



**MBF 845**

**INTERNATIONAL  
BANKING**

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## MODULE 1

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Unit 2	Domestic Banking in Nigeria
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## UNIT 1 NATURE OF INTERNATIONAL BANKING

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### 1.0 INTRODUCTION

This unit provides you with a comprehensive introduction to the concept of International Banking Operations that deals with banking activities across the national frontiers. Explanations of the reasons for and modes of foreign banking operations were also provided in order to accelerate the understanding of all other units of the course.

### 2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Define the meaning of international banking
- Differentiate between international and domestic banking
- Explain the modes of entry into international operations

### 3.0 MAIN CONTENT

#### 3.1 International Banking Defined

International Banking is a process that involves banks dealing with money and credit between different countries across the political boundaries. It is also known as Foreign/Offshore Banking. In another words, International Banking involves banking activities that cross national frontiers. It concerns the international movement of money and offering of financial services through off shore branching, correspondents banking, representative offices, branches and agencies, limited branches, subsidiary banking, acquisitions and mergers with other foreign banks. All the basic tools and concepts of domestic bank management are relevant to international banking. However, special problems or constraints arise in international banking not normally experience when operating at home. In particular:

- Business activities have to be transacted in foreign languages and under foreign laws and regulations.
- Information on foreign countries needed by a particular bank wishing to operate internally may be difficult to obtain.
- Control and communication systems are normally more complex for foreign than for domestic operations.
- Risk level may be higher in foreign markets.
- Foreign currency transaction is necessary.
- International bank managers require a broader range of management skills than managers who are concerned only with domestic problems.
- It is more difficult to observe and monitor trends and activities in foreign countries.
- Larger amounts of important work might have to be left to intermediaries, consultants and advisers.

International banking deals with all banking transactions-private and governmental- of two or more countries. Private Banks undertake such transactions for profit; governments may be for provision of various services.

#### 3.2 Reasons for Engaging in International Banking

Banks undertake international operations in order to expand their revenue/profit base, acquire resources from foreign countries, or diversify their activities. Specific reasons expanding operations abroad include the saturation of domestic market; discovery of lucrative opportunities in other countries; desire to expand volume of operations

in order to obtain economy of scale. Further motives for operating internationally are as follows:

- Commercial risk can be spread across several countries
- Facilitation of international businesses and trade
- Involvement in international banking can facilitate experience curve effect
- Economies of scope might become available
- Reduce cost of service delivery
- Recognition and reputation

### 3.3 Modes of International Banking

There are a lot of available methods for entry into international banking operations. This include; Correspondent Banks, Representative Offices, Branches and Agencies, Limited Branches, Subsidiary Banks, Bank Acquisitions and Bank Mergers.

#### Correspondent Banks

In order to adequately provide needed international banking services, commercial banks establish a network of foreign correspondent banks to supplement their own facilities worldwide. Frequently, the expense of establishing a related banking entity, such as overseas branch, is not warranted due to the low volume of transactions concluded for the bank's international clients. Therefore, to provide services while keeping costs minimal, account relationships are developed with foreign banks to facilitate international payment mechanisms between the institutions. Deposit accounts are opened at the correspondent banks, which enable them to make direct payments overseas by means of debiting and crediting the respective accounts with settlement to be made at a later date. Such accounts are termed due to (or nostro) accounts and due from (or vostro) accounts on the bank's books. In addition to payment accounts, correspondent bank relationship facilitates transactions such as letters of credit, documentary collection, foreign exchange services, and loan services for a bank's international clients. Thus, the correspondent bank relationship gives the domestic bank a presence in overseas markets, which permits international transactions to be concluded.

#### Representative Offices

A representative's office is both the most commonly used and the most limited in function of all foreign banking operating internationally. The international representative office functions mainly as liaison between correspondent banks and the parent bank. Representative offices are

usually prohibited from engaging in general banking activities, although they may receive checks for forwarding to the home office, solicit loans for the home office, and develop customer relations. However, they may not receive deposits or make loans. Generally, representative offices serve as the preliminary step to other forms of banking activity since they are a relatively inexpensive means of establishing a presence in a new location.

### **Branches and Agencies**

Depending upon the extent of services that the institution wishes to offer, either a branch or an agency may be established. The basic definition of 'branch' and 'agency' may be found in the U.S. International Banking Act of 1978. A branch is any office of a foreign bank at which deposits are received. On the other hand, an agency is any office at which deposits may not be accepted from citizens or residents of the U.S. if they are not engaged in international activities, but at which credit balance may be maintained. Thus, the principal difference between branches and agencies is that agencies cannot accept deposits for U.S. citizens or residents and can only maintain credit balances related to their international activities. In addition, agencies cannot engage in either fiduciary or investment advisory activities with the exception of acting as custodians for individual customers. Agencies do engage in a variety of activities to finance international trade, such as the handling of letters of credit. Both agencies and branches are principally active in international market.

As extensions of the foreign parent bank, branches are generally subject to more stringent state regulation than agencies due to the more extensive nature of their operations. The powers of a federal branch are similar in scope of those of a national bank; these branches possess full deposit-taking, loan, and commercial banking powers in addition to other trust powers. They are also subject to duties, restrictions, and limitations similar to those of a national bank organized in the same area.

### **Limited Branches**

In pursuant to the International Banking Activities, an additional means by which a foreign bank may participate in foreign banking market is through a so-called limited federal branch. Basically, this is an office chartered by the Comptroller of the Currency subject to the condition that the foreign bank enter into an agreement with the country's apex bank or regulatory authorities restricting the branch's deposit-taking activities to those permitted by law. Since this office may be established



outside the foreign bank's home state, they are restricted to deposit-taking activities of an international nature.

### **Subsidiary Banks**

Foreign banks gain control of subsidiary banks by establishing new institutions or by acquiring existing domestic banking institutions and these subsidiaries generally may engage in a full line of banking activities. With respect to the designation of a foreign bank subsidiary, the term 'bank' and 'subsidiary' has the same meaning as those provided by section 2 of the Bank Holding Company Act (BHCA). A subsidiary bank of a foreign bank may be either a national or a state bank. State banks are governed by the laws of the state in which they are located, while national banks are chartered by the Comptroller of the Currency under the National Bank Act. In United States for example, although foreign ownership is not restricted, non-U.S. citizens may not form a majority of a national bank's Board of Directors.

### **Bank Acquisitions**

Firms willing to gain access to international banking operations may also adopt the acquisition approach by acquiring indigenous or domestic banks. However, the acquisition process is guided by stringent conditions. For instance, Under the United States Bank Holding Company Act, the Federal Reserve Board must approve the acquisition of direct or indirect control of a U.S. bank by a domestic or foreign bank holding company. Various factors are considered in the approval or denial of a BHC application. These include analysis of the competitive effect of the acquisition, the acquirer's financial and managerial resources, and future prospects of the bank being acquired, community needs, and the applicant's organizational structure.

### **Bank Mergers**

Bank mergers is another option that is opened to those who wish to provide international banking services in foreign countries. There are several reasons for a foreign bank merging with a domestic bank. For example, this provides an expedient and economical means of expanding into new markets; it becomes easier to establish an identity on a state-wide basis; and the bank is able to continue smooth operations with experienced management and personnel.

## **3.4 Why studying International Banking**

Nowadays the great majority of larger banks operate internationally, so an awareness of the major issues in international banking is a valuable asset for any bank that operates in other countries. The study of

international banking helps the individual supplement his/her knowledge of general banking functions through examining issues, practices, problems and solutions relating to these functions in foreign states.

Also, it develops person's sensitivity to foreign banking cultures, values and norms, thus enabling the individual to adopt broader perspectives and hence improve his/her overall managerial efficiency.

### **3.5 Role of International Commercial Banks in Developing Countries**

While in foreign developing countries, international banks besides performing the usual commercial banking functions play an effective role in their economic development. These roles include the followings.

#### **Mobilization of Savings for Capital Formation**

International commercial banks help in overcoming savings through a network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing varieties of deposit scheme to suit the needs of individual depositors. They also mobilize idle savings of the few rich. By mobilizing savings, the banks channel them into productive investments. Thus, they help in capital formation of a developing country.

#### **Financing Industry**

The international commercial banks finance the industrial sector. They provide short time, medium-term and long-term loans to industries.

Besides, they underwrite the shares and debentures of large scale industries. Thus, they not only provide finance for industry but also help in developing the capital market, which is underdeveloped in such countries.

#### **Financing Trade**

The international commercial banks help in financing both internal and external trades. The banks provide loans to retailers and wholesalers to stock which they deal. They also help in the movement goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange. Moreover, they finance both exports and imports of developing countries by providing exchange facilities to importers and exporters.

## **Financing Agriculture**

The international commercial banks help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They provide finance directly to agriculturists for the marketing of the modernization and mechanization of their farms, for providing irrigation facilities and for developing lands.

**Help in Monetary Policy:** The international commercial banks help in economic development of a country by faithfully following the monetary policy of the country's central bank. In fact, the central bank depends upon the commercial banks for the success of its monetary management in keeping with requirement of a developing economy.

## **SELF ASSESSMENT EXERCISES**

- i. Define International Banking and state the need for International Banking Operations.
- ii. Distinguish between International and Domestic Banking.

## **4.0 CONCLUSION**

You have learned in this unit that International Banking deals with the banking activities across the national boundaries. One of the major reasons for international banking is to facilitate international business transactions, trade and payments between different countries of the world.

## **5.0 SUMMARY**

International banking as we have learnt is a concept synonymous with offering of banking services across the national borders. Off shore branching, correspondents banking, representative offices, branches and agencies, limited branches, subsidiary banking, as well as acquisitions and mergers are some of the popular route towards international banking operations. The need to spread risks, lucrative business opportunities, saturation of domestic market and economies of scale and scope were identify as some of the reasons advance for banks' international operations.

## **6.0 TUTOR MARKED ASSIGNMENT**

There is nothing International about International Banking. Amplify.

## ANSWER TO SELF-ASSESSMENT EXERCISES

- i. International banking deals with all banking transactions-private and governmental between two or more countries. It involves the international movement of money and offering of financial services through off shore branching, correspondents banking, representative offices, branches and agencies, limited branches, subsidiary banking, acquisitions and mergers with other foreign banks.

Some of the reasons advanced by off shore bankers include the need to; make huge profit, diversifications and expansion of services rendered, saturation of domestic market; discovery of lucrative opportunities in other countries, spreading of commercial risk across several countries, facilitation of international businesses and trade and for recognition and reputation

- ii. Domestic banking involves banking activities within a particular country or national boundary. The operation involves the use of common currency for transaction and legal operating requirements are usually the same. While international banking involves banking activities across the country's national boarder. Different currencies are used and banking activities are carried under different legal conditions and guidelines.

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## **UNIT 2 DOMESTIC BANKING IN NIGERIA**

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### **1.0 INTRODUCTION**

Every reputable international bank today started from domestic banking operation, this means, banking activities and transactions within the national boundary. In this unit, we explain the various types of domestic banks operating in Nigeria ranging from Central Banking, Commercial Banking to Development / Specialized Banking.

### **2.0 OBJECTIVES**

At the end of this unit, you should be able to:

- State the statutory functions of Central Bank of Nigeria
- Explain the various functions of Commercial Banking in Nigeria
- Describe different development banks operating in Nigeria and their objectives.

### **3.0 MAIN CONTENT**

#### **3.1 Central Banking**

Central Bank of Nigeria (CBN) was formed in 1957 and began operation in 1959. Central Bank is the regulatory monetary institution which is at the apex of the monetary and banking structure in Nigeria. It controls, regulates and supervises the activities of money market. CBN is the central monetary authority which manages the currency and credit

policy of the country and functions as a banker to the government as well as to the commercial banks. It is difficult to define central bank accurately. According to the Bank for International Settlements, a central bank is defined as 'the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in that country'. In other words, central bank is an 'institution charged with the management of the expansion and contraction of the volume of money in the interest of general public welfare.

### **3.1.1 Differences between Central Bank and Commercial Banks**

There are certain basic differences between a central bank and a commercial bank. They are:

The central bank is the apex monetary institution which has been specially empowered to exercise control over the banking system of the country. The commercial bank, on the contrary, is a constituent unit of the banking system.

The central bank is generally a state-owned institution, while the commercial banks are normally privately owned institutions.

The central bank does not operate with a profit motive. The primary aim of the central bank is to achieve the objectives of the economic policy of the government and maximize the public welfare through monetary measures. The commercial banks, on the other hand, have profit earning as their primary objective.

The central bank does not deal directly with the public, while the commercial banks, on the contrary, directly deal with the public. The central bank does not compete with the commercial banks rather it helps them by acting as the lender of the last resort.

The central bank has the monopoly of note-issue, whereas the commercial banks do not enjoy such right.

The central bank is the custodian of the foreign exchange reserves of the country. The commercial banks are only the dealers in foreign exchange.

The central bank acts as the banker to the government, the commercial banks act as bankers to the general public.

The central bank acts as the bankers' bank: (a) The commercial banks are required to keep a certain proportion of their reserves with central bank; (b) the central bank helps them at the time of emergency; and (c) the central bank acts as the clearing house for the commercial banks. But, the commercial banks perform no such function.

### **3.1.2 Functions of Central Bank of Nigeria**

The central bank generally performs the following functions:

#### **Bank of Note Issue**

The central bank has the sole monopoly of note issue in almost every country. The currency notes printed and issued by the central bank become unlimited legal tender throughout the country.

#### **Banker, Agent and Adviser to the Government**

The central bank functions as a banker, agent and financial adviser to the government. As a banker to government, the central bank performs the same functions for the government as a commercial bank performs for its customers. It maintains the accounts of the central as well as state governments. It receives deposits from government, it makes short-term advances to the government, it collects cheques and draft deposited in the government account.

It provides foreign exchange resources to the government for repaying external debt, or purchasing goods or making other payments. As an agent to the government, the central bank collects taxes and other payments on behalf of the government. It raises loans from the public and thus manages public debt. It also represents the government in the international financial institutions and conferences. As a financial adviser to the government, the central bank gives advice to the government on economic, monetary, financial and fiscal matters such as deficit financing, devaluation, trade policy, foreign exchange policy, etc.

#### **Bankers' Bank**

The central bank acts as the bankers' Bank in three capacities: custodian of the cash reserves of the commercial banks; as the lender of the last resort; and as clearing agent. In this way, the central bank acts as friend, philosopher and guide to the commercial banks. As a custodian of the cash reserves of the commercial banks, the central bank maintains the cash reserves of the commercial banks. Every commercial bank has to keep a certain percentage of its cash balances as deposits with the central banks. These cash reserves can be utilized by the commercial banks in times of emergency.

#### **Lender of Last Resort**

As the supreme bank of the country and the bankers' bank, the central bank acts as the lender of the last resort. In other words, in case the

commercial banks are not able to meet their financial requirements from other sources, they can, as a last resort, approach the central bank for financial accommodation. The central bank provides financial accommodation to the commercial banks by rediscounting their eligible securities and exchange bills.

### **Clearing Agent**

As the custodian of the cash reserves of the commercial banks, the central bank acts as the clearing house for these banks. Since all banks have their accounts with the central bank, the central bank can easily settle the claims of various banks against each other with least use of cash.

### **Custodian of Foreign Exchange Reserves**

The central bank also functions as the custodian of the country's foreign exchange reserves. This function helps the central bank to overcome the balance of payments difficulties and to maintain stability in the exchange rates. In order to minimize the fluctuations in the foreign exchange rates, the central bank buys (or sells) foreign currencies in the market as the value of foreign currencies falls (or rise).

### **Controller of Credit**

Controlling credit is the most important function of the central bank. It is the function which embraces the most important question of central banking policy and the one through which practically all the functions are united and made to serve a common purpose. Uncontrolled credit causes economic fluctuations in the economy. By controlling the credit effectively, the central bank establishes stability not only in the internal price level, but also in the foreign exchange rates.

### **Development Role**

In Nigeria, the central bank, besides performing the traditional functions, also performs developmental and promotional functions. The central bank, on the one hand, helps to develop money and capital markets and on the other hand, undertakes suitable measures to promote economic development and maintain price and exchange rate stability.

### **Other Functions**

The central bank also performs certain other miscellaneous functions. It maintains relations with international financial institutions such as the IMF and World Bank, it collects various types of statistics providing



information about current state of the economy. It conducts surveys and seminars and publishes reports on other matters. It helps in developing the banking system and banking habits in the country. It formulates appropriate monetary policy to deal with economic crisis in the country and it also extends training facilities to the staff working in the various banking institutions.

### **3.1.3 Instruments of Credit Control**

The various instruments of credit control used by the central bank can be broadly classified into two categories: (a) quantitative or general methods, and (b) qualitative or selective methods.

#### **(a) Quantitative or General Methods**

The methods used by the central bank to influence the total volume of credit in the banking system, without any regard for the use to which it is put, are called quantitative or general methods of credit control. These methods regulate the lending ability of the financial sector of the whole economy and do not discriminate among the various sectors of the economy. The important quantitative methods of credit control are (a) bank rate, (b) open market operations, and (c) cash reserve ratio.

#### **(b) Qualitative or Selective Method**

The methods used by the central bank to regulate the flow of credit into particular direction of the economy are called qualitative or selective methods of credit control. Unlike the quantitative methods, which affect the total volume of credit, the qualitative methods affect the type of credit extended by the commercial banks, they affect the composition rather than the size of credit in the economy. The important qualitative or selective methods of credit control are: (a) marginal requirements; (b) regulation of consumer credit; (c) control through directives; (d) credit rationing; (e) moral suasion and publicity, and (f) direct action.

