of political entities or legal jurisdictions, such as governments, states or sub national administrative divisions. They may foster the setting up of buffer zones. Some borders are fully or partially controlled, and may be crossed legally only at designated border checkpoints.

Definitions of borders

In the past many borders were not clearly defined lines, but were neutral zones called marchlands. This has been reflected in recent times with the neutral zones that were set up along part of Saudi Arabia's borders with Kuwait and Iraq (however, these zones no longer exist). In modern times the concept of a marchland has been replaced by that of the clearly defined and demarcated border. For the purposes of border control, airports and seaports are also classed as borders. Most countries have some form of border control to restrict or limit the movement of people, animals, plants, and goods into or out of the country. Under international law, each country is generally permitted to define the conditions which have to be met by a person to legally cross its borders by its own laws, and to prevent persons from crossing its border when this happens in violation of those laws.

In order to cross borders, the presentation of passports and visas or other appropriate forms of identity document is required by some legal orders. To stay or work within a country's borders aliens (foreign persons) may need special immigration documents or permits that authorize them to do so.

Moving goods across a border often requires the payment of excise tax, often collected by customs officials. Animals (and occasionally humans) moving across borders may need to go into quarantine to prevent the spread of exotic or infectious diseases. Most countries prohibit carrying illegal drugs or endangered animals across their borders. Moving goods, animals or people illegally across a border, without declaring them, seeking permission, or deliberately evading official inspection constitutes smuggling.

Border economics

The presence of borders often fosters certain economic features or anomalies. Wherever two jurisdictions come into contact, special economic opportunities arise for border trade. Smuggling provides a classic case; contrariwise, a border region may flourish on the provision of excise or of import–export services — legal or quasi-legal, corrupt or corruption-free. Different regulations on either side of a border may encourage services to position themselves at or near that border: thus the provision of pornography, of prostitution, of alcohol and/or of narcotics may cluster around borders, city limits, county lines, ports and airports. In a more planned and official context, Special Economic Zones (SEZs) often tend to cluster near borders or ports.

Human economic traffic across borders (apart from kidnapping), may involve mass commuting between workplaces and residential settlements. The removal of internal barriers to commerce, as in France after the French Revolution or in Europe since the 1940s, de-emphasizes border-based economic activity and fosters free trade. Euro regions are similar official structures built around commuting across borders.

International finance

International finance is the branch of economics that studies the dynamics of exchange rates, foreign investment, and how these affect international trade. It also studies international projects, international investments and capital flows, and trade deficits. It includes the study of futures, options and currency swaps. Together with international trade theory, international finance is also a branch of international economics.

Some of the theories which are important in international finance include the Mundell-Fleming model, the optimum currency area (OCA) theory, as well as the purchasing power parity (PPP) theory. Moreover, whereas international trade theory makes use of mostly microeconomic methods and theories, international finance theory makes use of predominantly intermediate and advanced macroeconomic methods and concepts.

International economics is concerned with the effects upon economic activity of international differences in productive resources and consumer preferences and the institutions that affect them. It seeks to explain the patterns and consequences of transactions and interactions between the inhabitants of different countries, including trade, investment and migration.

- **International trade** studies goods-and-services flows across international boundaries from supply-and-demand factors, economic integration, and policy variables such as tariff rates and trade quotas.
- **International finance** studies the flow of capital across international financial markets, and the effects of these movements on exchange rates.
- **International monetary economics** and **macroeconomics** studies money and macro flows across countries.

International trade

Scope and methodology

The economic theory of international trade differs from the remainder of economic theory mainly because of the comparatively limited international mobility of the capital and labour [8]. In that respect, it would appear to differ in degree rather than in principle from the trade between remote regions in one country. Thus the methodology of international trade economics differs little from that of the remainder of economics. However, the direction of academic research on the subject has been influenced by the fact that governments have often sought to impose restrictions upon international trade, and the motive for the development of trade theory has often been a wish to determine the consequences of such restrictions.

The branch of trade theory which is conventionally categorized as "classical" consists mainly of the application of deductive logic, originating with Ricardo's Theory of *Comparative Advantage* and developing into a range of theorems that depend for their practical value upon the realism of their postulates. "Modern" trade theory, on the other hand, depends mainly upon *empirical analysis*.

Classical theory

The law of *comparative advantage* provides a logical explanation of international trade as the rational consequence of the comparative advantages that arise from inter-regional differences - regardless of how those differences arise. Since its exposition by John Stuart Mill the techniques of neo-classical economics have been applied to it to model the patterns of trade that would result from various postulated sources of comparative advantage. However, extremely restrictive (and often unrealistic) assumptions have had to be adopted in order to make the problem amenable to theoretical analysis. The best-known of the resulting models, the Heckscher-Ohlin theorem (H-O) depends upon the assumptions of no international differences of technology, productivity, or consumer preferences; no obstacles to pure competition or free trade and no scale economies. On those assumptions, it derives a model of the trade patterns that would arise solely from international differences in the relative abundance of labour and capital (referred to as factor endowments). The resulting theorem states that, on those assumptions, a country with a relative abundance of capital would export capital-intensive products and import labour-intensive products. The theorem proved to be of very limited predictive value, as was demonstrated by what came to be known as the "Leontief Paradox" (the discovery that, despite its capital-rich factor endowment, America was exporting labour-intensive products and importing capital-intensive products) Nevertheless the theoretical techniques (and many of the assumptions) used in deriving the H-O model were subsequently used to derive further theorems. The Stolper-Samuelson theorem , which is often described as a corollary of the H-O theorem, was an early example. In its most general form it states that if the price of a good rises (falls) then the price of the factor used intensively in that industry will also rise (fall) while the price of the other factor will fall (rise). In the international trade context for which it was devised it means that trade lowers the real wage of the scarce factor of production, and protection from trade raises it. Another corollary of the H-O theorem is Samuelson's factor price equalisation theorem which states that as trade between countries tends to equalise their product prices, it tends also to equalise the prices paid to their factors of production. Those theories have sometimes been taken to mean that trade between an industrialised country and a developing country would lower the wages of the unskilled in the industrialised country. (But, as noted below, that conclusion depends upon the unlikely assumption that productivity is the same in the two countries). Large numbers of learned papers have been produced in attempts to elaborate on the H-O and Stolper-Samuelson theorems, and while many of them are considered to provide valuable insights, they have seldom proved to be directly applicable to the task of explaining trade patterns.)

Modern theory

Modern trade theory moves away from the restrictive assumptions of the H-O theorem and explores the effects upon trade of a range of factors, including technology and scale economies. It makes extensive use of *econometrics* to identify from the available statistics, the contribution of particular factors among the many different factors that affect trade. The contribution of differences of technology have been evaluated in several such studies. The temporary advantage arising from a country's development of a new technology is seen as contributory factor in one study Other researchers have found research and development expenditure, patents issued, and the availability of skilled labor, to be indicators of the technological leadership that enables some countries to produce a flow of such technological innovations. and have found that technology leaders tend to export hi-tech products to others and receive imports of more standard products from them. Another econometric study also established a correlation between country size and the share of exports made up of goods in the production of which there are scale economies . It is further suggested in that study that internationally-traded goods fall into three categories, each with a different type of comparative advantage:

- goods that are produced by the extraction and routine processing of available natural resources – such as coal, oil and wheat, for which developing countries often have an advantage compared with other types of production – which might be referred to as "Ricardo goods";
- low-technology goods, such as textiles and steel, that tend to migrate to countries with appropriate factor endowments - which might be referred to as "Heckscher-Ohlin goods"; and,
- high-technology goods and high scale-economy goods, such as computers and aeroplanes, for which the comparative advantage arises from the availability of R&D resources and specific skills and the proximity to large sophisticated markets.

The effects of international trade

Gains

There is a strong presumption that any exchange that is freely undertaken will benefit both parties, but that does not exclude the possibility that it may be harmful to others. However (on assumptions that included constant returns and competitive conditions) Paul Samuelson has proved that it will always be possible for the gainers from international trade to compensate the losers . Moreover, in that proof, Samuelson did not take account of the gains to others resulting from wider consumer choice, from the international specialisation of productive activities - and consequent economies of scale, and from the transmission of the benefits of technological innovation. An OECD study has suggested that there are further dynamic gains resulting from better resource allocation, deepening specialisation, increasing returns to R&D, and technology spillover. The authors found the evidence concerning growth rates to be mixed, but that there is strong evidence that a 1 per cent increase in openness to trade increases the level of GDP per capita by between 0.9 per cent and 2.0 per cent . They suggested that much of the gain arises from the growth of the most productive firms at the expense of the less productive. Those findings and others have contributed to a broad consensus among economists that trade confers very substantial net benefits, and that government restrictions upon trade are generally damaging.

Factor price equalization

Nevertheless there have been widespread misgivings about the effects of international trade upon wage earners in developed countries. Samuelson's factor price equalisation theorem indicates that, if productivity were the same in both countries, the effect of trade would be to bring about equality in wage rates. As noted above, that theorem is sometimes taken to mean that trade between an industrialised country and a developing country would lower the wages of the unskilled in the industrialised country. However, it is unreasonable to assume that productivity would be the same in a low-wage developing country as in a high-wage developed country. A 1999 study has found international differences in wage rates to be approximately matched by corresponding differences in productivity . (Such discrepancies that remained were probably the result of over-valuation or under-valuation of exchange rates, or of inflexibilities in labour markets.) It has been argued that, although there may sometimes be short-term pressures on wage rates in the developed countries, competition between employers in developing countries can be expected eventually to bring wages into line with their employees' *marginal products*. Any remaining international wage differences would then be the result of productivity differences, so that there would be no difference between unit labour costs in developing and developed countries, and no downward pressure on wages in the developed countries.

Terms of trade

There has also been concern that international trade could operate against the interests of developing countries. Influential studies published in 1950 by the Argentine economist Raul Prebisch and the British economist Hans Singer suggested that there is a tendency for the prices of agricultural products to fall relative to the prices of manufactured goods; turning the *terms of trade* against the developing countries and producing an unintended transfer of wealth from them to the developing countries. Their findings have been confirmed by a number of subsequent studies, although it has been suggested that the effect may be due to *quality bias* in the index numbers used or to the possession of *market power* by manufacturers . The Prebisch/Singer findings remain controversial, but they were used at the time - and have been used subsequently - to suggest that the developing countries should erect barriers against manufactured imports in order to nurture their own “infant industries” and so reduce their need to export agricultural products. The arguments for and against such a policy are similar to those concerning the *protection* of infant industries in general.