## **3.2 Commercial Banking**

The banks perform all kinds of banking business and generally finance trade and commerce are called commercial banks. In Nigeria, many commercial banks are in operation. They include First Bank, Union Bank, Zenith Bank and Oceanic Bank, Access Bank and Eco-bank amongst others. Since their deposits are mostly for a short period, these banks normally advance short-term loans to the businessmen and traders

and avoid medium-term and long-term lending. However, recently, the commercial banks in Nigeria have also extended their areas of operation to medium-term and long-term finance. They increased their capital base to a minimum of N25 billion as mega-banks, consequently, they can extend credits for longer periods.

### **3.2.1 Functions of Commercial Banks in Nigeria**

In Nigeria, commercial banks perform a variety of functions. It may not be possible to make an all-inclusive list of their functions and services. However, some basic functions performed by the banks are discussed below.

#### **(1) Accepting Deposits**

The first important function of commercial bank is to accept deposits from those who can save but cannot profitably utilize this saving. People consider it more rational to deposit their savings in a bank because by doing so, they on the one hand, earn interest, and on the other hand, avoid the danger of theft. To attract savings from all sorts of individuals, the commercial banks maintain different types of accounts.

##### **(i) Fixed Deposit Account**

Money in these accounts is deposited for fixed period of time and cannot be withdrawn before the expiry of that period. The rate of interest on this account is higher than that on other types of deposits. The longer the period, the higher will be the rate of interest. Fixed deposits are also called time deposits.

##### **(ii) Current Deposit**

Account: These accounts are generally maintained by the traders and businessmen who have to make a number of payments every day. Money from these accounts can be withdrawn in as many times and in as much amount as desired by the depositors. Normally, no interest is paid on these accounts. Rather, the depositors have to pay certain incidental charges to the bank for the services rendered by it. Current deposits are also called demand deposits.

##### **(iii) Savings Deposit Account**

The aim of these accounts is to encourage and mobilize small savings of the public. Certain restrictions are imposed on the depositors regarding the number of withdrawals and the amount to be withdrawn in a given

period. Rate of interest paid on these deposits is low as compared to that on fixed deposits.

#### **(iv) Recurring Deposit Account**

The purpose of these accounts is to encourage regular savings by the public, particularly by the fixed income group. Generally, money in these accounts is deposited in monthly installment for a fixed period and is repaid to the depositors along with interest on maturity. The rate of interest on these accounts is nearly the same as on fixed deposits.

#### **(2) Advancing of Loans**

The second important function of a commercial bank is advancing of loans to the public. After keeping certain cash reserves, the banks lend their deposits to the needy borrowers. Before advancing loans, the banks satisfy themselves about the creditworthiness of the borrowers. Various types of loans granted by the banks include: money at call, cash credit, overdrafts, discounting of bills of exchange, and term loans.

#### **(3) Credit Creation**

A unique function of the commercial bank is to create credit. In fact, credit creation is the natural outcome of the process of advancing loan as adopted by the banks. When a bank advances a loan to its customer, it does not lend cash but opens an account in the borrower's name and credits the amount of loan to this account. Thus, whenever a bank grants a loan, it creates an equal amount of bank deposit. Creation of such deposits is called credit creation which results in a net increase in the money stock of the economy. Banks have the ability to create credit many times more than their deposits and this ability of multiple credit creation depends upon the cash reserve ratio of the banks.

#### **(4) Promoting Cheque System**

Commercial banks also render a very useful medium of exchange in the form of cheques. Through a cheque, the deposit directs the bankers to make payment to the payee. Cheque is the most developed credit instrument in the money market. In the modern business transactions, cheques have become much more convenient method of settling debts than the use of cash.

### **(5) Agency Functions**

Commercial banks also perform certain agency functions for and on behalf of their customers. These functions include: remittance of funds, collection and payment of credit instruments, execution of standing orders, purchasing and sale of securities, collection of dividends on shares, income tax consultancy, acting as trustee and executor, acting as representative and correspondent.

### **(6) General Utility Function**

In addition to agency services, the commercial banks provide many general utility services such as: locker facility, travelers' cheques, letter of credit, collection of statistics, underwriting securities, acting as referee, foreign exchange business.

## **3.3 Development Banking in Nigeria**

Development Banks are government owned banks which have the major function of providing long-term loans to farmers, industrialists, businessmen and government projects to develop different sectors of the economy. They neither take deposits from the public nor grant short-term loans. They underwrite shares for public limited liability companies. Examples of development banks in Nigeria are:

- (i) Nigerian Industrial Development Bank (NIDB) now called Banking of Industry (BOI);
- (ii) Nigerian Agricultural and Rural Development Bank (NACRDB);
- (iii) Nigerian Bank for Commerce and Industry (NBCI), etc.

The NIDB provides medium-term and long-term financial needs of the industries. Such long-term needs cannot be met by the commercial banks which mostly deal with short-term lending. The main functions of the Bank of Industry are:

They grant long-term loans to the industrialists to enable them to purchase land, construct factory building, purchase heavy machinery, etc.

They help selling or even underwrite the debentures and shares of industrial firms.

They can also provide information regarding the general economic position of the economy.

The NACRDB provides farmers with medium credit to buy seeds, fertilizers and other inputs, and long-term credit to purchase land, to

make permanent improvements on land, to purchase agricultural machinery and equipments.

### **SELF ASSESSMENT EXERCISES**

- i. Explain the concept of commercial bank in Nigeria.
- ii. Identify the statutory functions of Central Bank of Nigeria.

### **4.0 CONCLUSION**

In this unit, you have learned the mode of domestic banking operations from the Nigerian perspective. You have also learned about the various functions and working objectives of Central Bank, commercial banks and development banks.

### **5.0 SUMMARY**

As explained in this unit, central bank is the regulatory monetary institution which is at the apex of the monetary and banking structure in Nigeria. Some of its functions include issuing of national currency, bankers to other commercial banks and formulation of monetary policy.

Commercial banks are banks which perform all kinds of banking businesses and generally finance trade and commerce. Development banks on the other hand, are established for the purpose of achieving specific objectives.

### **6.0 TUTOR MARKED ASSIGNMENT**

Explain the various methods of credit control used by the Central Bank of Nigeria.

### **ANSWER TO SELF-ASSESSMENT EXERCISES**

- i. The balance of payment is a summary statement of account of all of a country's economic transactions with the rest of the world during a given period, usually one year. It shows relationship between all the receipts of a country from all other countries and all payments made to them during the period. Balance of trade consists of the differences between visible exports and imports between a country and the rest of its trading partners. The balance of trade represents the visible trade segment of the balance of payment account.
- ii. Disequilibrium occurs in the balance of payment when the receipts and payments of a country resulting from international

trade are not the same or equal. This represents surplus or deficits trade relationship. Deficit balance of payment is harmful to any country. Therefore, for a country with deficit balance of payment, she must take appropriate steps to correct the abnormality. Some of the available options include: deflation, depreciation, devaluation, exchange control, capital movement, encourage of exports and discouragement of imports.

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## **UNIT 3 BALANCE OF PAYMENT**

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### **1.0 INTRODUCTION**

The concept of balance of payments is important to understanding the economic forces behind events affecting international banking. This unit provides an insight into the concept of balance of payment as it relates to international banking operations. Starting from the definition of the term, all through the corrections approach to balance of payment disequilibrium, this unit provides a comprehensive coverage and analysis of the concept.

### **2.0 OBJECTIVES**

At the end of this unit, you should be able to:

- Define balance of payment;
- Distinguish balance of payment from balance of trade
- Discuss various methods of correcting balance of payment;
- Explain the components/structure of balance of payment account.

### **3.0 MAIN CONTENT**

#### **3.1 Balance of Payment Definition**

Balance of payment is a systematic record of all economic transactions visible as well as invisible, in a period, between one country and the rest

of the world. It shows the relationship between one country's total payments to all other countries and its total receipts from them. Balance of payment thus is statement of payments and receipts on international transactions. Payments and receipts on international account are of three kinds: the visible balance of trade; the invisible items; and capital transfers. In other words, balance of payment of a country is a record of the monetary transactions over a period with the rest of the world.

### **3.2 Features of Balance of Payments**

**Balance of payment has the following features**

- (i) It is a systematic record of all economic transactions between one country and the rest of the world;
- (ii) It includes all transactions, visible as well as invisible;
- (iii) It relates to a period of time, generally, an annual statement;
- (iv) It adopts a double entry book keeping system. It has two sides: credit side and debit side. Receipts are recorded on the credit side and payments on the debit side;
- (v) When receipts are equal to payments, the balance of payments is in equilibrium; when receipts are greater than payments, there is surplus in the balance of payments; when payments are greater than receipt, there is deficit in the balance of payments;
- (vi) In the accounting sense, total credits and debits in the balance of payment statement always balances each other.

### **3.3 Structure of Balance of Payment**

Balance of Payment is a summary statement of a country's total economic transactions with other countries. It has two sides: credit side and debit side. The credit side shows all payments to be received from abroad and debit side shows all payments to be made to the foreigners. A balance of payment statement consists of two parts: current account and capital account.

#### **Current Account**

The current account of the balance of payment statement relates to real and short-term transactions. It contains receipts and payments on account of exports, or visible and invisible items. Exports and imports of material goods are visible items; and exports and imports of services are invisible items. Transactions in the current account are called real transactions because they are concerned with actual transfer of goods and services which affect income, output and expenditure of the country. These are income generating transfers and are not merely financial transactions.



## **Items of Current Account**

According to the International Monetary Fund (IMF), the current account of the balance of payment includes the following items:

### **Merchandise**

Exports and imports of goods form the visible account and have dominant position in the current account of balance of payment. Exports constitute the credit side and import the debit side.

### **Travel**

Travel is an invisible item in the balance of payments. Travel may be for reasons of business, education, health, international conventions or pleasures. Expenditure by the foreign tourists in our country forms the credit item and the expenditure by our tourists abroad constitutes the debit item in our balance of payment.

### **Transportation**

International transportation of goods is another invisible transaction. It includes warehousing (while in transit) and other transit expenses. Use of domestic transport services by the foreigners is the credit item and the use of foreign transport service by domestic traders is the debit item.

### **Insurance**

Insurance premium and payments of claims is also an invisible transaction in a country's balance of payment account. Insurance policies sold to foreigners are a credit item and the insurance policies purchased by domestic users from the foreigners are a debit item.

### **Investment Income**

Another visible item in the current account of the balance of payment is the investment account which includes interest, rents, dividends and profits. Income received on capital invested abroad is the credit item and income paid on capital borrowed from abroad is the debit item.

### **Government Transactions**

Government transactions refer to the expenditure incurred by a government for the upkeep of its organizations abroad (e.g. payment of salaries to the ambassadors, high commissioners, etc). Such amounts

received by a government from abroad constitute the credit item and made to the foreign governments form the debit item.

### **Miscellaneous**

Miscellaneous invisible items include expenditure incurred on services like advertisement, commissions, films rental, patent fees, royalties, subscriptions to the periodicals, membership fees, etc. Such payments received by a country from abroad are a credit item and sent to the foreign countries are the debit item in the balance of payment account.

Donations and gifts are unilateral transfers or unrequited payments because nothing is given in return for them.

### **Capital Account**

The capital account of the balance of payment of a country deals with the financial transactions. It includes all types of short-term and long-term international movements of capital. Gold transactions also form part of capital account. If a country invests or lends abroad, it is a payment and will be recorded on the debit side. On the other hand, capital inflows in the form of borrowings from abroad or the foreign investments in the home country are entered on the credit side of the balance of payment account. These are all financial transactions relating only to the transfer of money and therefore have no direct impact on the level of income and output of the economy.

### **Items of Capital Account**

The main items of capital account in Nigeria are:

#### **Private Loans**

Foreign loans received by the private sector (credit item) and foreign loans repaid by the private sector (debit items).

#### **Movements in Banking Capital**

Inflow of banking capital excluding the central bank (credit item); and outflow of banking capital excluding the central bank (debit items).

## **Official Capital Transactions**

### **Loans**

Foreign loans and credits received by the official sector including the drawings from the IMF (credit item); and loans extended to the other countries as well as repurchase of the drawings from the IMF (debit item).

### **Amortization**

Repayment of official loans by other countries (credit items) and repayment of official loans by home country (debit item).

### **Miscellaneous**

All other official receipts including those of central bank (credit item); and all other official capital payments including those of central bank (debit items).

### **Reserve and Monetary Gold**

Changes in the official foreign exchange holdings, gold reserves of the central bank and Special Drawing Rights (SDR) holdings of the government, purchases from the IMF and similar other capital transactions; all such receipts represent credit item and payments represent debit item.

## **3.4 Balance of Payments and Balance of Trade**

Balance of payments should be distinguished from balance of trade.

### **Balance of Trade**

Balance of trade refers to the export and import of visible items, i.e. material goods. It is the difference between the value of visible exports and imports. Visible items are those items which are recorded in the customs returns; for example, material goods exported and imported. If the value of visible exports is greater than that of visible imports, the balance of trade is said to be favourable. On the other hand, if the visible imports are greater than the visible exports the balance of trade is unfavourable. Finally, if the value of visible export is equal to that of visible imports, the balance of trade is in equilibrium. Balance of trade is also known as merchandise of exports and imports.

## **Balance of Payments**

Balance of payments, on the other hand, is a more comprehensive concept, because it covers visible items (i.e. balance of trade or merchandise account) and invisible items. Invisible items are those items which are not recorded in the customs returns; for example, services (such as transportation, banking, insurance etc.), capital flows, purchase and sale of gold, etc. Thus, balance of payments is a broader term than balance of trade; balance of payments includes both visible as well as invisible items, whereas balance of trade includes only visible items.

### **3.5 Disequilibrium in Balance of Payment**

Normally, the balance of payments of a country should be in equilibrium, i.e. the imports and exports of goods and services should be equal. But in reality, it is not so. Disequilibrium generally arises in the balance of payment account. Balance of payment may be unfavourable when there is excess of imports over exports (deficit balance); it may be favourable when there is excess of exports over imports (surplus account). The phenomenon of disequilibrium is particularly related to the current account of balance of payment statement; the capital account is used to settle the imbalance in the current account through changes in the financial flows of funds. Viewed in this sense, disequilibrium in the balance of payments (deficit or surplus) affects the fundamental economic relationships among the nations and reflects a country's economic weakness or strength relative to others.

### **3.6 Types of Disequilibrium**

The main types of disequilibrium in balance of payment are as given below:

#### **(1) Cyclical Disequilibrium**

Cyclical disequilibrium in the balance of payment arises due to business cycles. It is caused by cyclical patterns of income, or by different income elasticities, or by different price elasticities. These factors bring changes in the terms of trade as well as growth of trade which, in turn, lead to a deficit or surplus in the balance of payment. When prices rise in prosperity, a country with more elastic demand for imports will experience a decline in the value of imports, thus leading to a surplus in the balance of payments. Conversely, as prices decline in depression, more elastic demand will increase imports and cause a deficit in the balance of payments. These tendencies may, however, be offset by the

effects of income changes. High incomes during prosperity increase imports and low income during depression reduce imports.

## (2) **Secular Disequilibrium**

Secular or long-term disequilibrium in balance of payments occur because of long-seated and deep-rooted changes in the economy as it moves from one stage of growth to another. In the initial stages of economic development, domestic investment exceeds savings and imports surplus. Then, there comes a stage when domestic savings tend to exceed domestic investment and exports exceed imports. Disequilibrium arises because the surplus savings exceed investment opportunities abroad. At a still later stage, domestic savings tend to equal domestic investment and long-term capital movements on balance become zero.

## (3) **Structural Disequilibrium**

Structural disequilibrium in the balance of payment occurs when structural changes in some sectors of the economy alter the demand and supply forces influencing exports and imports. Structural disequilibrium may be of two types:

- (i) Structural disequilibrium at the goods level occurs when a change in demand or supply of exports or imports alters a previously existing equilibrium or when a change occurs in the basic circumstances under which income is earned or spent abroad, in both cases without the requisite parallel changes elsewhere in the economy.
- (ii) Structural disequilibrium at the factor level results from factors which fail to reflect accurately factor endowments i.e. when factor prices, out of line with factor endowments, distort the structure of production from the allocation of resources which appropriate factor prices would have indicated.
- (iii) Structural disequilibrium is caused by changes in technology, tastes and attitude towards foreign investment. Political disturbances, strikes, lockouts, etc. which affect the supply of exports also cause structural disequilibrium.

## (4) **Fundamental Disequilibrium**

The term fundamental disequilibrium has been originally used by the IMF to indicate a persistent and long-term disequilibrium in a country's balance of payment. Fundamental disequilibrium are: excessive or inadequate international demand for foreign goods; excessive or

inadequate competitive strength in the world market; and excessive capital movements.

### **3.7 Causes of Disequilibrium**

Various causes of disequilibrium in the balance of payment or adverse balance of payment are as follows:

#### **(1) Development Schemes**

The main reason for adverse balance of payment in the developing countries is the huge investment in development schemes in these countries. The propensity to import of the developing countries increases for want of capital for industrialization. The exports, on the other hand, may not increase because these countries are traditionally primary good/product producing countries. Moreover, the volume of exports may fall because newly created domestic industries may need them. All this leads to structural changes in the balance of payment resulting in structural disequilibrium.