Infant industries

The term "infant industry" is used to denote a new industry which has prospects of becoming profitable in the long-term, but which would be unable to survive in the face of competition from imported goods. That is a situation that can occur because time is needed either to achieve potential *economies of scale*, or to acquire potential *learning curve* economies. Successful identification of such a situation followed by the temporary imposition of a barrier against imports can, in principle, produce substantial benefits to the country that applies it – a policy known as “import substitution industrialization”. Whether such policies succeed depends upon governments’ skills in picking winners, and there might reasonably be expected to be both successes and failures. It has been claimed that North Korea’s automobile industry owes its existence to initial protection against imports , but a study of infant industry protection in Turkey reveals the absence of any association between productivity gains and degree of protection, such as might be expected of a successful import substitution policy. . Another study provides descriptive evidence suggesting that attempts at import substitution industrialisation since the 1970s have usually failed , but the empirical evidence on the question has been contradictory and inconclusive . It has been argued that the case against import substitution industrialization is not that it is bound to fail, but that subsidies and tax incentives do the job better]. It has also been pointed out that, in any case, trade restrictions could not be expected to correct the domestic market imperfections that often hamper the development of infant industries

Trade policies

Economists’ findings about the benefits of trade have often been rejected by government policy-makers, who have frequently sought to protect domestic industries against foreign competition by erecting barriers, such as *tariffs* and *quotas*, against imports. Average tariff levels of around 15 per cent in the late 19th century rose to about 30 percent in the 1930s, following the passage in the United States of the Smoot-Hawley Act . Mainly as the result of international agreements under the auspices of the General Agreement on Tariffs and Trade (GATT) and subsequently the World Trade Organisation (WTO), average tariff levels were progressively reduced to about 7 per cent during the second half of the 20th century, and some other trade restrictions were also removed. The restrictions that remain are nevertheless of major economic importance: among other estimates the World Bank estimated in 2004 that the removal of all trade restrictions would yield benefits of over $500 billion a year by 2015 . The largest of the remaining trade-distorting policies are those concerning agriculture. In the OECD countries government payments account for 30 per cent of farmers’ receipts and tariffs of over 100 per cent are common OECD economists estimate that cutting all agricultural tariffs and subsidies by 50% would set off a chain reaction in realignments of production and consumption patterns that would add an extra $26 billion to annual world income.

Quotas prompt foreign suppliers to raise their prices toward the domestic level of the importing country. That relieves some of the competitive pressure on domestic suppliers, and both they and the foreign suppliers gain at the expense of a loss to consumers, and to the domestic economy, in addition to which there is a *deadweight loss* to the world economy. When quotas were banned under the rules of the General Agreement on Tariffs and Trade (GATT), the United States, Britain and the European Union made use of equivalent arrangements known as *voluntary restraint agreements* (VRAs) or voluntary export restraints (VERs) which were negotiated with the governments of exporting countries (mainly Japan) - until they too were banned. Tariffs have been considered to be less harmful than quotas, although it can be shown that their welfare effects differ only when there are significant upward or downward trends in imports. Governments also impose a wide range of non-tariff barriers that are similar in effect to quotas, some of which are subject to WTO agreements A recent example has been the application of the *precautionary principle* to exclude innovatory products].

International Finance

Scope and methodology

The economics of international finance do not differ in principle from the economics of international trade but there are significant differences of emphasis. The practice of international finance tends to involve greater uncertainties and risks because the assets that are traded are claims to flows of returns that often extend many years into the future. Markets in financial assets tend to be more volatile than markets in goods and services because decisions are more often revised and more rapidly put into effect. There is the share presumption that a transaction that is freely undertaken will benefit both parties, but there is a much greater danger that it will be harmful to others. For example, mismanagement of mortgage lending in the United States led in 2008 to banking failures and credit shortages in other developed countries, and sudden reversals of international flows of capital have often led to damaging financial crises in developing countries. And, because of the incidence of rapid change, the methodology of *comparative statics* has fewer applications than in the theory of international trade, and *empirical analysis* is more widely employed. Also, the consensus among economists concerning its principal issues is narrower and more open to controversy than is the consensus about international trade.

Exchange rates and capital mobility

A major change in the organisation of international finance occurred in the latter years of the twentieth century, and economists are still debating its implications. At the end of the second world war the national signatories to the Bretton Woods Agreement had agreed to maintain their currencies each at a fixed exchange rate with the United States dollar, and the United States government had undertaken to buy gold on demand at a fixed rate of $35 per ounce. In support of those commitments, most signatory nations had maintained strict control over their nationals' use of foreign exchange and upon their dealings in international financial assets. But in 1971 the United States government announced that it was suspending the convertibility of the dollar, and there followed a progressive transition to the current regime of *floating exchange rates* in which most governments no longer attempt to control their exchange rates or to impose controls upon access to foreign currencies or upon access to international financial markets. The behavior of the international financial system was transformed. Exchange rates became very volatile and there was an extended series of damaging financial crises. One study estimated that by the end of the twentieth century there had been 112 banking crises in 93 countries , another that there had been 26 banking crises, 86 currency crises and 27 mixed banking and currency crises - many times more than in the previous post-war years.

The outcome was not what had been expected. In making an influential case for flexible exchange rates in the 1950s, Milton Friedman had claimed that if there were any resulting instability, it would mainly be the consequence of macroeconomic instability but an empirical analysis in 1999 found no apparent connection .Economists began to wonder whether the expected advantages of freeing financial markets from government intervention were in fact being realized .Neoclassical theory had led them to expect capital to flow from the capital-rich developed economies to the capital-poor developing countries - because the returns to capital there would be higher. Flows of financial capital would tend to increase the level of investment in the developing countries by reducing their costs of capital, and the direct investment of physical capital would tend to promote specialization and the transfer of skills and technology. However, theoretical considerations alone cannot determine the balance between those benefits and the costs of volatility, and the question has had to be tackled by empirical analysis. A 2006 International Monetary Fund working paper offers a summary of the empirical evidence The authors found little evidence either of the benefits of the liberalization of capital movements, or of claims that it is responsible for the spate of financial crises. They suggest that net benefits can be achieved by countries that are able to meet threshold conditions of financial competence but that for others, the benefits are likely to be delayed, and vulnerability to interruptions of capital flows is likely to be increased.

Policies and Institutions

Although the majority of developed countries now have "floating" exchange rates, some of them – together with many developing countries – maintain exchange rates that are nominally "fixed", usually with the US dollar or the euro. The adoption of a fixed rate requires intervention in the foreign exchange market by the country's central bank, and is usually accompanied by a degree of control over its citizens' access to international markets. A controversial case in point is the policy of the Chinese government who had, until 2005, maintained the renminbi at a fixed rate to the dollar, but have since "pegged" it to a basket of currencies. It is frequently alleged that in doing so they are deliberately holding its value lower than if it were allowed to float (but there is evidence to the contrary . Some governments have abandoned their national currencies in favour of the common currency of a currency area such as the "*eurozone*" and some, such as Denmark, have retained their national currencies but have pegged them at a fixed rate to an adjacent common currency. On an international scale, the economic policies promoted by the International Monetary Fund (IMF) have had a major influence, especially upon the developing countries. The IMF was set up in 1944 to encourage international cooperation on monetary matters, to stabilise exchange rates and create an international payments system. Its principal activity is the payment of loans to help member countries to overcome *balance of payments problems*, mainly by restoring their depleted currency reserves. Their loans are, however, conditional upon the introduction of economic measures by recipient governments that are considered by the Fund's economists to provide conditions favourable to recovery. Their recommended economic policies are broadly those that have been adopted in the United States and the other major developed countries (known as the "*Washington Consensus*") and have often included the removal of all restrictions upon incoming investment. The Fund has been severely criticised by Joseph Stiglitz and others for what they consider to be the inappropriate enforcement of those policies and for failing to warn recipient countries of the dangers that can arise from the volatility of capital movements.

International financial stability

From the time of the Great Depression onwards, regulators and their economic advisors have been aware that economic and financial crises can spread rapidly from country to country, and that financial crises can have serious economic consequences. For many decades, that awareness led governments to impose strict controls over the activities and conduct of banks and other credit agencies, but in the 1980s many governments pursued a policy of deregulation in the belief that the resulting efficiency gains would outweigh any *systemic risk*s. The extensive financial innovations that followed are described in the article on financial economics. One of their effects has been greatly to increase the international inter-connectedness of the financial markets and to create an international financial system with the characteristics known in control theory as "complex-interactive". The stability of such a system is difficult to analyze because there are many possible failure sequences. The internationally-systemic crises that followed included the equity crash of October 1987 , the Japanese asset price collapse of the 1990s the Asian financial crisis of 1997the Russian government default of 1998 (which brought down the Long-Term Capital Management hedge fund) and the 2007-8 sub-prime mortgages crisis. The symptoms have generally included collapses in asset prices, increases in risk premiums, and general reductions in liquidity. Measures designed to reduce the vulnerability of the international financial system have been put forward by several international institutions. The Bank for International Settlements made two successive recommendations (Basel I and Basel II concerning the regulation of banks, and a coordinating group of regulating authorities, and the Financial Stability Forum, that was set up in 1999 to identify and address the weaknesses in the system, has put forward some proposals in an interim report .

Free trade

Free trade is a type of trade policy that allows traders to act and transact without interference from government. According to the law of comparative advantage the policy permits trading partners mutual gains from trade of goods and services.

Under a free trade policy, prices are a reflection of true supply and demand, and are the sole determinant of resource allocation. Free trade differs from other forms of trade policy where the allocation of goods and services amongst trading countries are determined by artificial prices that do not reflect the true nature of supply and demand. These artificial prices are the result of protectionist trade policies, whereby governments intervene in the market through price adjustments and supply restrictions. Such government interventions generally increase the cost of goods and services to both consumers and producers.

Interventions include subsidies, taxes and tariffs, non-tariff barriers, such as regulatory legislation and quotas, and even inter-government managed trade agreements such as the North American Free Trade Agreement (NAFTA) and Central America Free Trade Agreement (CAFTA) (contrary to their formal titles) and any governmental market intervention resulting in artificial prices that do not reflect the principles of supply and demand.

Most states conduct trade polices that are to a lesser or greater degree protectionist. One ubiquitous protectionist policy employed by states comes in the form agricultural subsidies whereby countries attempt to protect their agricultural industries from outside competition by creating artificial low prices for their agricultural goods.

Free trade agreements are a key element of customs unions and free trade areas. The details and differences of these agreements are covered in their respective articles.

Features of free trade

Free trade implies the following features

- trade of goods without taxes (including tariffs) or other trade barriers (*e.g.,* 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

Economics of free trade

Economic models

Two simple ways to understand the potential benefits of free trade are through David Ricardo's theory of comparative advantage and by analyzing the impact of a tariff or import quota.

The pink regions are the net loss to society caused by the existence of the tariff.

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.[10]

The chart at the right analyzes the effect of the imposition of an import tariff on some imaginary good. Prior to the tariff, the price of the good in the world market (and hence in the domestic market) is P. The tariff increases the domestic price to P. The higher price causes domestic production to increase from Q^{S1} to Q^{S2} and causes domestic consumption to decline from Q^{C1} to Q^{C2}. This has three main effects on societal welfare. Consumers are made worse off because the consumer surplus (green region) becomes smaller. Producers are better off because the producer surplus (yellow region) is made larger. The government also has additional tax revenue (blue region). However, the loss to consumers is greater than the gains by producers and the government. The magnitude of this societal loss is shown by the two pink triangles. Removing the tariff and having free trade would be a net gain for society.

An almost identical analysis of this tariff from the perspective of a net producing country yields parallel results. From that country's perspective, the tariff leaves producers worse off and consumers better off, but the net loss to producers is larger than the benefit to consumers (there is no tax revenue in this case because the country being analyzed is not collecting the tariff). Under similar analysis, export tariffs, import quotas, and export quotas all yield nearly identical results. Sometimes consumers are better off and producers worse off, and sometimes consumers are worse off and producers are better off, but the imposition of trade restrictions causes a net loss to society because the losses from trade restrictions are larger than the gains from trade restrictions. Free trade creates winners and losers, but theory and empirical evidence show that the size of the winnings from free trade are larger than the losses.

Trade diversion

According to mainstream economic theory, global free trade is a net benefit to society, but the selective application of free trade agreements to some countries and tariffs on others can sometimes lead to economic inefficiency through the process of trade diversion. It is economically efficient for a good to be produced by the country which is the lowest cost producer, but this will not always take place if a high cost producer has a free trade agreement while the low cost producer faces a high tariff. Applying free trade to the high cost producer (and not the low cost producer as well) can lead to trade diversion and a net economic loss. This is why many economists place such high importance on negotiations for global tariff reductions, such as the Doha Round.

Opposition

The relative costs, benefits and beneficiaries of free trade are debated by academics, governments and interest groups. A number of arguments for and against in the ongoing public debate can be seen in the free trade debate article.

Arguments for protectionism fall into the economic category (trade hurts the economy) or the moral category (the effects of trade might help the economy, but have ill effects in other areas). The moral category is wide, including concerns of income inequality, environmental degradation, supporting child labor and sweatshops, race to the bottom, wage slavery, accentuating poverty in poor countries, harming national defense, and forcing cultural change.

Free trade is often opposed by domestic industries that would have their profits and market share reduced by lower prices for imported goods.For example, if United States tariffs on imported sugar were reduced, U.S. sugar producers would receive lower prices and profits, while U.S. sugar consumers would spend less for the same amount of sugar because of those same lower prices. Economics says that consumers would necessarily gain more than producers would lose. Since each of those few domestic sugar producers would lose a lot while each of a great number of consumers would gain only a little, domestic producers are more likely to mobilize against the lifting of tariffs. More generally, producers often favor domestic subsidies and tariffs on imports in their home countries, while objecting to subsidies and tariffs in their export markets.

Socialists frequently oppose free trade on the ground that it allows maximum exploitation of workers by capital. For example, Karl Marx wrote in *The Communist Manifesto*, "The bourgeoisie... has set up that single, unconscionable freedom -- Free Trade. In one word, for exploitation, veiled by religious and political illusions, it has substituted naked, shameless, direct, brutal exploitation."

"Free trade" is opposed by many anti-globalization groups, based on their assertion that free trade agreements generally do not increase the economic freedom of the poor, and frequently make them poor These opponents see free trade deals as being materially harmful to the common people, whether these agreements are really for free trade or for government-managed trade. Nevertheless, if the deals are essentially for government-managed trade, arguing against them is not a direct argument against free trade *per se*. For example, it is argued that it would be wrong to let subsidized corn from the U.S. into Mexico freely under NAFTA at prices well below production cost (dumping) because of its ruinous effects to Mexican farmers. Of course, such subsidies violate free trade, so this argument is not actually against the principle of free trade, but rather its selective implementation.

Comparative advantage

In economics, the **law of comparative advantage** refers to the ability of a party (an individual, a firm, or a country) to produce a particular good or service at a lower opportunity cost than another party. It is the ability to produce a product most efficiently given all the other products that could be produced. It can be contrasted with absolute advantage which refers to the ability of a party to produce a particular good at a lower absolute cost than another.

Comparative advantage explains how trade can create value for both parties even when one can produce all goods with fewer resources than the other. The net benefits of such an outcome are called gains from trade.

Examples for Comparative Advantage

The following hypothetical examples explain the reasoning behind the theory. In Example 2 all assumptions are italicized for easy reference, and some are explained at the end of the example.

Example 1

Two men live alone on 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. He is also, 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.

Despite the fact that the younger man has absolute advantage in all activities, it is not in the interest of either of them to work in isolation since they both can benefit from specialization and exchange. If the two men divide the work according to comparative advantage then the young man will specialize in tasks at which he is most productive, while the older man will concentrate on tasks where his productivity is only a little less than that of the young man. Such an arrangement will increase total production for a given amount of labor supplied by both men and it will benefit both of them.

Example 2

Suppose there are two countries *of equal size*, **Northland** and **Southland**, that both produce and consume two goods, **Food** and **Clothes**. The productive capacities and efficiencies of the countries are such that if both countries devoted all their resources to Food production, output would be as follows:

- Northland: 100 tonnes
- Southland: 400 tonnes

If all the resources of the countries were allocated to the production of Clothes, output would be:

- Northland: 100 tonnes
- Southland: 200 tonnes

Assuming each has *constant opportunity costs of production* between the two products and both economies have *full employment at all times*. All *factors of production are mobile within the countries* between clothing and food industries, but are *immobile between the countries*. *The price mechanism must be working to provide perfect competition*.

Southland has an absolute advantage over Northland in the production of Food and Clothing. There seems to be no mutual benefit in trade between the economies, as Southland is more efficient at producing both products. The **opportunity costs** shows otherwise. Northland's opportunity cost of producing one tonne of Food is one tonne of Clothes and vice versa. Southland's opportunity cost of one tonne of Food is 0.5 tonne of Clothes. The opportunity cost of one tonne of Clothes is 2 tonnes of Food. Southland has a comparative advantage in food production, because of its lower opportunity cost of production with respect to Northland. Northland has a comparative advantage over Southland in the production of clothes, the opportunity cost of which is higher in Southland with respect to Food than in Northland.

To show these different opportunity costs lead to mutual benefit if the countries specialize production and trade, consider the countries produce and consume only domestically. The volumes are:

This example includes no formulation of the preferences of consumers in the two economies which would allow the determination of the international exchange rate of Clothes and Food. Given the production capabilities of each country, in order for trade to be worthwhile Northland requires a price of at least one tonne of Food in exchange for one tonne of Clothes; and Southland requires at least one tonne of Clothes for two tonnes of Food. The exchange price will be somewhere between the two. The remainder of the example works with an international trading price of one tonne of Food for 2/3 tonne of Clothes.

If both specialize in the goods in which they have comparative advantage, their outputs will be:

World production of food increased. Clothing production remained the same. Using the exchange rate of one tonne of Food for 2/3 tonne of Clothes, Northland and Southland are able to trade to yield the following level of consumption:

Northland traded 50 tonnes of Clothing for 75 tonnes of Food. Both benefited, and now consume at points outside their production possibility frontiers.

Assumptions in Example 2

- **Two countries, two goods** - the theory is no different for larger numbers of countries and goods, but the principles are clearer and the argument easier to follow in this simpler case.
- **Equal size economies** - again, this is a simplification to produce a clearer example.
- **Full employment** - if one or other of the economies has less than full employment of factors of production, then this excess capacity must usually be used up before the comparative advantage reasoning can be applied.
- **Constant opportunity costs** - a more realistic treatment of opportunity costs the reasoning is broadly the same, but specialization of production can only be taken to the point at which the opportunity costs in the two countries become equal. This does not invalidate the principles of comparative advantage, but it does limit the magnitude of the benefit.
- **Perfect mobility of factors of production within countries** - this is necessary to allow production to be switched *without cost*. In real economies this cost will be incurred: capital will be tied up in plant (sewing machines are not sowing machines) and labour will need to be retrained and relocated. This is why it is sometimes argued that 'nascent industries' should be protected from fully liberalised international trade during the period in which a high cost of entry into the market (capital equipment, training) is being paid for.
- **Immobility of factors of production between countries** - why are there different rates of productivity? The modern version of comparative advantage (developed in the early twentieth century by the Swedish economists Eli Heckscher and Bertil Ohlin) attributes these differences to differences in nations' factor endowments. A nation will have comparative advantage in producing the good that uses intensively the factor it produces abundantly. For example: suppose the US has a relative abundance of capital and India has a relative abundance of labor. Suppose further that cars are capital intensive to produce, while cloth is labor intensive. Then the US will have a comparative advantage in making cars, and India will have a comparative advantage in making cloth. If there is international factor mobility this can change nations' relative factor abundance. The principle of comparative advantage still applies, but who has the advantage in what can change.
- **Negligible Transport Cost** - Cost is not a cause of concern when countries decided to trade. It is ignored and not factored in.

- **Assume that half the resources are used to produce each good in each country.** This takes place before specialization
- **Perfect competition** - this is a standard assumption that allows perfectly efficient allocation of productive resources in an idealized free market.

Example 3

The economist Paul Samuelson provided another well known example in his *Economics*. Suppose that in a particular city the best lawyer happens also to be the best secretary, that is he would be the most productive lawyer and he would also be the best secretary in town. However, if this lawyer focused on the task of being an attorney and, instead of pursuing both occupations at once, employed a secretary, both the output of the lawyer and the secretary would increase.

Effects on the economy

Conditions that maximize comparative advantage do not automatically resolve trade deficits. In fact, in many real world examples where comparative advantage is attainable may in fact require a trade deficit. For example, the amount of goods produced can be maximized, yet it may involve a net transfer of wealth from one country to the other, often because economic agents have widely different rates of saving.

As the markets change over time, the ratio of goods produced by one country versus another variously changes while maintaining the benefits of comparative advantage. This can cause national currencies to accumulate into bank deposits in foreign countries where a separate currency is used.

Macroeconomic monetary policy is often adapted to address the depletion of a nation's currency from domestic hands by the issuance of more money, leading to a wide range of historical successes and failures.

Criticism

Free mobility of capital in a globalized world

Ricardo explicitly bases his argument on an assumed immobility of capital:

> *" ... if capital freely flowed towards those countries where it could be most profitably employed, there could be no difference in the rate of profit, and no other difference in the real or labor price of commodities, than the additional quantity of labor required to convey them to the various markets where they were to be sold."*

He explains why from his point of view (anno 1817) this is a reasonable assumption: *"Experience, however, shows, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connexions, and entrust himself with all his habits fixed, to a strange government and new laws, checks the emigration of capital."*

Some scholars, notably Herman Daly, an American ecological economist and professor at the School of Public Policy of University of Maryland, have voiced concern over the applicability of Ricardo's theory of comparative advantage in light of a perceived increase in the mobility of capital: *"International trade (governed by comparative advantage) becomes, with the introduction of free capital mobility, interregional trade (governed by Absolute advantage)."*

Protectionism

Protectionism is the economic policy of restraining trade between states, through methods such as tariffs on imported goods, restrictive quotas, and a variety of other restrictive government regulations designed to discourage imports, and prevent foreign take-over of local markets and companies. This policy is closely aligned with anti-globalization, and contrasts with free trade, where government barriers to trade are kept to a minimum. The term is mostly used in the context of economics, where **protectionism** refers to policies or doctrines which protect businesses and workers within a country by restricting or regulating trade with foreign nations.

Protectionist policies

A variety of policies can be used to achieve protectionist goals. These include:

8. *Tariffs*: Typically, tariffs (or taxes) are imposed on imported goods. Tariff rates usually vary according to the type of goods imported. Import tariffs will increase the cost to importers, and increase the price of imported goods in the local markets, thus lowering the quantity of goods imported. Tariffs may also be imposed on exports, and in an economy with floating exchange rates, export tariffs have similar effects as import tariffs. However, since export tariffs are often perceived as 'hurting' local industries, while import tariffs are perceived as 'helping' local industries, export tariffs are seldom implemented.
9. *Import quotas*: To reduce the quantity and therefore increase the market price of imported goods. The economic effects of an import quota is similar to that of a tariff, except that the tax revenue gain from a tariff will instead be distributed to those who receive import licenses. Economists often suggest that import licenses be auctioned to the highest bidder, or that import quotas be replaced by an equivalent tariff.
10. *Administrative Barriers*: Countries are sometimes accused of using their various administrative rules (eg. regarding food safety, environmental standards, electrical safety, etc.) as a way to introduce barriers to imports.
11. *Anti-dumping legislation* Supporters of anti-dumping laws argue that they prevent "dumping" of cheaper foreign goods that would cause local firms to close down. However, in practice, anti-dumping laws are usually used to impose trade tariffs on foreign exporters.
12. *Direct Subsidies*: Government subsidies (in the form of lump-sum payments or cheap loans) are sometimes given to local firms that cannot compete well against foreign imports. These subsidies are purported to "protect" local jobs, and to help local firms adjust to the world markets.
13. *Export Subsidies*: Export subsidies are often used by governments to increase exports. Export subsidies are the opposite of export tariffs, exporters

are paid a percentage of the value of their exports. Export subsidies increase the amount of trade, and in a country with floating exchange rates, have effects similar to import subsidies.