#### **(2) Price ± Cost Structure**

Changes in price ± cost structure of export industries affect the volume of exports and create disequilibrium in the balance of payment. Increase in prices due to higher wages, higher cost of raw materials, etc. reduces exports and makes the balance of payments unfavourable.

#### **(3) Changes in Rate of Exchange**

Changes in the rate of exchange are another cause of disequilibrium in the balance of payment. An increase in the external value of money makes imports cheaper and exports dearer; thus, imports increase and exports fall and consequently balance of payment becomes unfavourable. Similarly, a reduction in the external value of money leads to a reduction in imports and an increase in exports, consequently leading to a favourable balance of payment.

#### **(4) Fall in Export Demand**

There has been a considerable decline in the export demand for the primary goods of underdeveloped countries as a result of the large increase in the domestic production of foodstuffs, raw materials and substitutes in the rich countries. Similarly, the advanced countries also find a fall in their export demand because of loss of colonial market. However, the deficit in the balance of payment due to the fall in export

demand is more persistent in the underdeveloped countries than in the advanced countries.

**(5) Demonstration Effect**

The people in the less developed countries tend to follow the consumption patterns of the developed countries. As a result of this demonstration effect, the imports of the less developed countries will increase and create disequilibrium in the balance of payments.

**(6) International Borrowing and Lending**

International borrowing and lending is another reason for the disequilibrium in the balance of payments. The borrowing country tends to have unfavourable balance of payment.

**(7) Cyclical Fluctuations**

Cyclical fluctuations cause cyclical disequilibrium in the balance of payment. During depression, the incomes of the people in foreign countries fall. Consequently, the exports of these countries tend to decline which, in turn, produces disequilibrium in the home country's balance of payment.

**(8) Newly Independent Countries**

The newly independent countries, in order to develop international relations, incur huge amount of expenditure on the establishment of embassies, missions, etc. in other countries. This adversely affects their balance of payment position.

**(9) Population Explosion**

Another important reason for adverse balance of payment in the poor countries is population explosion. Rapid growth of population in countries like Nigeria increases imports and decreases the capacity to export.

**(10) Natural Factors**

Natural calamities, such as droughts, floods, etc. adversely affect the production in the country. As a result, the exports fall, the imports increase and the country experiences deficit in its balance of payment.

### 3.8 Methods of Correcting BOP Disequilibrium

Persistent disequilibrium in the balance of payment, particularly the deficit balance, is undesirable because it weakens the country's economic position at the international level, and affects the progress of the economy adversely. It must be cured by taking appropriate measures. There are many methods to correct disequilibrium in the balance of payments. Important among them are discussed below:

#### (1) Deflation

Deflation is the classical medicine for correcting the deficit in the balance of payment. Deflation refers to the policy of reducing the quantity of money in order to reduce the prices and the money income of the people. The central bank, by raising the bank rate, through selling of securities in the open market and by other methods can reduce the volume of credit in the economy, which will lead to a fall in prices and money income of the people. Fall in prices will stimulate exports and reduction in income checks imports.

#### (2) Depreciation

Another method of correcting disequilibrium in the balance of payment is depreciation. Depreciation means a fall in the rate of exchange of one currency (home currency) in terms of another (foreign currency). A currency will depreciate when its supply in the foreign exchange market is large in relation to its demand. In other words, a currency is said to depreciate if its value falls in terms of foreign currencies, i.e. if more domestic currency is required to buy a unit of foreign currency. The effect of depreciation of a currency is to make imports dearer and export cheaper. Thus, depreciation helps a country to achieve a favourable balance of payment by checking imports and stimulating exports.

#### (3) Devaluation

Devaluation refers to the official reduction of the external values of a currency. The difference between devaluation and depreciation is that while devaluation means the lowering of external value of a currency by the government, depreciation means an automatic fall in the external value of the currency by the market forces; the former is arbitrary and the latter is the result of market mechanism. Thus, devaluation serves only as an alternative method to depreciation. Both methods imply the same thing, i.e. decrease in the value of a currency in terms of foreign currencies. Both methods can be used to produce the same effects; they discourage imports, encourage exports and thus, lead to a reduction in the balance of payment deficit.



#### **(4) Exchange Control**

Exchange control is the most widely used method for correcting disequilibrium in the balance of payment. Exchange control refers to the control over the use of foreign exchange by the central bank. Under this method, all the exporters are directed by the central bank surrender their foreign exchange earnings. Foreign exchange is rationed among the licensed importers. Only essential imports are permitted. Exchange control is the most direct method of restricting a country's imports. The major drawback of this method is that it deals with the deficit only, and not its causes. Rather reduce the deficit, it may aggravate these causes and thus create a more basic disequilibrium. In short, exchange control does not provide a permanent solution for chronic disequilibrium.

#### **(5) Capital Movement**

Inflow of capital or capital imports can be used to correct a deficit in the balance of payment. If the capital is perfectly mobile between the countries, an increase in the domestic rate of interest above the world rate will result in the inflow of capital. This will reduce the deficit in the balance of payment.

#### **(6) Encouraging Exports**

In order to correct an adverse balance of payment, all efforts should be made to encourage exports. The government should adopt various export promotion programmes, such as: the reduction of export duties, provision of export subsidies, quality controls, incentives for exports, etc.

#### **(7) Discouraging Imports**

Attempt should also be made to reduce imports by adopting various measures. These important measures to discourage imports are: import duties, import quotas, and import substitution.

### **SELF ASSESSMENT EXERCISES**

- i. Distinguish between balance of trade and balance of payment.
- ii. What do you understand by disequilibrium in the balance of payments? What are the causes of such disequilibrium?

## **4.0 CONCLUSION**

You have learned in this unit the meaning of balance of payment which deals with all records of economic transactions visible or non-visible in

a period usually between one country and the rest of the world (or trading partners). Balance of payment provides an overall reflection of a country's internal and external economic condition. Its components are balance of trade, current account and capital account. The reasons for keeping record of these trading activities is to enable the trading partners understand their positions.

## **5.0 SUMMARY**

Balance of payment is the difference between a country's receipts and payments with regards to her exports and imports. Balance of trade, which is a sub-set of balance of payment, is measured in terms of the differences between visible and invisible exports and imports. The balance of payment's financial statements is made of two parts: current account and capital account. In the event of disequilibrium in the balance of payment, deflation, depreciation, devaluation, exchange control, capital movement, encourage of exports and discouragement of imports are some of the available methods for correcting the imbalances in the trade.

## **6.0 TUTOR MARKED ASSIGNMENT**

State the various sections of a country's balance of payment account.

### **ANSWER TO SELF-ASSESSMENT EXERCISES**

- i. The balance of payment is a summary statement of account of all of a country's economic transactions with the rest of the world during a given period, usually one year. It shows relationship between all the receipts of a country from all other countries and all payments made to them during the period. Balance of trade consists of the differences between visible exports and imports between a country and the rest of its trading partners. The balance of trade represents the visible trade segment of the balance of payment account.
- ii. Disequilibrium occurs in the balance of payment when the receipts and payments of a country resulting from international trade are not the same or equal. This represents surplus or deficits trade relationship. Deficit balance of payment is harmful to any country. Therefore, for a country with deficit balance of payment, she must take appropriate steps to correct the abnormality. Some of the available options include: deflation, depreciation, devaluation, exchange control, capital movement, encourage of exports and discouragement of imports.

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## **UNIT 4 INTERNATIONAL LETTERS OF CREDIT**

### **CONTENTS**

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- 2.0 Objectives
- 3.0 Main Content
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### **1.0 INTRODUCTION**

The period of expansion in international and domestic trade invariably increases the demand for methods of facilitating payments between trade partners. As a principal method of transfer, the letter of credit plays a central role in the world of international banking and finance. This unit covers all the detail analysis of the International letter of credit.

### **2.0 OBJECTIVES**

At the end of this unit, you should be able to:

- Define the meaning of letter of credit
- Trace the origin of letter of credit
- Identify the different types of letter of credit

### **3.0 MAIN CONTENT**

#### **3.1 Letter of Credit Defined**

Although there have been numerous attempts to define the letter of credit, a simplified definition will illustrate its basic character. A 'letter of credit' is an instrument issued by a bank at the request of its customer by which it promises to pay an indicated amount to a beneficiary upon receipt of certain documents in accordance with some specific terms.

Therefore, the documentary credit represents the bank's commitment to put a specified sum at the customer's disposal on behalf of a beneficiary under precisely defined terms and conditions. It is important to note that the bank's commitment to pay is enforceable only when the seller (or beneficiary) fulfills all of the conditions stipulated in the letter of credit.

The letter of credit differs materially from other means of transfer in the rights and duties conferred upon the parties. These differences determine the appropriateness of one method of transfer over another.

### **3.2 Historical Background of Credit Letter**

The highest level of development in the area of letters of credit was achieved by England before World War I. The practical monopoly on international letters of credit held by England was broken after the war, and the United States penetrated and became dominant in this particular market, quickly learning the 'know-how' from London bankers. The Federal Reserve Act of 1913 permitted member banks to issue letters of credit. In the 1930s England went off the gold standard, which, together with her loss of domination of world trade to the United States, further enhanced the worldwide importance and recognition of the American dollar as a world currency.

After World War II, America became the most important supplier of goods in international trade and the largest buyer of foreign goods. This accelerated the development of letters of credit in the United States, and American banks today play a leading role in the field of issuance of letters of credit.

Since various customs and practices developed in the United States and in foreign countries concerning the interpretations and usage surrounding letters of credit, the International Chamber of Commerce in Paris, in cooperation with various national Chambers of Commerce and banks, developed the Uniform Customs and Practice for Documentary Credit. The rules were published in 1962 and since July 1, 1963, the American banks, through their various associations, have subscribed to them and are governed by these rules. Virtually every country and territory in the World including Nigeria has accepted these rules.

Reflecting the numerous changes in international trading and transport techniques occurring since 1962, the rules were amended in 1974 and a further revision has been approved by the International Chamber of Commerce to become effective on October 1, 1984.

### **3.3 Types of Letter of Credit**

Letters of Credit may initially be differentiated according to three broad functional categories: Revocable and Irrevocable, Clean and Documentary, as well as Sight and time.

#### **Irrevocable/Revocable Credit**

Irrevocable Letters of Credit are instruments that may not be revoked, cancelled, or changed without the consent of all parties involved, especially of the beneficiary. Conversely, revocable letters of credit may be altered or withdrawn by a party up to the moment of presentation for payment. In cases involving ancillary financing by intermediary banks, the consent of the participating banks may also be required to change the terms of the credit.

Since a credit that does not specify whether or not it is revocable is assumed to be revocable, the text of every credit should always state which type it is. A revocable letter of credit is not an ironclad guarantee to the beneficiary, since it can be revoked at any time, even minutes before the required documents are presented. Furthermore, prior notice to the beneficiary would not be necessary in case of amendment or cancellation. For this reason, it is most unusual for a credit to be issued without the word 'irrevocable' being mentioned. If the revocable credit can be revoked or amended at any time without notice, the seller has no assurance that payment is protected because of the lack of a legally binding agreement between the bank and the seller.

#### **Clean/Document Credit**

Clean and documentary credits are another broad functional type. A clean credit calls only for presentation of a draft or other demand in order to obtain payment; no accompanying documents are necessary. On the other hand, a documentary credit calls for payment to be made against presentation of specified documents proving compliance with the terms of the credit. These may include documents of title to goods or documents certifying performance of a service.

If the documents refer to a sale of merchandise, the letter of credit is considered a commercial documentary credit. Depending upon whether the opening of the credit is initiated by the Nigerian exporter or the Nigerian importer, the document is called a documentary export letter of credit or a documentary import letter of credit. Although there is no difference between the two credits, banks often differentiate between them because sometimes they are handled by separate departments.

## **Sight/Time Credit**

Once performance by the beneficiary has been established, the terms of payment will distinguish sight from time letters of credit. A sight letter of credit is payable upon presentation of required documents. The stipulated amount is released as soon as the prescribed documents have been submitted and checked by the bank. Consequently, the exporter may receive money for the goods shortly after shipment and will be able to finance further transactions.

A time letter of credit defers payment to a certain date subsequent to the presentation to the bank of the required documents. The text of a time letter of credit authorized the beneficiary to draw a draft on a specified bank if certain documents are also submitted. In return for the documents surrendered, the beneficiary will receive the draft back <sup>3</sup>accepted by the drawee bank.

The originator of the letter of credit frequently arranges with the beneficiary that payment will be made only 30, 60, or 90 days, and occasionally six months, after the date of presentation of the documents or other specified date. The wording of the letter of credit names the bank on which the draft is to be drawn (that is, advising or confirming bank) and states the length of time that must run before actual payment is made.

With acceptance of the exporter's draft by the bank, payment by that bank at a later date is assured. The accepted time draft is returned to the exporter and the letter of credit continues to be a binding obligation of the bank, with a maturity fixed on a specified future date.

## **3.4 Other forms of Letter of Credits**

Other forms of Letter of Credits normally use in international settlements includes; Assignable/Transferable Credit, Negotiation Credit, and Revolving Letter of Credit

### **Assignable/Transferable Credit**

Sometimes there is an intermediary between the buyer and the seller of goods. For example, the broker might decide to purchase goods from several producers or manufacturers for export to the buyer. The suppliers might in turn require a domestic letter of credit from the broker to secure payment. With a letter of credit from the foreign buyer, the broker can instruct his or her bankers to split up the letter of credit in favor of various suppliers. The banker is permitted to do so, however, only if the letter of credit stipulates that the credit is indeed assignable and

divisible. If the letter of credit does not so specify, then the bank would not be allowed to divide or assign the letter of credit. Therefore, if there are several intermediaries the letter of credit should be made **assignable and re-assignable**.

The basic principle behind an assignment is the alienation of the right to receive monies due or to become due under the letter of credit contract. However, regardless of the manner in which the assignment of the proceeds is accomplished, no independent contract rights in favor of the assignee are established against the issuer.

A **transferable letter of credit** is a distinct variety. It entails a substitution of the parties and includes the transfer by the beneficiary of both the right to perform and receive payment under the terms of the letter of credit to a third party. The beneficiary's right to substitute a third party in his or her place is limited in several respects. Firstly, the ability to transfer the credit is limited by its actual terms and conditions. The letter of credit must expressly state that it is transferable. Second, a transferable credit may be transferred only once unless otherwise specified. That is, the party to whom the beneficiary transfers the letter of credit cannot transfer it again.

### **Negotiation Credit**

If the letter of credit contains an extension of the issuer's obligation to third parties who purchase the beneficiary's draft or other demand, it is called a negotiation credit. Language to this effect must be included in the terms of the letter of credit if so desired; without the engagement of the bank to endorsers and bona fide holders of a draft drawn according to the term of the letter of credit. It will be assumed that the credit is not a negotiation credit. Therefore, if the party opening the letter of credit wishes to provide the endorsers and bona fide holders of drafts drawn with the same rights as the named beneficiary of the credit, a negotiation credit should be opened.

Another feature of negotiation credits is that they provide for negotiation of the beneficiary's drafts and documents at banks other than the confirming bank. The bank that purchases drafts drawn under a negotiation credit is called the **negotiation bank**.

### **Revolving Letter of Credit**

It may arise that the shipment of goods is to be made over a period of time or for an amount larger than any bank or buyer desires to have outstanding. To solve the problem, the buyer may open a **revolving letter of credit**. When opened, the revolving credit covers merely a



portion of the entire quantity of goods; however, the bank undertakes an irrevocable obligation to restore the amounts drawn once a portion of the delivery is made and paid for up to a fixed maximum. The advantage of using a credit that may be reinstated up to a specified amount is that only a single letter of credit is used instead of issuing a new letter of credit for every shipment.

### **3.5 Discounting Letter of Credit**

If the beneficiary wishes to receive payment prior to the future date specified in the letter of credit and stated in the draft or in the acceptances, it may request the bank to discount the draft. Since an accepted draft represents the bank's own obligation, it will normally discount it, with the interest cost of discounting borne by the exporter.

Under certain conditions the bank can rediscount its time drafts originating from import/export transactions with the Central Bank, if it is a member; such draft can be easily discounted since they represent an unconditional banking commitment for future payment. Such drafts should state that the transaction creating these instruments is the consequence of an importation of goods. Thus, the time letter of credit implies an extension of credit by the issuing bank beyond the date when documents are supposed to be presented. In effect, there is an extension of credit on a trust receipt during this time period.

### **3.6 Applications of Letter of Credit**

Letters of credit were originally used to facilitate transactions involving sales of merchandise by assuring payment for goods. By obtaining the obligation of a bank whose credit was considered more valuable than that of a distant purchaser, the seller knew that an independent party (the bank) would make payment as soon as the goods were shipped and the documents prescribed by the credit were delivered. On the other hand, the buyer knew that the amount of the purchase price would only be released against receipt of the documents specified in the credit.

The use of letters of credit for this purpose continues today. For example, if a Nigerian exporter receives an order from a foreign buyer, he wants assurance, before making shipments or before starting to manufacture the goods ordered that he will be paid upon the shipment of the goods.