14. Exchange Rate manipulation: A government may intervene in the foreign exchange market to lower the value of its currency by selling its currency in the foreign exchange market. Doing so will raise the cost of imports and lower the cost of exports, leading to an improvement in its trade balance. However, such a policy is only effective in the short run, as it will most likely lead to inflation in the country, which will in turn raise the cost of exports, and reduce the relative price of imports.

De facto protectionism

In the modern trade arena many other initiatives besides tariffs have been called protectionist. For example, some commentators, such as Jagdish Bhagwati, see developed countries efforts in imposing their own labor or environmental standards as protectionism. Also, the imposition of restrictive certification procedures on imports are seen in this light.

Further, others point out that free trade agreements often have protectionist provisions such as intellectual property, copyright, and patent restrictions that benefit large corporations. These provisions restrict trade in music, movies, drugs, software, and other manufactured items to high cost producers with quotas from low cost producers set to zero

Arguments for protectionism

Opponents of free trade often argue that the comparative advantage argument for free trade has lost its legitimacy in a globally integrated world—in which capital is free to move internationally. Herman Daly, a leading voice in the discipline of ecological economics, emphasizes that although Ricardo's theory of comparative advantage is one of the most elegant theories in economics, its application to the present day is illogical: "Free capital mobility totally undercuts Ricardo's comparative advantage argument for free trade in goods, because that argument is explicitly and essentially premised on capital (and other factors) being immobile between nations. Under the new globalization regime, capital tends simply to flow to wherever costs are lowest—that is, to pursue absolute advantage."

Protectionists fault the free trade model as being reverse protectionism in disguise, that of using tax policy to protect foreign manufacturers from domestic competition. By ruling out revenue tariffs on foreign products, government must fully rely on domestic taxation to provide its revenue, which falls disproportionately on domestic manufacturing. As Paul Craig Roberts notes: "[Foreign discrimination of US products] is reinforced by the US tax system, which imposes no appreciable tax burden on foreign goods and services sold in the US but imposes a heavy tax burden on US producers of goods and services regardless of whether they are sold within the US or exported to other countries."

Infant industry argument

: Infant industry argument

Some proponents of protectionism claim that imposing tariffs that help protect newly founded infant industries allows those domestic industries to grow and become self-sufficient within the international economy once they reach a reasonable size.

Arguments against protectionism

Protectionism is frequently criticized as harming the people it is meant to help. Nearly all mainstream economists instead support free trade. Economic theory, under the principle of comparative advantage, shows that the gains from free trade outweigh any losses as free trade creates more jobs than it destroys because it allows countries to specialize in the production of goods and services in which they have a comparative advantage.Protectionism results in deadweight loss; this loss to overall welfare gives no-one any benefit, unlike in a free market, where there is no such total loss. According to economist Stephen P. Magee, the benefits of free trade outweigh the losses by as much as 100 to 1.

Most economists, including Nobel prize winners Milton Friedman and Paul Krugman, believe that free trade helps workers in developing countries, even though they are not subject to the stringent health and labor standards of developed countries. This is because "the growth of manufacturing — and of the myriad of other jobs that the new export sector creates — has a ripple effect throughout the economy" that creates competition among producers, lifting wages and living conditions. Economists have suggested that those who support protectionism ostensibly to further the interests of third world workers are in fact being disingenuous, seeking only to protect jobs in developed countries. Additionally, workers in the third world only accept jobs if they are the best on offer, as all mutually consensual exchanges must be of benefit to both sides, else they wouldn't be entered into freely. That they accept low-paying jobs from first world companies shows that their other employment prospects are worse.

Alan Greenspan, former chair of the American Federal Reserve, has criticized protectionist proposals as leading "to an atrophy of our competitive ability. ... If the protectionist route is followed, newer, more efficient industries will have less scope to expand, and overall output and economic welfare will suffer."

Protectionism has also been accused of being one of the major causes of war. Proponents of this theory point to the constant warfare in the 17th and 18th centuries among European countries whose governments were predominantly mercantilist and protectionist, the American Revolution, which came about primarily due to British tariffs and taxes, as well as the protective policies preceding both World War I and World War II. According to Frederic Bastiat, "When goods cannot cross borders, armies will."

Current world trends

Since the end of World War II, it has been the stated policy of most First World countries to eliminate protectionism through free trade policies enforced by international treaties and organizations such as the World Trade Organization.

Certain policies of First World governments have been criticized as protectionist, however, such as the Common Agricultural Policyin the European Union and proposed "Buy American" provisions in economic recovery packages in the United States.

The current round of trade talks by the World Trade Organization is the Doha Development Round and the last session of talks in Geneva, Switzerland led to an impassé. The leaders' statement in the G20 meeting in London in early 2009 included a promise to continue the Doha Round.

Economic integration

Economic integration is a term used to describe how different aspects between economies are integrated. The basics of this theory were written by the Hungarian Economist Béla Balassa in the 1960s. As economic integration increases, the barriers of trade between markets diminishes. The most integrated economy today, between independent nations, is the European Union and its euro zone.

Economist Fritz Machlup traces the origin of the term 'economic integration' to a group of five economists writing in the 1940s, including Wilhelm Röpke, Ludwig von Mises and Friedrich von Hayek. Economic integration was a foundational plank of US foreign policy after World War II

The degree of economic integration can be categorized into six stages:

7. Preferential trading area
8. Free trade area
9. Customs union
10. Common market
11. Economic and monetary union
12. Complete economic integration

Economic integration also tends to precede political integration. In fact, Balassa believed that supranational common markets, with their free movement of economic factors across national borders, naturally generate demand for further integration, not only economically (via monetary unions) but also politically--and, thus, that economic communities naturally evolve into political unions over time.

Trade creation

Trade creation is an economic term related to international economics in which trade is created by the formation of a customs union.

Occurrence of Trade Creation

When a customs union is formed, the member nations establish a free trade area amongst themselves and a common external tariff on non-member nations. As a result, the member nations establish greater trading ties between themselves now that protectionist barriers such as tariffs, quotas, and non-tariff barriers such as subsidies have been eliminated. The result is an increase in trade among member nations in the good or service of each nation's comparative advantage.

Downside of Trade Creation

The creation of trade is important to the nation entering the customs union in that increased specialization may hurt other industries. Arguments for protectionism, such as the infant industry argument, national defense, outsourcing, and issues with health and safety regulations are brought to mind. However, customs unions are typically formed with friendly nations, eliminating the national defense argument, and in the long run serves to create more jobs and output due to specialization.

Trade diversion

Trade diversion is an economic term related to international economics in which trade is diverted from a more efficient exporter towards a less efficient one by the formation of a free trade agreement.

Occurrence

When a country applies the same tariff to all nations, it will always import from the most efficient producer, since the more efficient nation will provide the goods at a lower price. With the establishment of a bilateral or regional free trade agreement, that may not be the case. If the agreement is signed with a less-efficient nation, it may well be that their products become cheaper in the importing market than those from the more-efficient nation, since there are taxes for only one of them. Consequently, after the establishment of the agreement, the importing country would acquire products from a higher-cost producer, instead of the low-cost producer from which it was importing until then. In other words, this would cause a trade diversion.

Term

The term was coined by Jacob Viner in *The Customs Union Issue* in 1950. In its literal meaning the term was however incomplete, as it failed to capture all welfare effects of discriminatory tariff liberalization, and it was not useful when it came to non-tariff barriers. Economists have however dealt with this incompleteness in two ways. Either they stretched the original meaning to cover all welfare effects, or they introduced new terms like trade expansion or internal versus external trade creation.

Downside

Diverted trade may hurt the non-member nation economically and politically and create a strained relationship between the two nations. The decreased output of the good or service traded from one nation with a high comparative advantage to a nation of lower comparative advantage works against creating more efficiency and therefore more overall surplus. It is widely believed by economists that trade diversion is harmful to consumers.

Example

An example of trade diversion is the UK's import of lamb, before Britain joined the EU most lamb imports came from New Zealand, the cheapest lamb producer, however when Britain joined the EU the common external tariff made it more expensive to import lamb from New Zealand than countries inside the union, thus France became the majority exporter of lamb to the UK. Trade was diverted from New Zealand, and created between France and the UK. Balance of trade

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 of output in an economy over a certain period. It is the relationship between a nation's imports and exports. A favourable balance of trade is known as a **trade surplus** and consists of exporting more than is imported; an unfavourable 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.

Definition

The balance of trade forms part of the current account, which 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 trade can be problematic because of problems with recording and collecting data. As an illustration of this problem, when official data for all the 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.

Factors that can affect the balance of trade include:

- The cost of production (land, labor, capital, taxes, incentives, etc.) in the exporting economy vis-à-vis those in the importing economy;
- The cost and availability of raw materials, intermediate goods and other inputs;

- Exchange rate movements;
- Multilateral, bilateral and unilateral taxes or restrictions on trade;
- Non-tariff barriers such as environmental, health or safety standards;
- The availability of adequate foreign exchange with which to pay for imports; and
- Prices of goods manufactured at home (influenced by the responsiveness of supply)

In addition, the trade balance 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) the trade balance will worsen at the same stage in the business cycle.

Since the mid 1980s, United States has had a growing deficit in tradeable goods, especially with Asian nations (China and Japan) which now hold large sums of U.S debt that has funded the consumption.The U.S. has a trade surplus with nations such as Australia and Canada. The issue of trade deficits can be complex. Trade deficits generated in tradeable goods such as manufactured goods or software may impact domestic employment to different degrees than trade deficits in raw materials.

Economies such as Canada, Japan, and Germany which have savings surpluses, typically run trade surpluses. China, a high growth economy, has tended to run trade surpluses. A higher savings rate generally corresponds to a trade surplus. Correspondingly, the United States with its lower savings rate has tended to run high trade deficits, especially with Asian nations.

Views on economic impact

Economists are sometimes divided on the economic impact of the trade deficit.

Conditions where trade deficits may be considered harmful

Those who ignore the effects of long run trade deficits may be confusing David Ricardo's principle of comparative advantage with Adam Smith's principle of absolute advantage, specifically ignoring the latter. The economist Paul Craig Roberts notes that the comparative advantage principles developed by David Ricardo do not hold where the factors of production are internationally mobile, a phenomenon described by economist Stephen S. Roach, where one country exploits the cheap labor of another, would be a case of absolute advantage that is not mutually beneficial.Detiorating U.S. net international investment position (NIIP) has caused concern among economists over the effects of outsourcing and high U.S. trade deficits over the long-run.

Conditions where trade imbalances may not be harmful

Small trade imbalances are generally not considered to be harmful to either the importing or exporting economy. However, when a national trade imbalance expands beyond prudence (generally thought to be several percent of GDP, for several years), adjustments tend to occur. While unsustainable imbalances may persist for long periods (cf, Singapore and New Zealand's surpluses and deficits, respectively), the distortions likely to be caused by large flows of wealth out of one economy and into another tend to become intolerable.

In simple terms, trade deficits are paid for out of foreign exchange reserves, and may continue until such reserves are depleted. At such a point, the importer can no longer continue to purchase more than is sold abroad. This is likely to have exchange rate implications: a sharp loss of value in the deficit economy's exchange rate with the surplus economy's currency will change the relative price of tradable goods, and facilitate a return to balance or (more likely) an over-shooting into surplus the other direction.