He will require the foreign buyer to open a letter of credit in his favor, which will be payable to him upon proof to the bank through which the letter of credit is opened, that the shipment has been made in accordance with the order. Upon presentation of such proof, the bank will then pay

the exporter. The exporter thus has obtained the promise of the bank to make payment for the buyer upon fulfilling the order, without having to depend on the reliability or willingness of the foreign buyer directly.

Conversely, if a Nigerian importer wants to buy goods abroad, the foreign seller will want to know that payment will be made when shipment is made to or received in Nigeria. Therefore, he will require the Nigerian importer to open a letter of credit through his bank, possibly through an intermediary of Nigerian bank and the foreign bank, in favor of the foreign exporter before shipment is made. The advantages and benefits for both the buyer and seller lie in the assurance that payment will be made for the goods shipped.

Letters of credit are not confined to international trade and are used domestically. Their use is not confined to financing importation or exportation of merchandise, but includes assuring payment by domestic parties as well. Variations in local laws, customs, and usages, together with the peculiar demands of foreign trade, however, make for distinction between domestic and foreign, or international, documentary letters of credit.

Letters of credit can be required not only for delivery of goods, but also to assure the performance of certain service. A broker, for example, may wish to assure payment of his or her commission by means of a letter of credit, payable upon proof of having obtained funds for financing a certain enterprise. Similarly, a letter of credit arrangement could assure payment of a real estate. Finally, a fixed sum may be paid under a letter of credit upon delivery of a document to the bank waiving certain rights.

When issued for payment of service instead of for delivery of goods, the credit is called a financial letter of credit. This is because the nature of the documents required to be presented as a condition for payment is different from that of trade documents, though still of a financial character. Furthermore, the underlying transaction does not involve the exchange of goods, but nevertheless involve a financial transaction of some kind.

The benefits of establishing a financial letter of credit include the elimination of the need for credit investigation as well as the prevention of default due to possible cancellation of an order by the buyer. In this respect, financial letters of credit also support a promise of payment.

### **3.7 Red-Line and Green Clause**

#### **Red-Line Clause**

In connection with the shipment and export of commodities, the bank is often required to include a red-line clause in the letter of credit, so-called from the common law businesses practice of printing the clause in red ink. Such provisions permit advance partial payments of the credit in order to facilitate performance by the beneficiary. For example, an exporter may purchase goods from various sources, including minor manufacturers who assemble the shipment. If payment for these goods is due when the goods to be shipped are purchased, the exporter may not have funds available for this purpose; he or she is, of course, prevented from drawing from the letter of credit to alleviate the situation until shipping documents are presented.

To overcome this problem, if the importer has faith in the exporter, he or she will permit the bank to make an advance partial payment to the exporter against presentation of draft and/or other papers, and pending the presentation of the final documents. This, the red-line clause permits the exporter to assemble the goods to be shipped from various sources and make payments on the spot before shipping documents can be presented. Use of such a clause entails the risk that the seller of bad faith may draw the advance without ever shipping the goods to the buyer and so disadvantages the buyer and the buyer's bank. Therefore, a letter of credit containing a red-line clause will be issued only when the bank is assured it will receive reimbursement from the buyer.

#### **Green Clause**

A variety of the red clause offering more protection to the buyer is the green clause letter of credit. Its terms require the merchandise to be stored under the bank's control until shipment is made. This practice used in countries such as Australia, reduce the buyer's risk of no delivery.

#### **SELF ASSESSMENT EXERCISE**

- i. Define the letter of credit and explain how it works
- ii. Distinguish between revocable and irrevocable letter of credit

### **4.0 CONCLUSION**

You have learnt the definition of letter of credit and explanation of different types normally used in international banking operations. You have also seen that the ability and skill needed to discern whether or not

the terms of the credit have been met and confirming documents presented determine the extent of risk in the transaction.

## **5.0 SUMMARY**

Letters of credit are issued by banks. The issuing banks assume responsibility for settling debts, subject to the conditions laid down in the credit letter. There are various types of letter of credit commonly used in international business for settling debts among trading partners. These include; Revocable and Irrevocable, Clean and Documentary, Sight and Time, Assignable and Transferable letters of credit amongst others.

## **6.0 TUTOR MARKED QUESTIONS**

Explain the Concept of Red-Line Clause in issuing letter of credit

### **ANSWER TO SELF-ASSESSMENT EXERCISES**

- i. The balance of payment is a summary statement of account of all of a country's economic transactions with the rest of the world during a given period, usually one year. It shows relationship between all the receipts of a country from all other countries and all payments made to them during the period. Balance of trade consists of the differences between visible exports and imports between a country and the rest of its trading partners. The balance of trade represents the visible trade segment of the balance of payment account.
- ii. Disequilibrium occurs in the balance of payment when the receipts and payments of a country resulting from international trade are not the same or equal. This represents surplus or deficits trade relationship. Deficit balance of payment is harmful to any country. Therefore, for a country with deficit balance of payment, she must take appropriate steps to correct the abnormality. Some of the available options include: deflation, depreciation, devaluation, exchange control, capital movement, encourage of exports and discouragement of imports.

## **7.0 REFERENCES/FURTHER READINGS**

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## **UNIT 5 BANKERS' ACCEPTANCES, COLLECTIONS AND CHEQUES**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Bankers Acceptances Defined
  - 3.2 Dimensions of Acceptances
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  - 3.7 Types of Checks
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### **1.0 INTRODUCTION**

Several methods are available to those who wish to effect international payments, apart from the use of letter of credit as discussed in the previous unit. In this unit, we examine other payment options that may be employed in making international payments. These include; Bankers' Acceptance, Collections and Cheques.

### **2.0 OBJECTIVES**

At the end of this unit, you should be able to:

- Explain bankers acceptances, collections and Cheques
- Identify different types of bankers' acceptances and Cheques
- Identify Uniform rules of collection

### **3.0 MAIN CONTENT**

#### **3.1 Bankers Acceptances Defined**

A bankers' acceptance is a draft or bill of exchange drawn on a bank (the drawee) by a party (the drawer) and accepted by that bank to pay a third party (the payee) a certain sum at a fixed future date. The bank's acceptance of a draft represents a formal acknowledgement of the bank's unconditional promise to pay the draft at maturity. A distinction

should be made between the bankers' acceptance and a letter of credit under which it is often created, since the acceptance is a credit mechanism whereas the letter of credit is a security device.

Bankers' acceptances represent a flexible and efficient means of obtaining credit for short periods of time. They are utilized particularly in instances where the underlying transaction is self-liquidating in nature.

The transaction financed by this type of acceptance will thus produce the funds necessary to pay off the acceptance. Thus, the bankers' acceptance covers the time normally needed to ship and sell goods. In theory, this eliminates a great deal of risk of the accepting bank since payment will be forthcoming from the transaction. On the other hand, the fact that the bank assumes primary responsibilities for payment upon creation of an acceptance eliminates substantial risk from the point of view of the purchaser of the acceptance.

The steps followed in the creation of an acceptance involve a presentation of the draft signed by the drawer to the drawee for acknowledgement or acceptance of its payment obligation on the face of the draft along with the drawee's signature. Any words of acceptance that accompany the signature can create a valid acceptance. If the drawee is a bank, the draft is called a bankers' acceptance. Since these actions are taken prior to the due date of the draft, all that remains is to await its maturity for payment of the draft. If funds are desired prior to maturity, the holder may be able to sell it at a discount as an alternative.

An acceptance is evidenced by an authorized signature appearing on the face of the draft and must be accompanied by delivery or appropriate notification to the holder. Liability on an accepted instrument is primarily that of the accepting bank and is unconditional. The drawer of the draft is now secondarily liable unless his signature was accompanied by the words 'without recourse'.

### **3.2 Dimensions of Acceptances**

Acceptances may be created for reasons related to trade and for non-trade reasons.

#### **Trade-Related Acceptances**

Trade-related acceptance may be created in the buyer's and seller's attempt to finance their deal. Typically a buyer of goods does not have cash to pay to the seller. The buyer will seek out a bank to act as his intermediary and provide the credit he needs until he has the cash (such

as when he has sold the goods that he is now seeking to buy). If a bank is willing to provide its assurance that payment will be made, it notifies the seller that he may draw a draft on the bank for an indicated amount payable at a future date. The bank then stamps 'ACCEPTED' across the face of the draft and places an authorized bank signature on the draft.

### **Non-trade-Related Acceptances**

The uses of acceptances are not limited to the needs of trade. One type of non-trade-related acceptance is known as a **finance bill**. This type of bill raises working capital for the firm drawing the draft, and it is a corollary to commercial paper. Another type of non-trade-related acceptance is known as a **dollar exchange bill**. Dollar exchange bill is another type of non-trade acceptance that is used to finance the extension of dollar exchange credits to foreign countries. This type of financing is especially attractive to foreign banks in countries whose exports to the U.S are highly seasonal. Through the dollar exchange acceptance, a bank seeks to provide itself with dollars to finance its customer's imports during seasons when export earnings are low and dollars are in short supply.

### **3.3 Investors in Dollar Exchange Acceptances**

Acceptance investors include state and local governments, governmental agencies, savings institutions, foreigners, foreign central banks, industrial corporations, insurance companies, investment funds, accepting banks, and individuals. In addition, banks may join together to syndicate eligible acceptances.

Non-bank investors play a limited role even though acceptance yields are comparable to commercial paper yields. This is so because it is difficult to obtain large blocks of bankers' acceptances with the maturity desired. Initial investors usually hold acceptances to maturity.

### **3.4 Concept of Collections**

In a typical import-export situation, the collection procedure entails the delivery of a collection order by the principal (a seller of goods) to the remitting bank with specific instructions to have them presented through a collecting bank to the buyer. The bank will arrange for presentation of the draft to the importer for payment or acceptance, depending upon the seller's instructions, in conformity with its role as collector for the principal. The most important bank in the collection process is the presenting bank because it is responsible for the release of documents against payment or acceptance. The bank is frequently designated by the

exporter since it controls the funds paid by the importer until receipt by the exporter's bank. However, if the principal does not choose a collecting bank, the remitting bank may choose any bank in the country of payment or acceptance in order to carry out the instructions of the principals.

Significantly, the intermediary banks involved in the collection process act as agents for collection. As agents for collection, banks would not normally have the authority to sell goods in the case of nonpayment by the initial buyer.

This method of payment minimizes the bank's responsibilities concerning payment when the standard procedures of presentation and acceptance are followed. More importantly, the bank's liability for payment of the draft is eliminated, since the credit of the bank is not substituted for that of the buyer.

### **3.5 Uniform Rules of Collections**

Over the years, uniform terms, rules, and procedures have evolved and are now routinely applied by banks when handling documents for collection payments. The uniform Rules Brochure No. 322 (URC), prepared by the International Chamber of Commerce, is one of the more comprehensive codifications of these principles; for that reason, it is recognized and used by most banks in both the developed nations like United States and developing countries like Nigeria.

The articles of the Uniform Rules for Collection are divided into subsections governing particular phases of the collection process. These include:

#### **Responsibilities of the Bank**

As a general matter, the responsibilities, as well as the limitations on the collecting bank's liability, are contained in the Uniform Rules for Collection (URC). Normally, an agreement for collection entered into with a bank is made subject to the URC. In addition, however, certain provisions of the Uniform Commercial Code (UCC) may otherwise be found applicable to a bank collection. The application of the UCC to bank collections may be varied by agreement of the parties.

Nevertheless, no agreement can disclaim a bank's responsibility to deal in good faith and exercise ordinary care. Furthermore, damages resulting from the bank's failure to exercise such duties may not be limited.



## **Collection Order**

The procedure for presentation of documents is contained in the **collection order** issued by the principal, which defines the permissible actions of the bank and, in so doing, establishes additional rights and obligations between the parties. The collecting banks have the responsibility to comply with the specific instructions for collection contained in the order, in the event that these instructions cannot be complied with, the bank must immediately advise the party who initially submitted the order of any difficulties.

Additional items that may be included in the collection order are terms concerning who will pay costs, conditions to be met for release of documents, methods of transferring payment, procedures to be employed in case of nonpayment, and protection of goods against loss.

## **Protest**

Frequently, the protest procedure or formal demand for payment is a legal prerequisite to suit in foreign jurisdictions for nonpayment of an accepted draft or bill of exchange. This official protest must satisfy the formal prerequisite to suit for payment on the accepted instrument. The case of the buyer's refusal to accept the draft, a suit for breach of contract is the most likely legal remedy.

## **Presentation**

Once the presenting bank is in possession of the collection order, drafts, and /or documents, presentation will be made to the buyer as drawee.

Therefore, the bank notifies the buyer of the arrival of the draft and documents. The bank is required to make presentation for payment without delay if the documents (including drafts) are payable on sight.

Presentation for acceptance must also be made without delay and before the specified maturity date. Advice of nonpayment or non-acceptance may be called for if difficulties arise. The draft will be presented to the buyer as drawee. The drawee only has the right to examine the collection documents held by the bank; that is, actual delivery of the documents to the buyer may occur only after the buyer has satisfied the seller's conditions.

## **Payment**

The currency of payment is an important factor to consider when international collections are being handled. Potential problems may be caused by local foreign exchange regulations and interfere with the immediate transfer of proceeds to the seller. If local currency is called for by the collection order, the presenting bank must release the documents only against payment in local currency that is immediately available for disposal according to the terms of the order. If the collection order requires payment to be made in foreign currency, the bank must only release documents against payment in the foreign currency provided it may immediately be remitted according to the terms of the collection order.

### **Partial Payment**

A situation may arise where the buyer wishes to make partial payment of his obligation. The URC specified that partial payment may not be accepted as a condition of release of documents unless authorized by the principal. Consequently, in the case of documentary collections, the presenting bank may release documents only against full payment. Unless authorized, partial payment need not be accepted.

### **3.6 Cheque Defined**

Cheque, drafts, and money orders are an integral part of the payment mechanism in use both in the International business environment. A Cheque is a three-party instrument drawn on a payer bank (the drawee) by its customer (the drawer) ordering a specific sum to be paid to a payee. The fact that the Cheque is drawn on a bank distinguishes it from an ordinary draft. A draft is an instrument whereby the drawer orders the drawee to pay a specific sum of money on the indicated date or on demand to the order of a payee. Therefore, Cheques are simply a demand unless postdated. In effect, the Cheque represents the drawee's instructions to the bank to pay money held in the drawee's account to the specific third party.

Two basic types of Cheques are used commercially; personal checks, which include checks drawn by business and other establishments, and bank Cheques. The most important distinction between personal and bank Cheque is the identity of the party having primary responsibility for payment of the Cheque. In the case of a bank Cheque, the bank is primarily liable as the drawer thereof, whereas in the case of a personal Cheque, the bank typically serves merely as drawee without assuming primary liability for payment for the instrument. Liability for a personal Cheque may be shifted onto the bank as regards third parties through the procedure of certification.

### **3.7 Forms of Cheques**

There are different forms of cheques. Some of these include: Certified Cheque, Cashier's Cheques, Teller's Cheques, Traveler's Cheque and Euro-Cheques.

#### **Certified Cheque**

Certification of Cheque indicates that: the Cheque is drawn on sufficient funds in the hands of the drawee bank; these funds have been set aside for the satisfaction of the Cheque; and that the funds will be paid to a holder entitled to the funds when the Cheque is presented for payment since certification constitutes an acceptance by the drawee bank. Because the customer's account is charged for the amount of the Cheque when it is certified, the bank is obliged to make proper payment even when it is presented for payment more than six months after its date. This differs from the general rule governing ordinary Cheques whereby the drawee bank is under no obligation to pay a Cheque that is considered 'stale' (that is, one that is presented for payment more than six months after its date).

#### **Cashier's Cheques**

Cashier's Cheques are one of the most frequently encountered forms of bank cheque. A cashier's cheque is a draft or bill of exchange that is drawn by the bank on itself and that is issued by an authorized officer or employee of the institution. Thus, a cashier's cheque differs significantly from an ordinary cheque drawn by a customer on an account, as well as from an ordinary bank or banker's cheque. The banker's cheque is a draft drawn by one bank upon another bank. For this reason, the banker's cheque is subject to the general rules governing ordinary cheques including those permitting stop-payment orders. When the bank issues a cashier's cheque, a direct payment obligation is created.

Furthermore, this obligation is said to be accepted by the mere issuance of the cashier's cheque. The bank has an independent and direct obligation to the holder to honour the instrument.

#### **Teller's Cheques**

Instruments drawn by savings banks and savings and loan association and commercial banks are known as teller's cheque. In effect, the institution draws a cheque on its account held at a commercial bank.

Such a cheque is not issued by the commercial bank as in the case of a cashier's cheque. For this reason, the act of issuing such a cheque does not in itself constitute acceptance of a primary payment obligation. Although courts are in disagreement on this point, several instances have occurred where a stop payment order was effectively placed by the drawer institution, making such a cheque resemble a personal cheque rather than bank cheque in this regard.

### **Traveler's Cheque**

Traveler's cheques *are* instruments having the features of a cash substitute, which offers the security of a cashier's cheque. In fact, when issued by a bank, traveler's cheques are essentially equivalent to cashier's cheques once a proper endorsement in the form of a countersignature is placed upon the instrument. The cheque form typically provides a space for the signature of the purchaser, which is used for comparison with the countersignature at the time payment. Thus, the countersignature requirement provides security against loss or theft subsequent to the purchase of the instrument since the cheque is properly payable only if a valid countersignature is placed on the instrument at the time of payment.