More complexly, an economy may be unable to export enough goods to pay for its imports, but is able to find funds elsewhere. Service exports, for example, are more than sufficient to pay for Hong Kong's domestic goods export shortfall. In poorer countries, foreign aid may fill the gap while in rapidly developing economies a capital account surplus often off-sets a current-account deficit. Finally, there are some economies where transfers from nationals working abroad contribute significantly to paying for imports. The Philippines, Bangladesh and Mexico are examples of transfer-rich economies.

Warren Buffett on trade deficits

The successful American businessman and investor Warren Buffett was quoted in the Associated Press (January 20, 2006) as saying "The U.S trade deficit is a bigger threat to the domestic economy than either the federal budget deficit or consumer debt and could lead to political turmoil... Right now, the rest of the world owns $3 trillion more of us than we own of them."

John Maynard Keynes on the balance of trade

In the last few years of his life, John Maynard Keynes was much preoccupied with the question of balance in international trade. He was the leader of the British delegation to the United Nations Monetary and Financial Conference in 1944 that established the Bretton Woods system of international currency management.

He was the principal author of a proposal—the so-called Keynes Plan—for an International Clearing Union. The two governing principles of the plan were that the problem of settling outstanding balances should be solved by 'creating' additional 'international money', and that debtor and creditor should be treated almost alike as disturbers of equilibrium. In the event, though, the plans were rejected, in part because *"American opinion was naturally reluctant to accept the principal of equality of treatment so novel in debtor-creditor relationships"*.

His view, supported by many economists and commentators at the time, was that creditor nations may be just as responsible as debtor nations for disequilibrium in exchanges and that both should be under an obligation to bring trade back into a state of balance. Failure for them to do so could have serious consequences. In the words of Geoffrey Crowther, then editor of The Economist, *"If the economic* *relationships between nations are not, by one means or another, brought fairly close to balance, then there is no set of financial arrangements that can rescue the world from the impoverishing results of chaos."*

These ideas were informed by events prior to the Great Depression when—in the opinion of Keynes and others—international lending, primarily by the United States, exceeded the capacity of sound investment and so got diverted into non-productive and speculative uses, which in turn invited default and a sudden stop to the process of lending.

Influenced by Keynes, economics texts in the immediate post-war period put a significant emphasis on balance in trade. For example, the second edition of the popular introductory textbook, *An Outline of Money*, devoted the last three of its ten chapters to questions of foreign exchange management and in particular the 'problem of balance'. However, in more recent years, since the end of the Bretton Woods system in 1971, with the increasing influence of Monetarist schools of thought in the 1980s, and particularly in the face of large sustained trade imbalances, these concerns—and particularly concerns about the destabilising affects of large trade surpluses—have largely disappeared from mainstream economics discourse and Keynes' insights have slipped from view, they are receiving some attention again in the wake of the financial crisis of 2007–2009.

Physical balance of trade

Monetary balance of trade is different from physical balance of trade (which is expressed in amount of raw materials). Developed countries usually import a lot of primary raw materials from developing countries at low prices. Often, these materials are then converted into finished products, and a significant amount of value is added. Although for instance the EU (as well as many other developed countries) has a balanced monetary balance of trade, its physical trade balance (especially with developing countries) is negative, meaning that a lot less material is exported than imported.

Balance of payments

In economics, the **balance of payments**, (or **BOP**) measures the payments that flow between any individual country and all other countries. It is used to summarize all international economic transactions for that country during a specific time period, usually a year. The BOP is determined by the country's exports and imports of goods, services, and financial capital, as well as financial transfers. It reflects all payments and liabilities to foreigners (debits) and all payments and obligations received from foreigners (credits). Balance of payments is one of the major indicators of a country's status in international trade, with net capital outflow.

The balance, like other accounting statements, is prepared in a single currency, usually the domestic. Foreign assets and flows are valued at the exchange rate of the time of transaction.

IMF definition

The IMF definition: "**Balance of Payments** is a statistical statement that summarizes transactions between residents and nonresidents during a period." The balance of payments comprises the **current account** and the **capital account** (or the **financial account**). "Together, these accounts balance in the sense that the sum of the entries is conceptually **zero**."

- The **current account** consists of the **goods and services account**, the primary income account and the secondary income account.
- The **capital account** is much smaller than the other two and consists primarily of debt forgiveness and assets from migrants coming to or leaving the country.
- The **financial account** consists of asset inflows and outflows, such as international purchases of stocks, bonds and real estate.

Balance of payments identity

The balance of payments identity states that:

> Current Account = Capital Account + Financial Account + Net Errors and Omissions

This is a convention of double entry accounting, where all debit entries must be booked along with corresponding credit entries such that the net of the Current Account will have a corresponding net of the Capital and Financial Accounts:

$$X + K_i = M + K_o$$

where:

- X = exports
- M = imports
- K_i = capital inflows
- K_o = capital outflows

Rearranging, we have:

$$(X - M) = K_o - K_i,$$

yielding the BOP identity.

The basic principle behind the identity is that a country can only *consume more than it can produce* (a current account deficit) if it *is supplied capital from abroad* (a capital account surplus).

Mercantile thought prefers a so-called balance of payments surplus where the net current account is in surplus or, more specifically, a positive balance of trade.

A **balance of payments equilibrium** is defined as a condition where the sum of debits and credits from the current account and the capital and financial accounts equal to zero; in other words, equilibrium is where

$$\text{Current account} + (\text{Capital and financial accounts}) = 0$$

This is a condition where there are no changes in Official Reserves.When there is no change in Official Reserves, the balance of payments may also be stated as follows:

$$\text{Current account} = -(\text{Capital and financial accounts})$$

or:

$$\text{Current account deficit (or surplus)} = \text{Capital and financial account surplus (or}$$

Canada's Balance of Payments currently satisfies this criterion. It is the only large monetary authority with no Changes in Reserves.

Criticism

According to Murray Rothbard:

> “ Fortunately, the absurdity of worrying about the balance of payments is made evident by focusing on inter-state trade. For nobody worries about the balance of payments between New York and New Jersey, or, for that matter, between Manhattan and Brooklyn, because there are no customs officials recording such trade and such balances. ”

Trade facilitation.

Trade facilitation looks at how procedures and controls governing the movement of goods across national borders can be improved to reduce associated cost burdens and maximise efficiency while safeguarding legitimate regulatory objectives. Business costs may be a direct function of collecting information and submitting declarations or an indirect consequence of border checks in the form of delays and associated time penalties, forgone business opportunities and reduced competitiveness.

Understanding and use of the term “trade facilitation” varies in the literature and amongst practitioners. "Trade facilitation" is largely used by institutions which seek to improve the regulatory interface between government bodies and traders at national borders. The WTO, in an online training package, once defined trade facilitation as: “The simplification and harmonisation of international trade procedures” where trade procedures are the “activities, practices and formalities involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade”.

In defining the term, many trade facilitation proponents will also make reference to trade finance and the procedures applicable for making payments (e.g. via a commercial banks). For example UN/CEFACT defines trade facilitation as "the simplification, standardization and harmonization of procedures and associated information flows required to move goods from seller to buyer and to make payment".

Occasionally, the term trade facilitation is extended to address a wider agenda in economic development and trade to include: the improvement of transport infrastructure, the removal of government corruption, the modernization of customs administration, the removal of other non-tariff trade barriers, as well as export marketing and promotion.

Examples of regulatory activity in international trade

Fiscal: Collection of customs duties, excise duties and other indirect taxes; payment mechanisms

Safety and security: Security and anti smuggling controls; dangerous goods; vehicle checks; immigration and visa formalities

Environment and health: Phytosanitary, veterinary and hygiene controls; health and safety measures; CITES controls; ships' waste

Consumer protection: Product testing; labelling; conformity checks with marketing standards (e.g. fruit and vegetables)

Trade policy: Administration of quota restrictions; export refunds

Topics and issues in trade facilitation

Trade facilitation has its intellectual roots in the fields of logistics and supply chain management. Trade facilitation looks at operational improvements at the interface between business and government and associated transaction costs. Trade facilitation has become a key feature in supply chain security and customs modernisation programmes. Within the context of economic development it has also come to prominence in the Doha Development Round. However, it is an equally prominent feature in unilateral and bilateral initiatives that seek to improve the trade environment and enhance business competitiveness. Reference to trade facilitation is sometimes also made in the context of "better regulation". Some organisations promoting trade facilitation will emphasis the cutting of red tape in international trade as their main objective. Propagated ideas and concepts to reforming trade and customs procedures generally resonate around the following themes:

- Simple rules and procedures
- Avoidance of duplication
- Memoranda of Understanding (MoUs)
- Alignment of procedures and adherence to international conventions
- Trade consultation
- Transparent and operable rules and procedures
- Accommodation of business practices

- Operational flexibility
- Public-service standards and performance measures
- Mechanisms for corrections and appeals
- Fair and consistent enforcement
- Proportionality of legislation and control to risk
- Time-release measures
- Risk management and trader authorisations
- Standardisation of documents and electronic data requirements
- Automation
- International electronic exchange of trade data
- Single Window System

International trade law

International trade law includes the appropriate rules and customs for handling trade between countries or between private companies across borders. Over the past twenty years, it has become one of the fastest growing areas of international law.

International trade law should be distinguished from the broader field of international economic law. The latter could be said to encompass not only WTO law, but also law governing the international monetary system and currency regulation, as well as the law of international development.

The body of rules for transnational trade in the 21st century derives from medieval commercial laws called the *lex mercatoria* and *lex maritima* — respectively, "the law for merchants on land" and "the law for merchants on sea." Modern trade law (extending beyond bilateral treaties) began shortly after the Second World War, with the negotiation of a multilateral treaty to deal with trade in goods: the General Agreement on Tariffs and Trade (GATT).

International trade law is based on theories of economic liberalism developed in Europe and later the United States from the 18th century onwards.

World Trade Organization

In 1995, the World Trade Organization, a formal international organization to regulate trade, was established. It is the most important development in the history of international trade law.

The purposes and structure of the organization is governed by the *Agreement Establishing The World Trade Organization*, also known as the "Marrakesh Agreement". It does not specify the actual rules that govern international trade in specific areas. These are found in separate treaties, annexed to the Marrakesh Agreement.

Trade in goods

The GATT has been the backbone of international trade law throughout most of the twentieth century. It contains rules relating to "unfair" trading practices — dumping and subsidies.

Trade and Human Rights

The World Trade Organisation Trade Related Intellectual Property Rights (TRIPS) agreement required signatory nations to raise intellectual property rights (also known as intellectual monopoloy privileges. This arguably has had a negative impact on access to essential medicines in some nations.

Dispute settlement

Since there are no international governing judges (2004) the means of dispute resolution is determined by jurisdiction. Each individual country hears cases that are brought before them. Governments choose to be party to a dispute. And private citizens determine jurisdiction by the Forum Clause in their contract.

Besides forum, another factor in international disputes is the rate of exchange. With currency fluctuation ascending and descending over years, a lack of Commerce Clause can jeopardize trade between parties when one party becomes unjustly enriched through natural market fluctuations. By listing the rate of exchange expected over the contract life, parties can provide for changes in the market through reassessment of contract or division of exchange rate fluctuations.

Dumping (pricing policy)

In economics, "**dumping**" can refer to any kind of predatory pricing. However, the word is now generally used only in the context of international trade law, where dumping is defined as the act of a manufacturer in one country exporting a product to another country at a price which is either below the price it charges in its home market or is below its costs of production. The term has a negative connotation, but advocates of free markets see "dumping" as beneficial for consumers and believe that protectionism to prevent it would have *net* negative consequences. Advocates for workers and laborers however, believe that safeguarding businesses against predatory practices, such as dumping, help alleviate some of the harsher consequences of free trade between economies at different stages of development (see *protectionism*). The Bolkestein directive, for example, was accused in Europe of being a form of "social dumping," as it favored competition between workers, as exemplified by the Polish Plumber stereotype. While there are very few examples of a national scale dumping that succeeded in producing a national-level monopoly, there are several examples of dumping that produced a monopoly in regional markets for certain industries. Ron Chenow points to the example of regional oil monopolies in *Titan : The Life of John D. Rockefeller, Sr.* where Rockefeller receives a message from Colonel Thompson outlining an approved strategy where oil in one market, Cincinnati, would be sold at or below cost to drive competition's profits down and force them to exit the market. In another area where other independent businesses were already driven out, namely in Chicago, prices would be increased by a quarter. A standard technical definition of dumping is the act of charging a lower price for a good in a foreign market than one charges for the same good in a domestic market. This is often referred to as selling at less than "fair value." Under the World Trade Organization (WTO) Agreement, dumping is condemned (but is not prohibited) if it causes or threatens to cause material injury to a domestic industry in the importing country.

Remedies and penalties

In United States, domestic firms can file an antidumping petition under the regulations determined by the United States Department of Commerce, which determines "less than fair value" and the International Trade Commission, which determines "injury". These proceedings operate on a timetable governed by U.S. law. The Department of Commerce has regularly found that products have been sold at less than fair value in U.S. markets. If the domestic industry is able to establish that it is being injured by the dumping, then antidumping duties are imposed on goods imported from the dumpers' country at a percentage rate calculated to counteract the dumping margin.

Related to antidumping duties are "countervailing duties." The difference is that countervailing duties seek to offset injurious subsidization while antidumping duties offset injurious dumping.

Some commentators have noted that domestic protectionism, and lack of knowledge regarding foreign cost of production, lead to the unpredictable institutional process surrounding investigation. Members of the WTO can file complaints against anti-dumping measures.

Anti-dumping actions

Legal issues

If a company exports a product at a price lower than the price it normally charges on its own home market, it is said to be "dumping" the product. Opinions differ as to whether or not this is unfair competition, but many governments take action against dumping in order to defend their domestic industries. The WTO agreement does not pass judgment. Its focus is on how governments can or cannot react to dumping—it disciplines anti-dumping actions, and it is often called the "Anti-Dumping Agreement". (This focuses only on the reaction to dumping contrasts with the approach of the Subsidies & Countervailing Measures Agreement.)

The legal definitions are more precise, but broadly speaking the WTO agreement allows governments to act against dumping where there is genuine ("material") injury to the competing domestic industry. In order to do that the government has to be able to show that dumping is taking place, calculate the extent of dumping (how much lower the export price is compared to the exporter’s home market price), and show that the dumping is causing injury or threatening to do so.

Definitions and degrees of dumping

While permitted by the WTO, General Agreement on Tariffs and Trade (GATT) (Article VI) allows countries the option of taking action against dumping. The Anti-Dumping Agreement clarifies and expands Article VI, and the two operate together. They allow countries to act in a way that would normally break the GATT principles of binding a tariff and not discriminating between trading partners—typically anti-dumping action means charging extra import duty on the particular product from the particular exporting country in order to bring its price closer to the “normal value” or to remove the injury to domestic industry in the importing country.

There are many different ways of calculating whether a particular product is being dumped heavily or only lightly. The agreement narrows down the range of possible options. It provides three methods to calculate a product’s “normal value”. The main one is based on the price in the exporter’s domestic market. When this cannot be used, two alternatives are available—the price charged by the exporter in another country, or a calculation based on the combination of the exporter’s production costs, other expenses and normal profit margins. And the agreement also specifies how a fair comparison can be made between the export price and what would be a normal price.

Calculating the extent of dumping on a product is not enough. Anti-dumping measures can only be applied if the dumping is hurting the industry in the importing country. Therefore, a detailed investigation has to be conducted according to specified rules first. The investigation must evaluate all relevant economic factors that have a bearing on the state of the industry in question. If the investigation shows dumping is taking place and domestic industry is being hurt, the exporting company can undertake to raise its price to an agreed level in order to avoid anti-dumping import duty.

Procedures in investigation and litigation

Detailed procedures are set out on how anti-dumping cases are to be initiated, how the investigations are to be conducted, and the conditions for ensuring that all interested parties are given an opportunity to present evidence. Anti-dumping measures must expire five years after the date of imposition, unless a review shows that ending the measure would lead to injury.

Anti-dumping investigations are to end immediately in cases where the authorities determine that the margin of dumping is, *de minimis,* or insignificantly small (defined as less than 2% of the export price of the product). Other conditions are also set. For example, the investigations also have to end if the volume of dumped imports is negligible (i.e., if the volume from one country is less than 3% of total imports of that product—although investigations can proceed if several countries, each supplying less than 3% of the imports, together account for 7% or more of total imports). The agreement says member countries must inform the Committee on Anti-Dumping Practices about all preliminary and final anti-dumping actions, promptly and in detail. They must also report on all investigations twice a year. When differences arise, members are encouraged to consult each other. They can also use the WTO’s dispute settlement procedure.

Actions in the European Union

European Union anti-dumping is under the purview of the European Council. It is governed by European Council regulation 384/96. However, implementation of anti-dumping actions (trade defence actions) is taken after voting by various committees with member state representation.

The bureaucratic entity responsible for advising member states on anti-dumping actions is the Directorate General Trade (DG Trade), based in Brussels. Community industry can apply to have an anti-dumping investigation begin. DG Trade first investigates the standing of the complainants. If they are found to represent at least 25% of community industry, the investigation will probably begin. The process is guided by quite specific guidance in the regulations. The DG Trade will make a recommendation to a committee known as the Anti-Dumping Advisory Committee, on which each member state has one vote. Member states abstaining will be treated as if they voted in favour of industrial protection, a voting system which has come under considerable criticism

As is implied by the criterion for beginning an investigation, EU anti-dumping actions are primarily considered part of a "trade defence" portfolio. Consumer interests and non-industry related interests ("community interests") are not emphasized during an investigation. An investigation typically looks for damage caused by dumping to community producers, and the level of tariff set is based on the damage done to community producers by dumping.

If consensus is not found, the decision goes to the European Council.

If imposed, duties last for five years theoretically. In practice they last at least a year longer, because expiry reviews are usually initiated at the end of the five years, and during the review process the status-quo is maintained.

Chinese economic situation

The dumping investigation essentially compares domestic prices of the accused dumping nation with prices of the imported product on the European market. However, several rules are applied to the data before the dumping margin is calculated. Most contentious is the concept of "analogue market". Some exporting nations are not granted "Market Economy Status" by the EU: China is a prime example. In such cases, the DG Trade is prevented from using domestic prices as the fair measure of the domestic price. A particular exporting industry may also lose market status if the DG Trade concludes that this industry receives government assistance. Other tests applied include the application of international accounting standards and bankruptcy laws.

The consequences of not being granted market economy status have a big impact on the investigation. For example, if China is accused of dumping widgets, the basic approach is to consider the price of widgets in China against the price of Chinese widgets in Europe. But China does not have market economy status, so Chinese domestic prices can not be used as the reference. Instead, the DG Trade must decide upon an analogue market: a market which does have market economy status, and which is similar enough to China. Brazil and Mexico have been used, but the USA is a popular analogue market. In this case, the price of widgets in the USA is regarded as the substitute for the price of widgets in China. This process of choosing an analogue market is subject to the influence of the complainant, which has led to some criticism that it is an inherent bias in the process.

However,China is one of the countries that has the cheapest labourforce. Criticizims have argued that it is quite unreasonable to compare China's goods price to the USA's as analogue. China is now developing to a more free and open market, unlike its planned-economy in the early 60s, the market in China is more willing to embrace the global competition. It is thus required to improve its market regulations and conquer the free trade barriers to improve the situation and produce a properly judged pricing level to assess the "dumping" behavior.

Agricultural support and dumping

European Union and Common Agricultural Policy

The Common Agricultural Policy of the European Union has often been accused of dumping though significant reforms were made as part of the Agreement on Agriculture at the Uruguay round of GATT negotiations in 1992 and in subsequent incremental reforms, notably the Luxembourg Agreement in 2003. Initially the CAP sought to increase European agricultural production and provide support to European farmers through a process of market intervention whereby a special fund - the European Agricultural Guidance and Guarantee Fund (EAGGF) - would buy up surplus agricultural produce if the price fell below a certain centrally determined level (the intervention level). Through this measure European farmers were given a 'guaranteed' price for their produce when sold in the European community. In addition to this internal measure a system of export reimbursements ensured that European produce sold outside of the European community would sell at or below world prices at no detriment to the European producer. This policy was heavily criticized as distorting world trade and since 1992 the policy has moved away from market intervention and towards direct payments to farmers regardless of production (a process of "decoupling"). Furthermore the payments are generally dependent on the farmer fulfilling certain environmental or animal welfare requirements so as to encourage responsible, sustainable farming in what is termed 'multifunctional' agricultural subsidies - that is, the social, environmental and other benefits from subsidies that do not include a simple increase in production.

Multinational corporation

A **multinational corporation** (**MNC**) or **transnational corporation** (**TNC**), also called **multinational enterprise** (**MNE**) is a corporation or enterprise that manages production or delivers services in more than one country. It can also be referred to as an ***international corporation***.

The first modern MNC is generally thought to be the Poor Knights of Christ and the Temple of Solomon, first endorsed by the pope in 1129. The key element of transnational corporations was present even back then: the British East India Company and Dutch East India Company were operating in different countries than the ones where they had their headquarters. Nowadays many corporations have offices, branches or manufacturing plants in different countries than where their original and main headquarter is located. This is the very definition of a transnational corporation. Having multiple operation points that all respond to one headquarter.

This often results in very powerful corporations that have budgets that exceed some national GDPs. Multinational corporations can have a powerful influence in local economies as well as the world economy and play an important role in international relations and globalization. The presence of such powerful players in the world economy is reason for much controversy.

Market imperfections

It may seem strange that a corporation can decide to do business in a different country, where it doesn't know the laws, local customs or business practices. Why is it not more efficient to combine assets of value overseas with local factors of production at lower costs by renting or selling them to local investors?

One reason is that the use of the market for coordinating the behaviour of agents located in different countries is less efficient than coordinating them by a multinational enterprise as an institution. The additional costs caused by the entrance in foreign markets are of less interest for the local enterprise. According to Hymer, Kindleberger and Caves, the existence of MNEs is reasoned by structural market imperfections for final products. In Hymer's example, there are considered two firms as monopolists in their own market and isolated from competition by transportation costs and other tariff and non-tariff barriers. If these costs decrease, both are forced to competition; which will reduce their profits. The firms can maximize their joint income by a merger or acquisition which will lower the competition in the shared market. Due to the transformation of two separated companies into one MNE the pecuniary externalities are going to be internalized. However, this doesn't mean that there is an improvement for the society. This could also be the case if there are few substitutes or limited licenses in a foreign market. The consolidation is often established by acquisition, merger or the vertical integration of the potential licensee into overseas manufacturing. This makes it easy for the MNE to enforce price discrimination schemes in various countries. Therefore Humyer considered the emergence of multinational firms as "an (negative) instrument for restraining competition between firms of different nations".Market imperfections had been considered by Hymer as structural and caused by the deviations from perfect competition in the final product markets. Further reasons are originated from the control of proprietary technology and distribution systems, scale economies, privileged access to inputs and product differentiation. In the absence of these factors, market are fully efficient.The transaction costs theories of MNEs had been developed simultaneously and independently by McManus (1972), Buckley & Casson (1976), Brown (1976) and Hennart (1977, 1982). All these authors claimed that market imperfections are inherent conditions in markets and MNEs are institutions which try to bypass these imperfections. The imperfections in markets are natural as the neoclassical assumptions like full knowledge and enforcement don't exist in real markets.