### **Euro-Cheques**

The Euro-Cheques is a blank cheque issued in a uniform format and color by any of the member banks of the European countries that formed the Euro-cheque system. Despite their official appearance, the Euro-cheque is like an ordinary cheque even when cashed with what is called the Euro-cheque Guarantee Card. The Euro-cheque guarantee of payment extends only to European countries and to some North African countries bordering on the Mediterranean Sea. Therefore, a Euro-cheque should be treated like an ordinary cheque since the guarantee does not extend to all parts of the world.

### **SELF ASSESSMENT EXERCISES**

- i. Define Banker's Acceptances and State the various types of acceptances.
- ii. Enumerate the key players in the acceptance market.

### **4.0 CONCLUSION**

You have learnt in this unit that the wide spread use of the banker's acceptances as means of providing credit shows that it represent an important financing instrument. In terms of collections, it has been learn that bank occupy an important role in the orderly collection of

international payment obligations. They greatly facilitate transactions covering great distance by providing measure of security over documents and goods. They have also understood the major features that differentiate several types of Cheques and money order used to effectuate domestic and foreign payments.

## **5.0 SUMMARY**

Bankers' acceptances represent the bill of exchange which is a written instruction sent by an exporter to an importer ordering the importer to pay to the exporter, or anyone specified by the exporter, a certain sum of money either on receipt of the bill, or at a specified date in the future.

Bankers' acceptances may be trade related or non-trade related. The collections method of payment minimizes the bank's responsibilities concerning payment when laid down procedures are followed. The collection uniform rule provide for liabilities and responsibilities off parties, payment, protest and advice of fate. Cheques are also used in making international payments. Different types of Cheques available include; certified, cashier, tellers, and travel's Cheques amongst others.

## **6.0 TUTOR MARKED ASSIGNMENT**

Differentiate between travel's and Teller's Cheques

### **ANSWER TO SELF ASSESSMENT EXERCISES**

- i. Bankers' acceptances can be defined as a bill of exchange drawn on a bank by a party and accepted by that bank to pay a third party a certain sum at a specific future date. Bankers' acceptances may be classified into two namely; trade acceptances and non-trade acceptances.
- ii. The bankers' acceptances investors include; local, state and federal governments, government agencies, savings institutions, foreign banks, industrial and insurance companies, investment funds and individuals.

## **7.0 REFERENCES/FURTHER READINGS**

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## **MODULE 2**

Unit 1	Foreign Exchange Market
Unit 2	Foreign Rate of Exchange
Unit 3	Foreign Exchange Control
Unit 4	Euro Dollar Market
Unit 5	Swiss Banking

### **UNIT 1 FOREIGN EXCHANGE MARKET**

#### **CONTENTS**

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3.2	Foreign Exchange Market Defined
3.3	Types of Foreign Exchange Market
3.4	Forward Exchange Market
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3.4.2	Advantages of Forward Exchange market
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#### **1.0 INTRODUCTION**

Foreign exchange market represents the medium for foreign currency transactions. In this unit, we investigate the activities taking place in the foreign exchange market viz the operators and participants in the market.

#### **2.0 OBJECTIVES**

At the end of this study unit, you should be able to:

Define the foreign exchange market

Describe the major types foreign exchange market

Identify the participants in the market.

### **3.0 MAIN CONTENT**

#### **3.1 Meaning of Foreign Exchange**

In the narrow sense, foreign exchange simply means the money of a foreign country. Thus, American dollars are foreign exchange to a Nigerian and Nigerian naira are foreign exchange to an American. In practice, foreign exchange is often used to refer to a Country's actual stock of foreign currency i.e., foreign currency notes or the means of obtaining such money through travel cheques or letters of credit. However, in the broader sense, the foreign exchange is related to the mechanism of foreign payments. It refers to the system where by one currency is exchanged for or converted into another.

#### **3.2 Foreign Exchange Market Defined**

Foreign exchange market is a market where foreign currencies are bought and sold by the traders to meet their obligations abroad. Foreign exchange market is a market in which foreign exchange transactions take place. It is a vehicle that makes possible the exchange of different national currencies. The basic purpose of foreign exchange market is to facilitate international trade and investment. In other words, foreign exchange market is a place where foreign moneys are bought and sold.

Foreign exchange market is an institutional arrangement for the sales and purchase of foreign currencies exporters sell and importers buy foreign currencies. Foreign exchange market is merely a part of the money market in the financial centres. It is the market for national currency (i.e. foreign money) anywhere in the world, as the financial centres of the world are united in a single market.

#### **3.3 Types of Foreign Exchange Market**

There are two foreign exchange markets: the retail market and the inter-bank market.

##### **Retail Market**

In the retail foreign exchange market, the individual and firms who require foreign currency can buy it and those who have acquired foreign currency can sell it. The commercial banks dealing in foreign exchange serve their customers by purchasing foreign exchange from some and selling foreign exchange to other. Thus, each bank acts as a clearing house where purchases of exchange can be offset by sales of foreign exchange.



## **Inter-bank Market**

Inter-bank foreign exchange market serves to smooth the excessive purchases or sales made by individual banks. At times, the quantity of foreign exchange supplied exceeds the quantity demanded, or vice versa. If the foreign exchange is in excess supply, the exchange rates falls; if the foreign exchange is in excess demand, the exchange rate rises. The movement in the exchange rate helps to correct the situation by encouraging or discouraging additional buyers and sellers into or from the market.

### **3.4 Forward Exchange Market**

A forward exchange involves a purchase or sale of foreign currency to be delivered at some future date. The rate at which the transaction is to take place is determined at the time of sale, but the payment is not made until the exchange is not delivered by the seller.

The transactions of the forward exchange market are known as forward exchange. The rates at which the foreign exchange is bought and sold in the forward market are called forward rates. In the foreign exchange market, forward exchange market functions side by side with the spot exchange market.

#### **3.4.1 Determination of Forward Rate**

In Forward Market, the determination of forward rate depends upon the interest rates between the money markets of the two countries and the interest arbitrage. In the absence of anticipated movements of foreign exchange rate, the forward (or future) rate will be the same as the spot rate if rates of interest are the same in the two money markets. On the other hand, if the interest rates are different in the two money markets, the different will be reflected by the different between the forward and the spot rates.

#### **3.4.2 Advantages of Forward Exchange market**

The need for the forward exchange market arises because of its following advantages:

- (i) The forward exchange market provides a method for hedging exchange risk. Hedging means forward buying and selling of foreign exchange to eliminate the risk of fluctuations in exchange rate.
- (ii) The forward market helps the investors to avoid the possibility that exchange rate fluctuations may wipe out their gains. An

American investor who wants to purchase foreign securities can protect himself against the risk of changes in the exchange rate by selling foreign currencies forward. If the effective yield (after deducting the cost of hedging) is still higher on foreign securities, he can go ahead without fear of loss due to exchange rate variation.

- (iii) Forward exchange market also provides an opportunity for speculators to make profits from dealing in foreign currencies.

### **3.5 Participants in Foreign Exchange Market**

Important dealers in the foreign exchange market are Central bank and Treasury authorities, Commercial banks, Brokers, and Acceptance houses.

#### **Central Bank and Treasury**

The central bank and the Treasury of a country are main dealers in foreign exchange. These institutions may intervene in the exchange market occasionally both as buyers and sellers to prevent excessive fluctuations in the exchange rates.

#### **Commercial Banks**

The Commercial banks dealing in foreign exchange have branches (called exchange banks) in different countries and maintain substantial foreign currency balances in these branches to serve the needs of their customers. These branches discount and sell foreign bills of exchange, issue bank drafts, make telegraphic transfer etc. If a bank has excess foreign currency balances, it can sell these balances to other commercial banks, foreign currency brokers, and sometimes to foreign monetary institutions. Similarly, if an exchange bank has deficit foreign currency balances, the other commercial banks, the brokers and the foreign monetary institutions become the sources of foreign currency supply.

#### **Brokers**

Commercial Banks most times do not deal directly with one another. They use the services of foreign exchange brokers. The brokers bring together the buyers and sellers of foreign exchange among banks. By using the brokers, the banks save time and effort. If a bank wants to buy or sell foreign exchange, it informs the broker the amount and the rate of exchange in which it is interested. If the broker succeeds in carrying out the transaction, he receives a commission from the selling bank.

## **Acceptance Houses**

Acceptance houses also deal in foreign exchange. They accept bills on behalf of their customers and thus help in foreign remittances.

### **3.6 Instruments of Foreign Exchange Payments**

A number of instruments are used to facilitate foreign payments. Important among them are discussed below:

#### **Bills of Exchange**

The bill of exchange is a commonly used instrument in international payments. It is an order from the drawer (creditor) to the drawee (debtor) to pay the specified sum of money on demand or on some specified future date. The following example makes the mechanism of foreign payment through bill of exchange clear: Suppose trader A in Lagos imports machinery from trader B in London. Similarly, another trader C in London imports tea from trade D in Lagos. Also assume that the value of the traded machinery is equal to the value of the traded tea. In this case, the British creditor (exporter of machinery) B will draw a bill for the amount equal to the value of machinery and get it accepted by his Nigerian debtor (importer of machinery) A. B then sells this bill to C, the British debtor (importer of tea) who has to pay money to Nigeria. C will send this bill to his creditor D (exporter of Tea) in Nigeria who collects the money from A, the Nigerian debtor (importer of machinery), who had originally accepted the bills. This mechanism of foreign bills of exchange, however, assumes that each international payment in one direction is matched by the equal payment in the opposite direction.

#### **Bank Draft**

Bank draft is an order of a bank to its branch or some other bank to pay the bearer the specified amount. The debtor (importer) in foreign transaction gets a bank draft from the bank and sends it to his creditor (exporter) who in turn, collects the specified amount from the bank in his own country.

#### **Letter of Credit**

A letter of credit is an assurance from the writer of the letter (a commercial bank) to the creditor on behalf of the debtor that the former will receive payment. In the international transaction, for example, an importer may arrange a letter of credit from his commercial bank according to which the exporter may draw bill on the bank rather than

on the importer. The letter of credit provides an assurance to the exporter that the bill will be paid by the bank. Thus, the issuance of letter of credit gives double assurance of payment because the exporter can now rely on the standing and integrity of the bank rather than on the standing and integrity of the importer alone.

### **Cable Transfers**

A cable transfer is a telegraphic order sent by a bank to its correspondent bank abroad to pay the specified amount to certain person from its deposit account. For example, a Nigerian importer who wants to make payment abroad can arrange for a cable transfer from his Nigerian bank. The Nigerian bank will direct its correspondent bank abroad to transfer the specified sum from its account of the exporter.

Other Instruments: Other means of foreign payments are: travelU's cheques, personal cheques, international money orders, home currency, gold, etc.

## **3.7 Functions of Foreign Exchange Market**

The foreign exchange market performs Transfer, Credit, and Hedging functions.

### **Transfer Function**

The basic function of the foreign exchange market is to transfer purchasing power between countries, i.e. to facilitate the conversion of one currency into another. The transfer function is performed through the credit instruments like, foreign bills of exchange, bank draft and telephonic/electronic transfers.

### **Credit Function**

Another function of foreign exchange market is to provide credit, both national and international, to promote foreign trade. Bills of exchange used in the international payments normally have a maturity period of three months. Thus, credit is required for that period to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.

### **Hedging Function**

In a situation of exchange risks, the foreign exchange market performs the hedging function. Hedging is the act of equating one's assets and liabilities in foreign currency to avoid the risk resulting from future

changes in the value of foreign currency. In a free exchange market, when the value of foreign currency varies, there may be a gain or loss to the traders concerned. To avoid or reduce this exchange risk, the exchange market provides facilities for hedging anticipated actual claims or liabilities through forward contracts in exchange. Forward contract is a contract of buying or selling foreign currency at some fixed date in future at a price agreed upon now. Thus, without transferring any currency, the forward contract makes it possible to ignore the likely change in the exchange rate and avoid the possible losses from such change.

### **3.8 Concept of Arbitrage**

Arbitrage refers to an act of simultaneously buying a currency in one market and selling it in another with a view to make profits from the difference between the exchange rates in the two markets. The effect of arbitrage is to iron out differences in the exchange rates of currencies in different centres, and thereby creating a single world market in foreign exchange.

The broad conclusions of the theory of interest arbitrage are as follows:

- (i) Interest arbitrage provides the link between the forward and spot exchange rates.
- (ii) The wider the short interest yield differential on comparable securities between two countries, the wider will be the spread between the forward and spot rates of exchange.
- (iii) If interest yield on domestic short-term securities exceed those available abroad, the domestic currency will sell forward at a discount relative to spot rate.
- (iv) Conversely, short-term interest yields abroad in excess of prevailing domestic yields will cause the home currency to sell at a premium on the forward market.

### **SELF ASSESSMENT EXERCISES**

- i. Defined Foreign Exchange Market and State the types of Foreign Exchange Market
- ii. Who are the dealers in Foreign Exchange Market?

### **4.0 CONCLUSION**

Students have learned about foreign exchange market, types of foreign exchange market, and dealers in the forex market as well as the functions of the market in promoting international business transactions.

## 5.0 SUMMARY

Foreign exchange market refers to the market where foreign currency are bought and sold. Retail market and Inter-bank market are the two types of foreign exchange market. The important dealers in the foreign exchange market are Banks, Brokers, Acceptance Houses, Central Bank and Treasury Authorities.

## 6.0 TUTOR MARKED ASSIGNMENT Of

what importance is Foreign Exchange Market?

### ANSWER TO SELF ASSESSMENT EXERCISES

- i. Foreign exchange market is a market in which foreign exchange transactions take place. There are two types of foreign exchange market that is Retail and Inter-Bank Market. In the retail foreign exchange market, the individual and firms who require foreign currency can buy it and those who have acquired foreign currency can sell it. The commercial banks dealing in foreign exchange serve their customers by purchasing foreign exchange from some and selling foreign exchange to other. Thus, each bank acts as a clearing house where purchases of exchange can be offset by sales of foreign exchange. Inter-bank foreign exchange market serves to smooth the excessive purchases or sales made by individual banks. At times, the quantity of foreign exchange supplied exceeds the quantity demanded, or vice versa. When such an imbalance occurs, the exchange rate changes. If the foreign exchange is in excess supply, the exchange rates falls; if the foreign exchange is in excess demand, the exchange rate rises. The movement in the exchange rate helps to correct the situation by encouraging or discouraging additional buyers and sellers into or from the market.
- ii. The major participants and dealers in the foreign exchange market includes; *Central Bank and Treasury*: The central bank and the Treasury of a country are main dealers in foreign exchange. These institutions may intervene in the exchange market occasionally both as buyers and sellers to prevent excessive fluctuations in the exchange rates. *Commercial Banks*: The Commercial banks dealing in foreign exchange have branches (called exchange banks) in different countries and maintain substantial foreign currency balances in these branches to serve the needs of their customers. These branches discount and sell foreign bills of exchange, issue bank drafts, make telegraphic transfer etc. *Brokers*: Commercial Banks most times

do not deal directly with one another. They use the services of foreign exchange brokers. The brokers bring together the buyers and sellers of foreign exchange among banks. By using the brokers, the banks save time and effort. If a bank wants to buy or sell foreign exchange, it informs the broker the amount and the rate of exchange in which it is interested.

### **Acceptance Houses**

Acceptance houses also deal in foreign exchange. They accept bills on behalf of their customers and thus help in foreign remittances.

## **7.0 REFERENCES/FURTHER READINGS**

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## **UNIT 2 FOREIGN RATE OF EXCHANGE**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
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### **1.0 INTRODUCTION**

In the international business arena, understanding of currency rate of exchange is very important in determining the volume of trade and goods to be bought. This unit provides a comprehensive explanation of foreign exchange that the rate at which one specific foreign currency is exchange with the order.

### **2.0 OBJECTIVES**

At the end of this study unit, student should be able to:

- Understand the different rates of exchange
- Know theories of foreign rates of exchange
- Explain factors influencing rate of exchange

### **3.0 MAIN CONTENT**

#### **3.1 Rate of Foreign Exchange Defined**

The rate at which one currency is exchanged for another is called the rate of exchange. The rate of exchange is the price of one currency stated in terms of another currency. In other words, the rate of exchange expresses the external purchasing power of a home currency. According



to Growther, the rate of exchange <sup>3</sup>measures the number of units of one currency which will exchange in the foreign exchange market for another'. In the words of Anatol <sup>3</sup>The ratio at which one country's currency can be exchanged for another is the rate of exchange between these two currencies'. According to Sayers, <sup>3</sup>the prices of currencies in terms of each other are called foreign exchange rate'.

### **3.2 Types of Exchange Rate**

In the foreign exchange market, at particular time, there exists, not one unique exchange rate, but a variety of rates, depending upon the credit instruments used in the transfer function. Major types of exchange rates are as follows:

#### **Spot Rate**

Spot rate of exchange is the rate at which foreign exchange is made available on the spot. It is also known as cable rate or telegraphic transfer rate because at this rate cable or telegraphic sale and purchase of foreign exchange can be arranged immediately. Spot rate is the day-to-day rate of exchange. The spot rate is quoted differently for buyers and sellers. This difference is due to the transport charges, insurance charges, dealers' commissions, etc. These costs are to be born by the buyers.

#### **Forward Rate**

Forward rate of exchange is the rate at which the future contract for foreign currency is made. The forward exchange rate is settled now but the actual sale and purchase of foreign exchange occurs in future. The forward rate is quoted at a premium or discount over the spot rate.

#### **Long Rate**

Long rate of exchange is the rate at which a bank purchases or sells foreign currency bills which are payable at a fixed future date. The basis of the long rate of exchange is the interest on the delayed payment. The long rate of exchange is calculated by adding premium to the spot rate of exchange in the case of credit purchase of foreign exchange and deducting premium from the spot rate in the case of sale.

### **Fixed Rate**

Fixed or pegged exchange rate refers to the system in which the rate of exchange of a currency is fixed or pegged in terms of gold or another currency.

### **Flexible Rate**

Flexible or floating exchange rate refers to the system in which the rate of exchange is determined by the forces of demand and supply in the foreign exchange market. It is free to fluctuate according to the changes in the demand and supply of foreign currency.

### **Multiple Rates**

Multiple rates refer to a system in which a country adopts more than one rate of exchange for its currency. Different exchange rates are fixed for importers, exporters, and for different countries.

### **Two-Tier Rate System**

Two-tier exchange rate system is a form of multiple exchange rate system in which a country maintains two rates, a higher rate for commercial transactions and a lower rate for capital transactions.

## **3.3 Exchange Rate Determination**

Rate of exchange is the price of one currency in terms of another currency. Therefore, like other prices, the rate of exchange is also determined in accordance with the general theory of value, i.e., by the interaction of the forces of demand and supply. In other words, the exchange rate in a free exchange market is determined at a level where demand for foreign exchange is equal to the supply of foreign exchange.

**Supply of Foreign Exchange:** The supply of foreign exchange comes from the domestic exporters who receive payment of foreign currency; the foreigners who invest and led in the home country; domestic residents who repatriate capital funds previously sent abroad; and the domestic residents who receive gifts from abroad.

The supply schedule for foreign exchange represent a functional relationship between different rates of exchange and the corresponding amounts of foreign exchange supplied. The supply schedule slopes upward to the right, indicating that at higher exchange rates larger amounts of foreign exchange are offered for sale.

## **Demand for Foreign Exchange**

Foreign exchange is demanded by the domestic residents to import goods and services from abroad; by the domestic residents investing and lending abroad; by the foreign residents to repatriate funds previously invested in the home country; and for sending gifts to foreign countries. The demand schedule for foreign exchange shows a functional relationship between different rates of exchange and the corresponding amounts of foreign exchange demanded. The demand schedule slopes downward to the right, indicating that greater amounts of foreign currency are demanded at lower rates of exchange.

### **3.4 Theories of Rate of Exchange**

Different theories have been developed to explain the determination of rate of exchange. They are: Mint Parity theory, Purchasing power parity theory, and Balance of payments theory.

#### **3.4.1 Mint Party Theory**

Mint parity theory explains the determination of exchange rate between the two gold standard countries. In a country on gold standard, either the currency is made of gold or its value is expressed in terms of gold.

According to the mint parity theory, the exchange rate under gold standard is equivalent to the gold content of one currency relative to that of another. This exchange rate is also known as mint rate.

A country is said to be on the gold standard if the following conditions are satisfied: The standard monetary unit is defined in terms of gold, i.e. either it is made of gold of given purity and weight, or it is convertible into gold at fixed rate; The government buys and sells gold in unlimited quantity at officially fixed price; There are no restrictions on the export and import of gold.

#### **Determination of Exchange Rate**

The mint parity theory states that under gold standard, the exchange rate tends to stay close to the ratio of gold values or the mint parity or par. In other words, the rate of exchange between the gold standard countries is determined by the gold equivalents of the concerned currencies. Thus, when the currencies of different countries are defined in gold, the exchange rate between such countries is automatically determined on a weight-to-weight basis of the gold content of their currencies, after making allowance for the purity of such gold content of these currencies.

### **3.4.2 Purchasing Power Parity Theory**

Purchasing power parity theory explains the determination of exchange rate and its fluctuations when the countries are on inconvertible paper standard. The theory is based on the fundamental principle that the different currencies have purchasing powers in their respective countries. When the domestic currency is exchanged for the foreign currency it is, in fact, the domestic purchasing power which is exchanged for the foreign purchasing power. Thus the most important factor determining the exchange rate is the relative purchasing power of the two currencies.

According to the purchasing power parity theory, under the system of inconvertible paper currency, the rate of exchange is determined by relative purchasing power of the two currencies in their respective countries. A country is said to be on inconvertible paper standard when money is made of paper or some cheap metals and its face value is greater than its intrinsic value; the money is not convertible into gold; the purchasing power of money is not maintained at par with that of gold or any other commodity; the currency may not be fully backed by gold or any other metallic reserves; the currency system is nationalistic in the sense that there is no link between the different paper currency systems adopted by different countries. Under such conditions, the rate of exchange between the two currencies must equalise the purchasing power of both the countries.

#### **Absolute Version of Purchasing Power Parity Theory**

The absolute version of the purchasing power parity theory explains the determination of rate of exchange between the two countries on inconvertible paper standard. According to the absolute version, the exchange rate should normally reflect the relationship between the internal purchasing power of various national currency units. In other words, the rate of exchange should be equal to the ratio of the outlay required to purchase a particular set of goods at home as compared with what it would be abroad.

Thus, according to the absolute version of the purchasing power theory, the rate of exchange is determined by the ratio of internal purchasing power of the foreign currency and the international purchasing power of the domestic currency. The ratio of internal purchasing power of the two currencies is called the purchasing power parity. The rate of exchange will be in equilibrium when the purchasing power of is equal in all the trading countries.

### **Relative Version of Purchasing Power Parity Theory**

The relative version of the purchasing power parity theory explains the measurement of the changes or fluctuations in the rate of exchange. It deals with the relationship between changes in internal purchasing power and the changes in exchange rate. According to the relative version, the change in the equilibrium rate of exchange depends upon the change in the ratio of the internal purchasing powers of the concerned currencies. The new and changed rate of exchange is determined by multiplying the old purchasing power parity by the ratio of the changes in the internal purchasing powers of the currencies.

### **3.4.3 Balance of Payments or Modern Theory**

The balance of payment theory is the modern and most satisfactory theory of the determination of the exchange rate. It is also called the demand and supply theory of exchange rate. According to this theory, the rate of exchange in the foreign exchange market is determined by the balance of payments in the sense of demand and supply of foreign exchange in the market. Here the term balance of payments is used in the sense of a market balance. If the demand for a country's currency falls at a given rate of exchange, we can speak of a deficit in its balance of payments. Similarly, if the demand for a country's currency rises at a given rate of exchange, we can speak of surplus in its balance of payment. A deficit balance of the payments leads to a fall or depreciation in the external value of the country's currency. A surplus balance of payments leads to an increase or appreciation in the external value of the country's currency.

There is a close relation between the balance of payments and the demand and supply of foreign exchange. Balance of payment is a record of international payments made due to various international transactions, such as, imports, export, investments and other commercial, financial, financial and speculative transactions.

### **Superiority of Balance of Payments Theory**

The balance of payments theory is superior to other theories on the following grounds:

According to the balance of payments theory, the rate of exchange is determined by the demand and supply of foreign exchange in the market. Thus, the theory is compatible with the general theory of value and regards the problem of the determination of rate of exchange as an integral part of general equilibrium theory.

The theory recognises the fact that imports and exports of goods alone do not determine the rate of exchange. There are a number of important forces other than the merchandise items which influence the supply of and demand for foreign exchange and, thereby, the rate of exchange.

The important implication of the theory is that any disequilibrium in the balance of payments of a country can be corrected by making appropriate adjustments in the rate of exchange, i.e. through devaluation of home currency when there is deficit balance and revaluation of home currency when there is surplus balance.

### **3.5 Exchange Rate Systems**

Broadly speaking, there can be two types of exchange rate systems; fixed exchange rate system; and flexible exchange rate system.

#### **Fixed Exchange rate system**

Fixed exchange rate system is a system where the rate of exchange between two or more countries does not vary or varies only within narrow limits. Under the fixed or stable exchange rate system, the government of a country adjusts its economic policies in such a manner that a stable exchange rate is maintained; it is a system of changing lock to the key. In the strict sense, fixed exchange rate system refers to the international gold standard under which the countries define their currencies in gold at a ratio assumed to be fixed indefinitely. But, in modern times, the fixed exchange rate system is identified with adjustable peg system of the International Monetary Fund (IMF) under which the exchange rate is determined by the government and enforced through pegging operations or through some exchange controls.

#### **Flexible Exchange Rate System**

Flexible or free exchange rate system, on the other hand, is a system where the value of one currency in terms of another is free to fluctuate and establish its equilibrium level in the exchange market through the forces of demand and supply. There are not restrictions on the buying and selling of the foreign currencies by the monetary authority and the exchange rates are free to change according to the changes in the demand and supply of foreign exchange.

### **3.6 Factors Influencing Rate of Exchange**

There are a host of factors which influence the supply of and demand for foreign exchange and thus are responsible for the fluctuations in the rate of exchange. Important among them are given below:

#### **Trade Movements**

Changes in the imports and exports cause changes in the demand for and supply of foreign exchange which in turn, lead to fluctuations in the rate of exchange. If the imports exceed exports, the demand for foreign exchange increases and, as a result, the rate of exchange of native currency will fall and move against the native country. On the other hand, if exports exceed imports, the demand for foreign exchange decreases and the rate of exchange rises and moves in favour of the native country.

#### **Capital Flow**

Capital flow from one country to another brings changes in the rate of exchange. If, for example, capital is exported from America for investment in Nigeria, the demand for Nigerian Naira will increase in the foreign exchange market. As a consequence, the rate of exchange of Nigerian Naira in terms of American dollar will rise.

#### **Granting of Loans**

If a country gets loans from some foreign country, the supply of the foreign currency will increase. As a result, the rate of exchange will move in favour of the home currency and against the foreign currency.

But, at the time of repayment of loan of granting loan to the foreign country, the supply of foreign currency will fall and the rate of exchange will move against the home currency and in favour of the foreign currency.

#### **Sale and Purchase of Securities**

Sale and purchase of foreign securities influence the demand for foreign exchange, and, thereby, the exchange rate. When the residents of a country purchase more foreign securities, foreign currency increases. As a result, the value of home currency falls, i.e. the rate of exchange moves against the home currency and in favour of foreign currency.

## **Banking Operations**

Banks are dealers in foreign exchange. They sell drafts, transfer funds, issue letter of credit, and accept foreign bills of exchange. When a bank issues drafts of other credit instruments on its foreign branches, it increases the supply of home currency in the foreign exchange market.

As a result, the rate of exchange moves in favour of the home currency and against the foreign currency.

## **Speculation**

Speculation (or anticipation about the future changes) in the foreign exchange market also causes variations in the rate of exchange. If the speculators expect the value of foreign currency to rise, they begin to buy foreign currency in order to sell it in future to earn profit. By doing so, they tend to increase the demand for foreign currency and raise its value. On the other hand, if the speculators anticipate a fall in the future value of foreign currency, they will sell their foreign exchange holdings. As a result of this increase in the supply of foreign exchange, the rate of exchange will move against foreign currency and in favour of home currency.

## **Protection**

When the government of a country gives protection to domestic industries, it tends to discourage imports from other countries. As a consequence, the demand for foreign currency will decrease and the rate of exchange will move in favour of the home currency and against the foreign currency.

## **Exchange Control**

The policy of exchange control also brings about changes in the rate of exchange. Generally, various measures of exchange control involve restrictions on imports which lead to a fall in the demand for foreign currency. As a result, the rate of exchange moves in favour of the home currency and against the foreign currency.

## **Inflation and Deflation**

Changes in the internal value of money also reflect themselves in the similar changes in the external values. During inflation, the internal value (or the purchasing power) of home currency falls and there will be outflow of foreign capital from the country to avoid financial losses. As a result, the demand for foreign currency will increase and the external



value of home currency will fall. On the contrary, during deflation, the internal value (or the purchasing power) of the home currency rises and there will be inflow of foreign capital to realise financial gains from the relative appreciation of the value of foreign currency and a change in the exchange rate in favour of home currency and against foreign currency.

### **Financial Policy**

Policy of deficit financing leads to inflationary conditions in the country.

As a result, the foreign capital will start leaving the country, the supply of foreign exchange will fall and the rate of exchange will turn in favour of foreign currency and against home currency.

### **Bank Rate**

Changes in the bank rate cause fluctuations in the exchange rate. When the central bank of a country raises the bank rate, there will be inflow of foreign capital with a view to earn higher interest income. As a result, the supply of foreign currency increases and the rate of exchange moves against the foreign currency and in favour of home currency. On the other hand, when the bank rate is reduced, there will be an outflow of foreign capital. This reduces the supply of foreign currency and the exchange rate moves in favour of the foreign currency and against the home currency.

### **Monetary Standard**

If the country is on the gold standard, then the exchange rate will move within the limits set by upper and lower gold points. On the contrary, in a country with inconvertible paper money system, there is no limit to the fluctuations in rate exchange.

### **Peace and Security**

The condition of peace and security in the country attracts foreign capital. This increases the supply of foreign currencies in the country and the rate of exchange moves against the foreign currencies and in favour of the home currency.

### **Political Conditions**

Political stability also encourages inflow of foreign capital in the country. As a result, the supply of foreign currencies increase and their value in terms of home currency falls.

All these factors cause fluctuations in the exchange rate only in the system of flexible exchange rates. However, if the country adopts the policy of complete exchange control, and the exchange rate is pegged at a certain level, there will be no variations in the rate of exchange.

### **SELF ASSESSMENT EXERCISES**

- i. What is Foreign Rate of Exchange? List the various types of Exchange Rate
- ii. Briefly explain the Mint Parity Theory of Rate of Exchange.

### **4.0 CONCLUSION**

Students have learned the meaning of foreign rate of exchange, the major theories of rate of exchange and the determinants of foreign rate of exchange. They have known the differences between the fixed and flexible foreign exchange rates as well as the factors influencing the rate of foreign exchange.

### **5.0 SUMMARY**

Foreign rate of exchange is the rate at which a country currency is exchange with the others in the international market. There are basically two systems of achieving this exchange that is the fixed and flexible exchange rates. While there are many different type of exchange rate such as Spot, Forward, Long, Fixed, Flexible, Multiple and Two-tier rate systems, foreign exchange rate is determine by the forces of currency demand and supply. Several theories have been developed about foreign exchange rates this includes; Mint Parity, Purchasing power parity and Balance of payment theories.

### **6.0 TUTOR MARKED ASSIGNMENT**

Distinguish between Fixed and Flexible Exchange Rate Policy.

### **ANSWER TO SELF ASSESSMENT EXERCISE**

- i. Foreign rate of exchange measures the number of units of one currency which will be exchange in the foreign market for another. There are several exchange rates, however the major ones includes; Spot rate, Forward rate, Long rate, Fixed rate, Flexible rate, Multiple rate and Two-tier rate system amongst others.

- ii. Mint Parity theory provides an explanation about the foreign exchange rate determination between countries whose currencies are either expressed in terms of gold or those whose currency has gold content. For a country to be categorized as being gold standard its monetary unit must be expressed in gold terms, the government of that country must be involved in buying and selling of gold in unlimited quantity and there must be no restriction placed in regards to the gold movements.

## **7.0 REFERENCES/FURTHER READINGS**

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## **UNIT 3 FOREIGN EXCHANGE CONTROL**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Foreign Exchange Control Defined
  - 3.2 Features of Foreign Exchange Control
  - 3.3 Objectives of Foreign Exchange Control
  - 3.4 Methods of Foreign Exchange Control
  - 3.6 Defects of Exchange Control
- 4.0 Conclusion
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### **1.0 INTRODUCTION**

This unit provides a comprehensive assessment of how the state and government monetary agency that is the Central Bank interference with the free play of market forces that determine the foreign exchange rate.

Understanding of the mechanism use in controlling foreign exchange rate in a country is crucial to international banking operations.

### **2.0 OBJECTIVES**

At the end of this unit, you should be able to:

- Describe the foreign exchange control and its basic features
- Identify various mechanism for foreign exchange control list
- the disadvantage of foreign exchange control

### **3.0 MAIN CONTENT**

#### **3.1 Foreign Exchange Control Defined**

Exchange control means the interference by the state, central bank or any other agency with the free play of market forces that determine foreign exchange rate. Exchange rates, under exchange control system, are fixed arbitrarily by the government and are not determined freely by the forces of demand and supply. In other words, exchange control system represents government domination of the foreign exchange market. Each international transaction requiring payment in foreign

currencies is sanctioned by the government and all foreign exchange receipts from international transactions are surrendered to the government. The main object of exchange control is to secure stability of fixed exchange rate and to ensure balance of payments equilibrium.

Exchange control may be complete or partial. Exchange control is complete when the government has full control over the exchange market. In fact, under complete exchange control, there exists no exchange market and disequilibrium in the balance of payment is impossibility. The exchange control applies to all types of international transactions and the government restricts the sale and purchase of all currencies. Exchange control is partial when the government partially controls the exchange market. The exchange control applies only to certain types of international transactions and the government restricts the sale and purchase of some selected currencies.

Exchange control is a method of influencing international trade and investment as well as the payments mechanism. As such, it has the advantages and disadvantages of other means of protection. It is adopted by and is specially suited to those nations which seek to achieve economic goals by manipulating the market behaviour. It is not an appropriate measure for the free-market economies. For this reason, the system of exchange control is commonly used in the less developed countries and the communist countries.