International power

Tax competition

Multinational corporations have played an important role in globalization. Countries and sometimes subnational regions must compete against one another for the establishment of MNC facilities, and the subsequent tax revenue, employment, and economic activity. To compete, countries and regional political districts sometimes offer incentives to MNCs such as tax breaks, pledges of governmental assistance or improved infrastructure, or lax environmental and labor standards enforcement. This process of becoming more attractive to foreign investment can be characterized as a race to the bottom, a push towards greater autonomy for corporate bodies, or both.

However, some scholars for instance the Columbia economist Jagdish Bhagwati, have argued that multinationals are engaged in a 'race to the top.' While multinationals certainly regard a low tax burden or low labor costs as an element of comparative advantage, there is no evidence to suggest that MNCs deliberately avail themselves of lax environmental regulation or poor labour standards. As Bhagwati has pointed out, MNC profits are tied to operational efficiency, which includes a high degree of standardization. Thus, MNCs are likely to tailor production processes in all of their operations in conformity to those jurisdictions where they operate (which will almost always include one or more of the US, Japan or EU) which has the most rigorous standards. As for labor costs, while MNCs clearly pay workers in, e.g. Vietnam, much less than they would in the US (though it is worth noting that higher American productivity—linked to technology—means that any comparison is tricky, since in America the same company would probably hire far fewer people and automate whatever process they performed in Vietnam with manual labour), it is also the case that they tend to pay a premium of between 10% and 100% on local labor rates. Finally, depending on the nature of the MNC, investment in any country reflects a desire for a long-term return. Costs associated with establishing plant, training workers, etc., can be very high; once established in a jurisdiction, therefore, many MNCs are quite vulnerable to predatory practices such as, e.g., expropriation, sudden contract renegotiation, the arbitrary withdrawal or compulsory purchase of unnecessary 'licenses,' etc. Thus, both the negotiating power of MNCs and the supposed 'race to the bottom' may be overstated, while the substantial benefits which MNCs bring (tax revenues aside) are often understated.

Market withdrawal

Because of their size, multinationals can have a significant impact on government policy, primarily through the threat of market withdrawal.For example, in an effort to reduce health care costs, some countries have tried to force pharmaceutical companies to license their patented drugs to local competitors for a very low fee, thereby artificially lowering the price. When faced with that threat, multinational pharmaceutical firms have simply withdrawn from the market, which often leads to limited availability of advanced drugs. In these cases, governments have been forced to back down from their efforts. Similar corporate and government confrontations have occurred when governments tried to force MNCs to make their intellectual property public in an effort to gain technology for local entrepreneurs. When companies are faced with the option of losing a core competitive technological advantage or withdrawing from a national market, they may choose the latter. This withdrawal often causes governments to change policy. Countries that have been the most successful in this type of confrontation with multinational corporations are large countries such as United States and Brazil , which have viable indigenous market competitors.

Lobbying

Multinational corporate lobbying is directed at a range of business concerns, from tariff structures to environmental regulations. There is no unified multinational perspective on any of these issues. Companies that have invested heavily in pollution control mechanisms may lobby for very tough environmental standards in an effort to force non-compliant competitors into a weaker position. Corporations lobby tariffs to restrict competition of foreign industries. For every tariff category that one multinational wants to have reduced, there is another multinational that wants the tariff raised. Even within the U.S. auto industry, the fraction of a company's imported components will vary, so some firms favor tighter import restrictions, while others favor looser ones. Says Ely Oliveira, Manager Director of the MCT/IR: This is very serious and is very hard and takes a lot of work for the owner.

Multinational corporations such as Wal-mart and McDonald's benefit from government zoning laws, to create barriers to entry.

Many industries such as General Electric and Boeing lobby the government to receive subsidies to preserve their monopoly.

Patents

Many multinational corporations hold patents to prevent competitors from arising. For example, Adidas holds patents on shoe designs, Siemens A.G. holds many patents on equipment and infrastructure and Microsoft benefits from software patents The pharmaceutical companies lobby international agreements to enforce patent laws on others.

Government power

In addition to efforts by multinational corporations to affect governments, there is much government action intended to affect corporate behavior. The threat of nationalization (forcing a company to sell its local assets to the government or to other local nationals) or changes in local business laws and regulations can limit a multinational's power. These issues become of increasing importance because of the emergence of MNCs in developing countries.

Micro-multinationals

Enabled by Internet based communication tools, a new breed of multinational companies is growing in numbers."How startups go global". http://money.cnn.com/2006/06/28/magazines/business2/startupsgoglobal.biz2/index.htm. These multinationals start operating in different countries from the very early stages. These companies are being called micro-multinationals. What differentiates micro-multinationals from the large MNCs is the fact that they are small businesses. Some of these micro-multinationals, particularly software development companies, have been hiring employees in multiple countries from the beginning of the Internet era. But more and more micro-multinationals are actively starting to market their products and services in various countries. Internet tools like Google, Yahoo, MSN, Ebay and Amazon make it easier for the micro-multinationals to reach potential customers in other countries.

Service sector micro-multinationals, like Indigo Design & Engineering Associates Pvt. Ltd. Facebook, Alibaba etc. started as dispersed virtual businesses with employees, clients and resources located in various countries. Their rapid growth is a direct result of being able to use the internet, cheaper telephony and lower traveling costs to create unique business opportunities

Criticism of multinationals

The rapid rise of multinational corporations has been a topic of concern among intellectuals, activists and laypersons who have seen it as a threat of such basic civil rights as privacy. They have pointed out that multinationals create false needs in consumers and have had a long history of interference in the policies of sovereign nation states. Evidence supporting this belief includes invasive advertising (such as billboards, television ads, adware, spam, telemarketing, child-targeted advertising, guerilla marketing), massive corporate campaign contributions in democratic elections, and endless global news stories about corporate corruption (Martha Stewart and Enron, for example). Anti-corporate protesters suggest that corporations answer only to shareholders, giving human rights and other issues almost no consideration.[15] Films and books critical of multinationals include *Surplus: Terrorized into Being Consumers*, *The Corporation*, *The Shock Doctrine*, *Downsize This* and others.

World Trade Organization

The **World Trade Organization** (**WTO**) is an international organization designed by its founders to supervise and liberalize international capital trade. The organization officially commenced on January 1, 1995 under the Marrakesh Agreement, replacing the General Agreements on Tariffs and Trade (GATT), which commenced in 1947. The World Trade Organization deals with regulation of trade between participating countries; it provides a framework for negotiating and formalising trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements which are signed by representatives of member governments and ratified by their parliaments. Most of the issues that the WTO focuses on derive from previous trade negotiations, especially from the Uruguay Round (1986-1994). The organization is currently endeavouring to persist with a trade negotiation called the Doha Development Agenda (or Doha Round), which was launched in 2001 to enhance equitable participation of poorer countries which represent a majority of the world's population. However, the negotiation has been dogged by "disagreement between exporters of agricultural bulk commodities and countries with large numbers of subsistence farmers on the precise terms of a 'special safeguard measure' to protect farmers from surges in imports. At this time, the future of the Doha Round is uncertain."

The WTO has 153 members,

representing more than 95% of total world trade and 30 bservers, most seeking membership. The WTO is governed by a ministerial conference, meeting every two years; a general council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a director-general, who is appointed by the ministerial conference. The WTO's headquarters is at the Centre William Rappard, Geneva, Switzerland.

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

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

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

GATT rounds of negotiations

General Agreement on Tariffs and Trade

The GATT was the only multilateral instrument governing international trade from 1948 until the WTO was established in 1995. Despite attempts in the mid 1950s and 1960s to create some form of institutional mechanism for international trade, the GATT continued to operate for almost half a century as a semi-institutionalized multilateral treaty regime on a provisional basis.

From Geneva to Tokyo

Seven rounds of negotiations occurred under the GATT. The first GATT trade rounds concentrated on further reducing tariffs. Then, the Kennedy Round in the mid-sixties brought about a GATT anti-dumping Agreement and a section on development. The Tokyo Round during the seventies was the first major attempt to tackle trade barriers that do not take the form of tariffs, and to improve the system, adopting a series of agreements on non-tariff barriers, which in some cases interpreted existing GATT rules, and in others broke entirely new ground. Because these plurilateral agreements were not accepted by the full GATT membership, they were often informally called "codes". Several of these codes were amended in the Uruguay

Round, and turned into multilateral commitments accepted by all WTO members. Only four remained plurilateral (those on government procurement, bovine meat, civil aircraft and dairy products), but in 1997 WTO members agreed to terminate the bovine meat and dairy agreements, leaving only two.

WTO Ministerial Conference of 2001

Was held in Doha In Persian Gulf nation of Qatar. The Doha Development Round was launched at the conference. The conference also approved the joining of China, which became the 143rd member to join.

Fifth ministerial conference

WTO Ministerial Conference of 2003

The ministerial conference was held in Cancún, Mexico, aiming at forging agreement on the Doha round. An alliance of 22 southern states, the G20 developing nations (led by India, China[22] and Brazil), resisted demands from the North for agreements on the so-called "Singapore issues" and called for an end to agricultural subsidies within the EU and the US. The talks broke down without progress.

Sixth ministerial conference

For more details on this topic, see WTO Ministerial Conference of 2005.

The sixth WTO ministerial conference was held in Hong Kong from 13 December – 18 December 2005. It was considered vital if the four-year-old Doha Development Agenda negotiations were to move forward sufficiently to conclude the round in 2006. In this meeting, countries agreed to phase out all their agricultural export subsidies by the end of 2013, and terminate any cotton export subsidies by the end of 2006. Further concessions to developing countries included an agreement to introduce duty free, tariff free access for goods from the Least Developed Countries, following the Everything But Arms initiative of the European Union — but with up to 3% of tariff lines exempted. Other major issues were left for further negotiation to be completed by the end of 2010

Seventh ministerial conference

The WTO General Council, on 26 May 2009, agreed to hold a seventh WTO ministerial conference session in Geneva from 30 November–December 2009. A statement by chairman Amb. Mario Matus acknowledged that the prime purpose was to remedy a breach of protocol requiring two-yearly "regular" meetings, which had lapsed with the Doha Round failure in 2005, and that the "scaled-down" meeting would not be a negotiating session, but "emphasis will be on transparency and open discussion rather than on small group processes and informal negotiating structures".

Functions

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

- It oversees the implementation, administration and operation of the covered agreements.
- It provides a forum for negotiations and for settling disputes. Additionally, it is the WTO's duty to review and propagate the national trade policies, and to ensure the coherence and transparency of trade policies through surveillance in global economic policy-making. Another priority of the WTO is the assistance of developing, least-developed and low-income countries in transition to adjust to WTO rules and disciplines through technical cooperation and training. The WTO is also a center of economic research and analysis: regular assessments of the global trade picture in its annual publications and research reports on specific topics are produced by the organization. Finally, the WTO cooperates closely with the two other components of the Bretton Woods system, the IMF and the World Bank.

Principles of the trading system

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

6. **Non-Discrimination**. It has two major components: the most favored nation (MFN) rule, and the national treatment policy. Both are embedded in the main WTO rules on goods, services, and intellectual property, but their precise scope and nature differ across these areas. The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO members, i.e. a WTO member has to grant the most favorable conditions under which it allows trade in a certain product type to all other WTO members. "Grant someone a special favor and you have to do the same for all other WTO members." National treatment means that imported and locally-produced goods should be treated equally (at least after the foreign goods have entered the market) and was introduced to tackle non-tariff barriers to trade (e.g. technical standards, security standards et al. discriminating against imported goods).
7. **Reciprocity**. It reflects both a desire to limit the scope of free-riding that may arise because of the MFN rule, and a desire to obtain better access to foreign markets. A related point is that for a nation to negotiate, it is necessary that the gain from doing so be greater than the gain available from unilateral liberalization; reciprocal concessions intend to ensure that such gains will materialize.
8. **Binding and enforceable commitments**. The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a schedule (list) of concessions. These schedules establish "ceiling bindings": a country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures.

9. **Transparency**. The WTO members are required to publish their trade regulations, to maintain institutions allowing for the review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO. These internal transparency requirements are supplemented and facilitated by periodic country-specific reports (trade policy reviews) through the Trade Policy Review Mechanism (TPRM). The WTO system tries also to improve predictability and stability, discouraging the use of quotas and other measures used to set limits on quantities of imports.
10. **Safety valves**. In specific circumstances, governments are able to restrict trade. There are three types of provisions in this direction: articles allowing for the use of trade measures to attain noneconomic objectives; articles aimed at ensuring "fair competition"; and provisions permitting intervention in trade for economic reasons. Exceptions to the MFN principle also allow for preferential treatment of developing countries, regional free trade areas and customs unions. There are 11 committees under the jurisdiction of the Goods Council each with a specific task. All members of the WTO participate in the committees. The Textiles Monitoring Body is separate from the other committees but still under the jurisdiction of Goods Council. The body has its own chairman and only ten members. The body also has several groups relating to textiles.

Council for Trade-Related Aspects of Intellectual Property Rights

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

Council for Trade in Services

The Council for Trade in Services operates under the guidance of the General Council and is responsible for overseeing the functioning of the General Agreement on Trade in Services (GATS). It is open to all WTO members, and can create subsidiary bodies as required. The Service Council has three subsidiary bodies: financial services, domestic regulations, GATS rules and specific commitments.

Other committees

The General council has several different committees, working groups, and working parties.

Committees on

- Trade and Environment
- Trade and Development (Subcommittee on Least-Developed Countries)
- Regional Trade Agreements
- Balance of Payments Restrictions
- Budget, Finance and Administration

Working parties on

- Accession

Working groups on

- Trade, debt and finance
- Trade and technology transfer

Trade Negotiations Committee

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

Voting system

The WTO operates on a *one country, one vote* system, but actual votes have never been taken. Decision making is generally by consensus, and relative market size is the primary source of bargaining power. The advantage of consensus decision-making is that it encourages efforts to find the most widely acceptable decision. Main disadvantages include large time requirements and many rounds of negotiation to develop a consensus decision, and the tendency for final agreements to use ambiguous language on contentious points that makes future interpretation of treaties difficult·

In reality, WTO negotiations proceed not by consensus of all members, but by a process of informal negotiations between small groups of countries. Such negotiations are often called "Green Room" negotiations (after the colour of the WTO Director-General's Office in Geneva), or "Mini-Ministerials", when they occur in other countries. These processes have been regularly criticised by many of the WTO's developing country members which are often totally excluded from the negotiations.

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

Dispute settlement

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

The operation of the WTO dispute settlement process involves the DSB panels, the Appellate Body, the WTO Secretariat, arbitrators, independent experts and several specialized institution·

Accession and membership

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

Members and observers

The WTO has 153 members (almost all of the 123 nations participating in the Uruguay Round signed on at its foundation, and the rest had to get membership).The 27 states of the European Union are represented also as the European Communities. WTO members do not have to be full sovereign nation-members. Instead, they must be a customs territory with full autonomy in the conduct of their external commercial relations. Thus Hong Kong (as "Hong Kong, China" since 1997) became a GATT contracting party, and the Republic of China (ROC) (commonly known as Taiwan, whose sovereignty has been disputed by the People's Republic of China) acceded to the WTO in 2002 under the name of "Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu" (Chinese Taipei). A number of non-members (30) are observers at WTO proceedings and are currently negotiating their membership. As observers, Iran, Iraq and Russia are not yet members. With the exception of the Holy See, observers must start accession negotiations within five years of becoming observers. Some international intergovernmental organizations are also granted observer status to WTO bodies. 14 states and 2 territories so far have no official interaction with the WTO.

Agreements

The WTO oversees about 60 different agreements which have the status of international legal texts. Member countries must sign and ratify all WTO agreements on accession

Some of the important agreements

- **Agreement on Agriculture (AoA)**

The Agreement on Agriculture came into effect with the establishment of the WTO at the beginning of 1995. The AoA has three central concepts, or "pillars": domestic support, market access and export subsidies.

- **General Agreement on Trade in Services (GATS)**

The General Agreement on Trade in Services was created to extend the multilateral trading system to service sector, in the same way the General Agreement on Tariffs and Trade (GATT) provides such a system for merchandise trade. The Agreement entered into force in January 1995

- **Trade-Related Aspects of Intellectual Property Rights Agreement (TRIPs)**

The Agreement on Trade-Related Aspects of Intellectual Property Rights sets down minimum standards for many forms of intellectual property (IP) regulation. It was negotiated at the end of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in 1994.

- **Sanitary and Phyto-Sanitary (SPS) Agreement**

The Agreement on the Application of Sanitary and Phytosanitary Measures - also known as the SPS Agreement was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the beginning of 1995.

Under the SPS agreement, the WTO sets constraints on members' policies relating to food safety (bacterial contaminants, pesticides, inspection and labelling) as well as animal and plant health (imported pests and diseases).

- **Agreement on Technical Barriers to Trade (TBT)**

The Agreement on Technical Barriers to Trade is an international treaty of the World Trade Organization. It was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the end of 1994.

The object ensures that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade".

Criticism The stated aim of the WTO is to promote free trade and stimulate economic growth. Critics argue that free trade leads to a divergence instead of convergence of income levels within rich and poor countries (the rich get richer and the poor get poorer) .Martin Khor, Director of the Third World Network, argues that the WTO does not manage the global economy impartially, but in its operation has a systematic bias toward rich countries and multinational corporations, harming smaller countries which have less negotiation power. He argues that developing countries have not benefited from the WTO agreements of the Uruguay Round because, among other reasons, market access in industry has not improved; these countries have had no gains yet from the phasing-out of textile quotas; non-tariff barriers such as anti-dumping measures have increased; and domestic support and export subsidies for agricultural products in the rich countries remain high. Jagdish Bhagwati asserts, however, that there is greater tariff protection on manufacturers in the poor countries, which are also overtaking the rich nations in the number of anti-dumping filings.

Other critics claim that the issues of labor relations and environment are steadfastly ignored. Steve Charnovitz, former director of the Global Environment and Trade Study (GETS), believes that the WTO "should begin to address the link between trade and labor and environmental concerns." Further, labor unions condemn the labor rights record of developing countries, arguing that, to the extent the WTO succeeds at promoting globalization, the environment and labor rights suffer in equal measure

On the other side, Khor responds that "if environment and labor were to enter the WTO system [...] it would be conceptually difficult to argue why other social and cultural issues should also not enter."Bhagwati is also critical towards "rich-country lobbies seeking on imposing their unrelated agendas on trade agreements." Therefore, both Bhagwati and Arvind Panagariya of Columbia University, have criticized the introduction of TRIPs into the WTO framework, fearing that such non-trade agendas might overwhelm the organization's function.

Other critics have characterized the decision making in the WTO as complicated, ineffective, unrepresentative and non-inclusive, and they have proposed the establishment of a small, informal steering committee (a "consultative board") that can be delegated responsibility for developing consensus on trade issues among the member countries.The Third World Network has called the WTO "the most non-transparent of international organisations", because "the vast majority of developing countries have very little real say in the WTO system"; the Network stresses that "civil society groups and institutions must be given genuine opportunities to express their views and to influence the outcome of policies and decisions."Certain non-governmental organizations, such as the World Federalist Movement, argue that democratic participation in the WTO could be enhanced through the creation of a parliamentary assembly, although other analysts have characterized this proposal as ineffective.Some libertarians and small-government conservatives, as well as think tanks such as the Ludwig von Mises Institute, oppose the World Trade Organization, seeing it as a bureaucratic and anti-capitalistic organization not promoting free trade, but political interventionism. The chairman of the Ludwig von Mises Institute, Llewellyn H Rockwell Jr, argued that

. . . the World Trade Organization says that the US must stop permitting US exporters to set up foreign subsidiaries that save as much as 30 percent in taxes they would otherwise pay. Now the US must either raise taxes by eliminating loopholes or face massive new sanctions that will seriously harm our export sector. [...] There's been a lot of talk recently about foreigners who hate our prosperity and civilization, and seek ways to inflict violence in retaliation. Well, here's another case in point, except these are not swarthy Islamic terrorists; they are diplomats and statesmen on nobody's list of suspicious characters.

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AFRICA POPULATION INSTITUTE
BUSINESS FINANCE
PAPER CODES: **APDBA 401, APDHR 404, APDFA 401**

1. a) Discuss the relevancy of budgeting to the government operations
   b) Differentiate between a capital budget and cash budget.
   c) Write briefly on the section of a cash budget.

2. a) A government needs money to carry out its programmers. Discuss the ways how it can raise money to support such programs?
   b) How is public finance managed?

3.a- What are the economic functions
   b- Explain the implication of law of rights and obligations of relationship in Banking.

INTERNATIONAL TRADE AND INVESTMENTS
PAPER CODES: **APDBA 4O2**

1. a) Describe at least 5 policies that can be used to achieve protectionist goals in international trade.
   b) Give at least 5 arguments against protectionism.
   c) Distinguish between a Bilateral Trade Agreement and a Bilateral Investment Treaty.

2. a) What are the functions of the world trade organization? (WTO)
   b) Discuss the reasons why companies get involved in divestiture.
   c) Discuss at least 5 foreign direct investment incentives.

3. a) Discuss the major barriers to trade for the developing countries in international trade.
   b) Discuss the advantages of having a global economy.

MARKETING PRINCIPLES
PAPER CODES: **APDBA 403, APDLPS 403, APDFA 403**

1. a) What are the four dimensions of marketing effectiveness.
   b) Briefly explain the five factors during market effectiveness.

2. a) How is market segmentation important to a sales executive.
   b) Why is positioning crucial for market segmentation.

3. a) There are four elements of market mix explain them.
   b) What are the approaches of market mix enlargement?
   c) Outline the different types of brand.

INTERNATIONAL BUSINESS STRATEGY

PAPER CODES: **APDIR 402, APDBA 404, APDLPS 404**

1. a) What are the drivers that determine an industry globalization potential?
   b) Diversification is a marketing strategy,Discuss the different types of diversification.

2. a) Strategic plan are very important for organizational survival why do strategic plan fail.
b) Discuss the importance of the relationship to integrated Marketing communications.

3. a) How was the Art of Japan sent management different from that of Americans.
   c) There are eight keys to excellence of a firm survival outline them.

APDBAM 405 Field Attachments

Internship report Template

1. Give a brief background of the institution where you were attached
2. Give a brief description of roles you were assigned
3. State the opportunities you encountered during the field excursion
4. Explain how you exploited those opportunities
5. Discuss the challenges that you encountered during the internship
6. State how you dealt with such challenges?
7. Suggest the recommendations to the institution where you were attached
8. What advice would do you give to Africa Population Institute