Exchange control is the most drastic means of balance of payments adjustment. It may be compared with other trade restrictions in respect of its impact and administration: Exchange control is more certain than tariffs in its impact on a country's balance of payments; Exchange control has the advantage of controlling visible trade and invisible transactions and capital movements; Whereas the trade controls are generally operated by the ministry of commerce through customs department, the exchange controls are usually operated by the central bank through commercial banks; There may be some degree of discretion given to the individual banks in case of exchange control. But, no such discretion exists in case of trade controls.

### **3.2 Features of Foreign Exchange Control**

The system of exchange control possesses the following broad features:

- The government monopolizes the foreign exchange business and exercise full control over the foreign exchange market.
- The rate of exchange is fixed officially by the government and the market forces of demand and supply have no effect on its determination.

The government centralizes all foreign exchange operations in the hands of the central bank which administers various foreign exchange regulations.

- The exporters have to deposit all their foreign exchange earnings with the central banks.
- Imports of the country are regulated and the importers are allocated foreign exchange at the official rates to enable them to make payments for the goods imported.
- The government or the central bank determines the priorities in the allocation of scarce foreign currencies.
- As a result of exchange control, the volume of imports gets automatically reduced and there is a favourable impact on country's balance of payments.

### **3.3 Objectives of Foreign Exchange Control**

The system of exchange control may be adopted to achieve different objectives. Important among them are given below:

#### **To Correct Adverse Balance of Payments**

A country may follow the system of exchange control when it faces a deficit in its balance of payments and does not want to leave the process of adjustment either on the mercy of automatic mechanism of fluctuating foreign exchange rates or on deflation. By adopting exchange control, imports are restricted to the level permitted by the availability of foreign exchange reserves and, thereby, the balance of payments equilibrium is established.

#### **To check flight of Capital**

Exchange control may be adopted to prevent the flight of capital from the country. Flight of capital refers to the action of the citizen of a country to convert their cash holdings (i.e., short-term securities and bank deposits) into foreign currencies. Flight of capital may be the result of speculative activities, economic fluctuations and political uncertainty.

Flight of capital exhausts the country's limited reserves of foreign exchange and destabilise the economy. Through exchange control, the government imposes restrictions on the sale of foreign currencies and there-by checks the flight of capital.

#### **To Stabilise Exchange rate**

The government may adopt exchange control to check fluctuations in the rate of exchange. Fluctuations in the rate of exchange are the normal

feature in a free exchange market and cause disequilibrium in the economic life of a country. These fluctuations can be checked by officially fixing the exchange rate at a predetermined level.

### **To Conserve Foreign Exchange**

Exchange control may be used to conserve country foreign exchange reserves through exports. These reserves are restricted for; paying off external debt; importing essential goods for economic development and purchasing defence materials.

### **To Check Economic Fluctuations**

Cyclical fluctuations depression and inflation, spread from one country to another through international trade. Exchange controls are used to check the spread of the de-stabilising tendencies by controlling imports and exports.

### **To Protect Home Industry**

Exchange control may be resorted to protect the home industry from foreign competition. For this purpose, the government restricts the imports through foreign exchange controls and thus provides opportunity to the domestic industries to develop without any fear of international competition.

### **To Practise Discrimination in Trade**

Exchange control helps a country to follow a policy of discrimination in international trade. The government fixes favourable rates of exchange for the countries with which it wants to strengthen its trade relation.

**To Check Undesirable Imports:** Exchange control is also needed to check the import of certain non-essential, harmful and socially undesirable goods in the country.

### **Source of Income**

Exchange control can also be used as a source of income to the government. Under the multiple exchange rate system, the government fixes the selling rates higher than the buying rates and earns income equal to the difference between the two rates.

### **Important for Planning**

Exchange control forms an integral part of economic policy in a planned economy. Planned economy development requires expansion, conservation and proper use of foreign exchange reserves of the country according to the national priorities. Exchange control system is directed to achieve these objectives.

### **To Check Enemy Nations**

Exchange control is also used by some countries to prevent the enemy countries from using their foreign assets. Regulations are adopted to freeze the assets held by the residents of the enemy country and they are not allowed to use or transfer these assets.

### **Overvaluation**

Overvaluation refers to the fixing of the value of a currency at a rate higher than the free market rate. It is also called  $\mu$ pegging up $\mu$ .

Overvaluation, by making the home currency dearer for the foreigners, reduces the prices of imports and raises the prices of exports. The policy of overvaluation is adopted to facilitate the country to make its purchases at cheaper prices and to pay off the foreign debts.

### **Undervaluation**

Undervaluation refers to the fixing of the value of a currency at a rate lower than the free market rate. It is also known as  $\mu$ pegging down $\mu$ .

Undervaluation, by making the currency cheaper for the foreigners, reduces the prices of exports and raises the prices of imports. The policy of undervaluation is adopted to promote exports, reduce imports and to give support to general rise in prices.

## **3.4 Methods of Foreign Exchange Control**

A country desirous of adopting exchange control system can employ various methods. Broadly these methods can be classified into two categories: direct methods and indirect methods. Important methods of exchange control are discussed below:



## **Direct Methods**

### **1. Intervention or Exchange Pegging**

A commonly adopted method of exchange control is the interference in the foreign exchange market by the government or the monetary authority with the purpose of either holding up or down the foreign exchange rate of its currency. This interference takes the form of purchasing and selling of home currency in the exchange market and, thereby influencing the exchange rate. Intervention may be active or passive. In the passive intervention, the monetary authority is prepared to buy or sell the foreign currency at fixed rate without curtailing the right of the public to deal in foreign exchange. In the active intervention the monetary authority itself takes the initiative and bids for the foreign currency or offers it for sale with a view to influence the exchange rate.

The government intervenes in the foreign exchange market through exchange pegging. Exchange pegging refers to the act of fixing the exchange value of the currency to some chosen rate. The government buys and sells the home currency in exchange for foreign currency in order to establish a desired rate of exchange. The pegging operation involves pegging up or pegging down the exchange rate. When the exchange rate is fixed higher than the market rate, it is called pegging up; when the exchange rate is fixed lower than the market rate, it is called pegging down. In other words, pegging up means overvaluation of home currency and pegging down means undervaluation of home currency.

In the pegging up operation, public demand for foreign currency increases and the government must be ready to sell adequate foreign currency in exchange for home currency. In the pegging down operation, public demand for home currency increases and the government must be in a position to purchase foreign currency in exchange for home currency. The exchange pegging should be used as a temporary measure to remove fluctuations in the foreign exchange rate.

### **2. Rationing of Foreign Exchange**

Under this method of exchange control, the government keeps the exchange value of its currency fixed by rationing the ability of its residents to acquire foreign exchange for spending abroad. The government imposes restrictions on the use, sale and purchase of foreign exchange. All foreign exchange business is centralized either with the government or with its agents. All foreign exchange earnings are to be surrendered by exporters to the central bank at the fixed exchange rate. The importers are allotted foreign exchange at the fixed rate and in fixed

amount. The government also determines the priorities in the allocation of scarce foreign currencies.

### **3. Blocked Accounts**

Block accounts refer to a method by which the foreigners are restricted to transfer funds to their home countries. The method of blocking the accounts of creditor countries is adopted by the debtor countries particularly during the periods of war or financial crisis. Under this method, the foreigners are not allowed to convert their deposits, securities and other assets into their currency. Their banking accounts are blocked and they are not permitted to withdraw their funds and remit them to their own countries.

### **4. Multiple Exchange Rates**

When a country, instead of one single exchange rate, fixes different exchange rate for the import and export of different goods, it is known as the system of multiple exchange rates. Even for different countries or import of different exchange rates are fixed. The system of multiple exchange rates amounts to a type of rationing by price rather than by quantity and therefore does not directly restrict free trade. The system of different exchange rates for different goods and for different countries is adopted with the objective of earning maximum possible foreign exchange by increasing exports and reducing imports. The under developed countries can employ this system to improve their balance of payments.

### **5. Standstill Agreements**

Standstill agreement aims at maintaining status quo in the relationship between two countries in terms of capital movement. This method was first adopted by Germany after Great Depression of 1929. The main features of standstill agreements include the fact that; the movement of capital is checked and the payments to the foreign exporters are made in easy installments instead of in lump sum; Short-term loans are converted into long-term loans with a view to allow more time to the debtor country to repay this debt.

### **6. Clearing Agreements**

Clearing agreement refers to a system under which agreement is made between two countries for settling their international trade account through their respective central banks. Under this system, the importers instead of making payment for the imported goods in foreign currency pay in home currency to their central bank. Similarly, the exporters,

instead of receiving payment for goods exported in foreign currency receive it through the central bank in the home currency. Thus, the individual importers and exporters need not clear their account in foreign currencies, but in home currencies through their respective central bank and the transfer of currencies from one country to another is avoided. If the exports and imports of the two countries balance with each other, no further difficulty arises. But, if the exports and imports of the two countries are not equal to each other, the net balance in the clearing account is paid off in terms of gold. In this way, stability of exchange rate is maintained through clearing agreement.

## **7. Payment Agreements**

The system of payment agreement solves two major problems experienced under the system of clearing agreement, that is the centralization of payments, and the problem of waiting for the exporters.

Under the payment agreement between the two countries A and B, the exporter in country A is paid as soon as information is received by the central bank of country A from country B's central bank that the importers in country B has discharged his payment obligation and vice versa.

## **8. Compensation Agreements**

This is a kind of barter agreement between the two countries under which the exporter in a country is paid by the importing country in terms of certain goods on an agreed basis. Since no payment is made in foreign exchange, the problem of foreign exchange does not arise. Since the imports and exports of the two countries exactly balance with each other, the rate of exchange between them remains stable and the balance of payments equilibrium is maintained in the two countries.

## **9. Transfer Moratoria**

Under the method of transfer moratoria, the payments for the imported goods or the interest on the foreign capital are not made immediately but are suspended for a pre-determined period, known as period of moratorium. A country adopts this method of exchange control to temporarily solve its payments problems. The importers and debtors make payments in the home currency and this payment is deposited with some authorized banks, generally the central bank. During the period of moratorium, the government used these funds and solves the foreign exchange problems of the country. After the expiry of the moratorium period, these deposits are transferred to exporters and creditors.

## **10. Exchange Stabilization Fund**

The exchange stabilization fund was established by England in 1932, by America in 1934, and by France, Holland and Belgium in 1936 with the objective of neutralizing the effects of wide fluctuations in the exchange rates as a result of any abnormal movements of capital. The purpose of such a fund is to control seasonal or temporary fluctuations in the exchange rate and not to interfere with the general trend in the exchange rate and the forces influencing it. If there is large inflow of foreign currency in the country, the exchange rate of the home currency rises. In such a situation, the fund starts purchasing the foreign currency as a result of which the upward movement in the exchange rate is checked. On the other hand if there is large outflow of foreign currency, the exchange rate of the home currency falls. In this case, the fund will sell the foreign currency which, in turn, will control the downward movement of the exchange rate.

### **Indirect Methods**

#### **1. Change in Interest Rate**

The government can influence the rate of exchange indirectly through changes in the rate of interest. The exchange rate can be reduced by lowering the interest rate and can be increased by raising the interest rate.

When the rate of interest is raised in the country, it attracts liquid capital and banking funds of the foreigners. It will also prevent the capital flight because the nationals of the country will tend to keep their funds in their own country. All this will tend to increase the demand for home currency and, as a result, the exchange rate will move in its favour (i.e. will rise). Similarly, lowering the rate of interest in the country will have the opposite (i.e., depressing) effect on the rate of exchange.

#### **2. Import Restrictions**

Another indirect method of exchange control is to restrict the imports of the country through measures like tariffs, import quotas and other such quantitative restrictions. Import duties reduce imports by making them costly. This raises the value of home currency relative to the foreign currency. Similarly, import quotas fixed by the government also reduce the volume of imports in the country, as a result of which the demand for foreign currency falls, thus raising the value of the home currency in relation to foreign currency. In this way, imposition of import duty and import quotas raise the rate of exchange making it favourable to the country using import restrictions.

### 3. Export subsidies

Export subsidies refer to the financial assistance to industries producing exportable goods. Export subsidies increase exports. As a consequence, the demand for home currency in the foreign exchange market increase, thus raising the rate of home currency in terms of foreign currencies.

#### 3.4 Defects of Exchange Control

In spite of the fact that a large number of nations, especially the less developed countries, have resorted to the exchange control system, International Monetary Fund (IMF) strongly opposes the adoption of exchange control by the member countries because of its serious defects. Important defects are as follows:

- i. The system of exchange control is not based on the sound comparative cost principle of international trade according to which every country tends to specialize in the production and export of that commodity of which it enjoys comparative natural advantage. Thus, the advantages of international specialization are sacrificed under the system of exchange control. Economic resources are not optimally utilized.
- ii. Exchange control leads to the reduction in the volume of international trade and contraction of world's welfare.
- iii. Exchange control encourages bilateral trade and deprives the country from the gains of multilateral trade.
- iv. Exchange control is an arbitrary system. It encourages retaliation and restrictive tendencies.
- v. Exchange control interferes in the competitive working of the economy and distorts its economic structure by diverting the resources in less economical and less efficient areas of production which do not represent maximum natural advantage.
- vi. Exchange control has undesirable effects on the internal economy of the country. Restrictions on imports may lead to inflationary rise in prices due to scarcity of restricted goods.
- vii. Exchange control provides only a temporary remedy to the problem of disequilibrium in the balance of payments. Instead of basically solving the problem, it prevents the situation from becoming worse.
- viii. Exchange controls involve; large administrative costs to enforce the exchange controls; resource waste in the process of trying to evade the controls or of applying for foreign exchange licenses; and psychological costs of the inevitable perceived injustices created by the controls or their evasion.
- ix. Exchange control system is also morally undesirable because it breeds corruption in the country. Need traders use all types of illegal

methods to obtain the desired amount of foreign exchange which has been rationed by the government?

- x. Exchange control system involves great social costs and does not lead to the maximization of community's welfare.

### **SELF ASSESSMENT EXERCISES**

- i. What is foreign Exchange Control?
- ii. Enumerate the objectives behind foreign Exchange Control

### **4.0 CONCLUSION**

This student has learned the meaning and concept of foreign exchange control which represents the interference government monetary agencies with the market forces that freely determine foreign exchange rate. We have also learn that though the foreign exchange control mechanism are put in place to influence international trade, business and investments as well as payment mechanism, it also has some negative consequences.

### **5.0 SUMMARY**

Foreign exchange control is a measure which replaces part of the equilibrating function of foreign exchange market by regulating alien to the pricing process. The need to correct balance of payment, check flight of capital, stability of exchange rate and protection of local industries are some of the reasons advance for exchange control. While in terms of the methods usually deployed in achieving the working objectives of foreign exchange control, direct and indirect approach are used. The direct methods include exchange pegging, rationing of foreign exchange, blocked accounts and multiple exchange rates amongst others. The indirect approach on the other hand, involves change in interest rates, import restrictions and export subsidies.

### **6.0 TUTOR MARKED ASSIGNMENT**

State the various methods normally adopted in controlling Foreign Exchange.

### **ANSWER TO SELF ASSESSMENT EXERCISE**

- i. Foreign exchange can be defined as that measure which replaces part of the equilibrating function of foreign exchange market by regulating alien to the pricing process. Foreign exchange control mechanisms are put in place to influence international trade, and investments as well as payment mechanism.

- ii. Some objectives advanced for foreign exchange rate control include the need to; correct balance of payment, check flight of capital, stability of exchange rate and protection of local industries. Others include; overvaluation, undervaluation, check undesirable import and practice discrimination in trade.

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## **UNIT 4 EURO DOLLAR MARKET**

### **CONTENTS**

- 1.0 Introduction
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### **1.0 INTRODUCTION**

In both domestic and international arena, among the most profitable of many services offered by a bank is its loan department. The existence of the Eurodollar market facilitates 'hot money' flows between nations through providing a safe base currency for speculative transactions. This unit investigates the operation of Euro Dollar Market in international business environment.

### **2.0 OBJECTIVES**

At the end of this study unit, student should be able to:

- Trace the origin of Euro Dollar Market
- Discuss operational modes of Euro Dollar Market
- Explain Risk associated with Euro Dollar Market

### **3.0 MAIN CONTENT**

#### **3.1 Nature of Eurodollar Market**

Eurodollars may be defined as United States dollars on deposit in banks located outside the country of issue. The Eurodollar market serves as an international money market used by commercial banks and institutions around the world. The Euro-currency market is comprised of those banks located outside the country in whose currency the deposits are denominated. This would include foreign branches of domestic banks as



well as foreign banks. The total Eurocurrency market is composed of all foreign currency denominated accounts which, besides the Eurodollar, is mainly composed of Euryen, Eurguilders, Eurdeutschemarkks, and Euroswiissfrance. The 'market' for such Eurocurrencies is centered in London. Nevertheless, substantial markets also exist in Hong Kong, Luxembourg, Singapore, the Caymen Islands, and the Bahamas. These centers can compete effectively with banks located in the issuing countries (that is, country of the currency). For example, Eurodollar deposits are as substitute for U.S dollar deposits at banks located in United States. However, only a few United State banks are involved in these markets due to the level of expertise and capital commitment required. Although there is presently a shift in the number of loans in major markets, most syndicated loan for Eurocurrencies are arranged in London due to the high level of expertise found there, even if ultimately the loans are booked elsewhere for tax or other reasons. In addition, the large majority of Eurocurrency loans are demonstrated in Eurodollars.

### **3.2 Historical Background of Eurodollar Market**

Events occurring in the late 1950s and early 1960s prompted the development of a Eurodollar market. The political climate during that period was such that there was rising concern on the part of the U.S.S.R. regarding the security and free accessibility of its U.S dollar deposits.

Rather than risk possible confiscation or blocking of their accounts, the U.S. dollar denominated deposits were placed in banks located in London. In that way, the accounts were beyond the jurisdictional reach of the United States by being booked outside its territory. This method was used since the U.S.S.R did not wish to convert its U.S dollar holdings to weaker and less reliable currencies. Thus, the creation of U.S dollar denominated accounts outside of the United States at that time offered a more political secure arrangement for the funds.

Further spurring the development of the Eurodollar market was the enactment of laws and regulations designed to improve the United States balance of payments by reducing outflow of capital for foreign investment. For example, the Interest Equalization Tax of 1964 and the Foreign Direct Investment Regulations prevent U.S capital markets from funding domestic or foreign capital needs for operations outside the United States. It was during this period that the growth of the Eurodollar market accelerated. In addition, the number of foreign branches of US banks established during this time increased significantly, due in large part of the fact that the transaction of these branches were not subject to regulations applicable to domestic institutions.

Therefore, dollars were drawn away from American banks to higher-yielding foreign accounts. The absence of regulatory controls, interest rate limitations, and reserve requirements imposed on domestic deposits, allowed offshore banks to offer a higher interest rate on deposits while realizing a greater rate of return than on domestic deposits.

Nevertheless, the main motivations for placing U.S. dollars in the Eurodollar market are lower costs of regulation as well as higher returns on funds. This is reflected in the fact that, from 1966 to 1973, growth in the Euro market was much greater than during the years after the 1973 oil price increase. Therefore, deposits of OPEC oil fund surpluses in the Euro-market can be said to represent redistribution in the ownership of wealth and Euro-deposits.

During the market's formative years, fixed time deposit accounts lured investors to place their funds in the Eurodollar market. Time deposits remain the dominant form of Eurodollar investment, in maturities ranging from overnight to several years, with the majority of deposits taken from three to six months.

### **3.3 Euro-dollar Market Activities**

The Euro-dollar market specialized in accepting short-term deposit and in making short-term loan. These funds are used to satisfy liquidity requirements of banks and financial firms, as well as being used for trade financing and interest arbitrage. If access to a longer-term market is desired, the smaller Eurobond market offers an alternative. With the growth of the market, various 'rollover' devices developed for both CD deposits and loans. As with CDs, the rolling-over of a Eurodollar loan achieves the same effect as entering a loan with a longer term; applicable interest rates are periodically adjusted by the terms of the loan agreement, however, to reflect fluctuations in the current market rate. Changes in short-term deposit rate, ordinarily based upon LIBOR (or the (London Inter-bank Operating Rate), account for such fluctuations.

In a Eurodollar loan context, the lender will acquire a deposit normally at an interest rate fixed on the LIBOR in effect two days from the date of acquisition. The amount of the deposit and its duration will match the amount of the loan and the period for which it will be outstanding. A loan agreement typically reflects this practice by setting the loan interest in relation to LIBOR rate two days from the beginning of the loan period.

### **3.4 Risk of Eurodollar Market**

The decision to lend is based upon the bank's assessment of the risk that the funds lent will not be repaid with the interest and at the time agreed upon. Assessment of risk affects not only the decision to lend, but also the structure of the loan and the interest rate to be charged as compensation for what is, in fact, a calculated gamble. While some of the risks to be found in Eurodollar transactions are amenable to negotiation and apportionment between borrower and lender, some general types of risk must be borne in mind by both parties when initially deciding to enter the market. Three major areas of assessment include currency risk, country risk, and credit risk.

## **CURRENCY RISK**

Currency risk encompasses two major forms of risk exposure; risk of fluctuations in currency value and risk of interference with repayment from local exchange control restrictions.

The transfer of funds across international borders requires conversion from one national currency into that of another, whether the transfer be the original transmission of loan funds, periodic advances of funds, or debt repayment. The exchange rates at which currency conversions are made constantly fluctuate. It is therefore possible that throughout the duration of loan, as fund transfers become necessary, the desired currency will either be unavailable or prohibitive in cost. Obviously, this subjects the parties to a potential serious risk of exposure to unpredictably greater funding costs than originally bargained for. The borrower, who will be making payments perhaps years from the signing of the loan agreement, is not the only party to face this problem. The lender also faces this risk when making periodic advances of funds, called *draw-downs*, as well as when receiving repayment of funds whose value may differ greatly from the time of lending.

## **COUNTRY RISK**

Political, economic, and jurisprudential conditions in the borrower's country will have obvious and far-ranging impacts on the decision to lend. This aspect of the loan decision may illustrate the limits of pure legal or economic analysis as experience and judgment are heavily called upon in assessing and limiting this risk. Certain risk factors may be anticipated in the loan agreement and guarded against. Nevertheless, adequate and realistic evaluation of political and economic events can mean the difference between a profitable loan transaction and a default situation.

In regard to defaults, one should realize that, in the event of a breach of the agreement, legal remedies will vary from state to state. Moreover,

these legal remedies may be either inconsistent or in conflict with each other and thus should be provided for Eurodollar transactions. Otherwise, disputes may arise as to the proper legal principles to be applied in the event of disagreement between the parties. Perhaps of more importance, the sophistication and integrity of local tribunals and judicial systems, upon which the parties will rely to enforce their agreement, must be also be considered.

Eurodollar transactions are particularly vulnerable to jurisdictional disputes. Since, in effect, Eurodollars are 'foreign currency' in every country, no one country can be relied upon for support in the event of a deposit holding bank's failure. Unlike banking systems such as that of the United States, the Eurodollar market does not have an official 'lending of last resort,' such as the Federal Reserve Bank to which it may turn in the event of an emergency.

## **CREDIT DECISIONS**

Greater costs are incurred in acquiring information with which to assess risks in dealing with foreign banks, particularly those new to international markets. Credit officers must deal with a greater lack of credit information when making an international investment decision as compared to similar investment in a domestic context. For example, the lending officer must evaluate:

- character and business reputation of the borrower;
- business history and financial policies of the institution;
- balance sheet, in particular, cash flow and earnings impact of the loan request; and
- source of repayment funds and anticipated developments in the future prospects of the borrower.

Despite the knowledge of which factors to assess, however, significant difference between domestic and foreign business and accounting practices frequently pose difficulties when a straightforward credit analysis based on domestic principles is attempted.

### **3.4.1 Concept of Syndication**

Syndication involves a number of lending banks, which when acting in concert are effectively able to extend the size limit of loans that could be made individually on the Eurodollar market. The banks are also able to spread their risks amongst themselves. Each lender's obligation is generally separate.

Syndication of the lending commitment among several participating banks adds flexibility to the making of Eurocurrency loans, a development that benefits both the borrowers and lenders. Many of the technical functions of credit evaluation and servicing are provided by a lead bank which typically is an experienced international bank. As a result of this procedure, access to the international lending market has been provided to relatively unsophisticated banks whose limited resources would otherwise prevent their being direct lenders. The resulting larger 'pool' of loan funds permits borrowers to arrange loans of a size that would be beyond the capabilities of individual institutions, due to limitations such as those found in U.S. banking regulations.

The syndication process requires the involvement of several participant-lenders from the outset and entails several steps aimed at meeting the requirements of individual lenders, as well as those of the borrower. These include:

- information of the loan package;
- marketing to other participants ;
- administration of the loan.

The responsibility for accommodating the demands of these divergent groups falls on the lending, or manager, bank.

At the outset, the lead bank's management responsibility is to negotiate with the borrower and determine the most efficient and profitable means of selling the loan. This is accomplished through credit analysis and a full assessment of the risk factors. Thereafter, interest in the package terms is solicited from other prospective participating banks that may ultimately join with the manager to extend credit. Participations may be offered on the general market, in much the same way that securities might be offered. However, due to this similarity the manager runs a risk of subjecting the offering to rigorous disclosure requirements under securities laws.

### **3.4.2 Syndication Loan Marketing**

Typically, one of the three distinct means is available for the manager to market the loan. Briefly, these include:

#### **Best-efforts syndication**

Best-efforts syndication contemplates a completed set of terms and conditions that will be offered on the market by the manager and, if not accepted by lenders, withdraw with no further commitment to the borrower.

### **Firm-commitment syndication**

Firm-commitment syndicate pre-suppose a commitment to lend by the manager, who, if unsuccessful in marketing the loan to others, will assume the un-marketed portions on its own books. Managers normally will not agree to underwrite a syndicated loan. As a result, borrowers typically agree on the best-efforts method.

### **Pre-advanced syndication**

Pre-advanced syndicate provides for a firm commitment by the manager to lend at specific terms, with the right to participate the loan out at a later date.

The syndication of international loans has developed in response to ever increasing credit demands of large borrowers. The Eurocurrency market is a main source of funding for international banks and institutions. With sufficient expertise, the extension of Eurocurrency loans offers the opportunity for increased revenues and business. However, some of the dangers present in such transactions must be appreciated and carefully analyzed.

### **SELF ASSESSMENT EXERCISES**

- i. Explain the concept of Euro Dollar Market
- ii. Trace the Historical Development of Euro Dollar Market

### **4.0 CONCLUSION**

The students have learned the concept of Euro Dollar Market which represents Dollars on deposit in Banks outside United States of America as well as the genesis of Euro Dollar Market. They have also learned about the reasons for the unprecedented growth of Euro Dollar as a world capital market.

### **5.0SUMMARY**

Euro Dollar Market is a market that deals on Dollar deposit in banks outside the United States. The development of Euro Dollar market began in the late 1950s when Soviet Union and Eastern bloc countries closed their accounts in U.S.A, for fear of confiscation. The market specializes in accepting short term deposit and granting short term loans.

Operating in an environment outside the USA regulatory jurisdictions is one the reasons for market unprecedented growth rate. However, currency risk and country risk are some the impending constraint that are associated with trading in Euro Dollar Market.

### **6.0 TUTOR MARKED ASSIGNMENT**

Analyze the Risk of operating in Euro Dollar Market.

### **ANSWER TO SELF ASSESSMENT EXERCISES**

- i. The Eurodollar Market represents a market where United States dollars on deposit in banks located outside the country of issue are traded. The Eurodollar market serves as an international money market used by commercial banks and institutions around the world. The supply of Eurodollars comes from private individuals, from enterprises which have exported to the US and been paid in dollars, and private or state owned banks and other financial institutions which wish to utilize part of their dollar reserves as Eurodollar deposit.
- ii. The development of Euro Dollar market began in the late 1950s when Soviet Union and Eastern bloc countries closed their accounts in U.S.A, for fear of confiscation. Instead they deposited their dollars with London banks, which then re-lent them to non-US residents who needed dollars to purchase imports from the United States. At this time the USA was the world's economic powerhouse and the US dollar was the dominant international currency, acceptable in all countries.

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## **UNIT 5 SWISS BANKING**

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### **1.0 INTRODUCTION**

Much of the myth surrounding Swiss Banking has been generated by strict bank secrecy found in Switzerland's custom and law, a feature which is now by no means unique to that country. This tradition of confidentiality often tends to overshadow the diversity of services and depth of technical expertise which are the true hallmarks of the Swiss system. These factors are responsible for Switzerland's preeminence as both a monetary conduit and depository. In this unit we examine the Swiss banking system and students should take particular note of the contrast between it and Nigeria.

### **2.0 OBJECTIVES**

At the end of this study unit, you should be able to:



- Discuss general operational approach of Swiss banking
- Explain the various components of Swiss Banking system
- Identify the regulation guiding Swiss banking operations

### **3.0 MAIN CONTENT**

#### **3.1 Nature of Swiss Banking System**

Apart from numerous other qualities, the Swiss banking system is noted for its variety. The Swiss banking system is based on the concept of universal banking, whereby all banks can offer all banking services.

This means that all banks can provide all banking services, such as:

- credit/lending business
- asset management and investment advice
- payment transactions
- deposits
- securities business (stock exchange transactions)
- underwriting business (issuing of bonds)
- financial analysis

This is directly opposite of banking systems in English-speaking countries and in Japan which separate commercial banking from investment banking. Legislation is, in fact, currently underway in the United States to liberalize the system. The advantages of universal banking include the ability to spread risk over a greater number of banking businesses and customers from all sectors of the economy.

#### **3.2 Components of Swiss Banking System**

Banking in Switzerland is extremely diverse, even though it is based on the principle of universal banking. Several bank groups are now fully or partially specialized:

Traditionally, the central banking institution of Switzerland, the Swiss National Bank (**Schweizerisch National bank-Banque Nationale Suisse**)

Has divided the Swiss Banking industry into the following categories:

- the national or 'ELJ' banks,
- the cantonal banks,
- the credit cooperative banks,
- the private banks,

foreign-held banks in Switzerland,  
the mortgage bond banks,

### 3.2.1 National or Big Bank

The national or "big" banks, as they are called, are merely Switzerland's large multinational banks, offering every conceivable banking services to the public, even though the primary thrust of their business is in the commercial banking sector. These banks formed during the early industrialization of Europe as collective associations of private banks. At present, the big banks are still heavily involved in commercial and trade financing, both nationally and internationally. The big banks of Switzerland are involved in the trading of securities, with this area accounting for a growing part of their overall profits. Big banks are also becoming increasingly involved in the commodities and forward exchange markets, handling both spot and forward contracts.

The big banks of Switzerland trade on securities and commodities exchanges both on their own account and on the accounts of tier individual clients. In the latter respect, the banks act as brokers for their clients, thereby giving the client a full range of investment services under one roof.

The "big three" banks, as they are called, are the Union Bank of Switzerland (Schweizerische Bankgesellschaft), the Swiss Bank Corporation (Schweizerischer Bankverein), and the Swiss Credit Bank (Schweizerische Kreditanstalt). All national banks are publicly sheets and liquidity statements. It should be noted, however, that they are not required to publish profit and loss statements.

### 3.2.2 Cantonal Banks

The cantonal banks, though in some instance very large, are primarily responsible for domestic and particularly cantonal banking. The original purpose for founding cantonal banks was to stabilize credit and money conditions as well as to encourage savings within the canton. In fact, this is still the aim of many cantonal banks today.

Each of Switzerland's 26 cantons (including the six half-cantons) has at least one state created cantonal bank and three of the larger cantons (including Berne, Geneva, and Vaud) have two. This brings the total number of cantonal banks to 29. These banks are given either state capital or state deposit guarantee. Being entities of the state, cantonal banks are required by law to make public certain types of information

that other banks can avoid disclosing. This does not, however, release them from the constraints imposed by the Swiss bank secrecy laws.

The lending rates of the cantonal banks are slightly lower than the rates of the big banks, and, as a result, they control a large percentage of the domestic mortgage market. All cantonal banks are members of the Association of Cantonal Banks, which may be formed as a link between themselves and the Swiss Federal Government. This organization also acts as an internal regulatory association.

### 3.2.3 Credit Cooperatives

The credit cooperatives, or Raiffeisen banks, are localized banking institutions established to provide credit to depositors so that they may better the local community. These cooperatives are grouped into associations that act as administrative centers and liaisons with the federal banking authorities.

Loan associations in the Raiffeisen system have a central bank for clearing called **Die Zentralbank des Schweizer Verbandes des Raiffeisen**. This umbrella organization provides the somewhat small and numerous Raiffeisen banks with an organizational center and allows them, through centralized cooperation, to take advantage of situations that otherwise would be outside their normal individual range. As a result of this greater organizational ability and more extensive reach, credit cooperatives, in recent years, have begun to expand beyond limited agricultural financing and entered into small-scale commercial financing as well. The current growth in the Raiffeisen sector is rapid, although it should be remembered that these banks were originally meant to function only in rural areas.

### 3.2.4 Private Banks

Private Banks represent the oldest form of banking in Switzerland, and they are the basis form which all other types of banking in Switzerland, particularly the big banks, have developed.

Private Banks cater to a wealthy clientele, and as a result, they are selective and quite secretive. Many of the world's oldest and greatest fortunes rest within the private banks in Zurich, Geneva, and Basel. The amounts of these deposits can only be estimated, as the private banks are not required by law to publish a balance sheet, though they still must file a periodic statement with the Swiss National Bank. These banks are either closely held or organized in some form of partnership; as a result, the liability of the directors or partners to the client is direct. The personal liability of the bankers, coupled with the increasing popularity

of big banks, has caused the number of private to decline over the last few decades. In addition, Swiss private banks frequently go out of business upon the death of the owners since Swiss law requires unincorporated business forms to carry the name of one of the unlimited partner. Despite this decline, however, private banks remain tremendously important to the world's economy, particularly in light of their vast amounts of undisclosed holdings and their ability to offer, to those who wish to have it, a truly discrete and personalized banking environment. It should be mentioned that private banks are also subject to the Federal Banking Law including requirement of independent auditing. In addition, many private banks are members of the Swiss Private Bankers Association.

### 3.2.5 Mortgage Bond Banks

The mortgage bond banks, or **Pfandbriefzentralen**, are set to issue long-term mortgage bonds with varying maturities to finance mortgage activities. Many other banks use these banks to convert short-term mortgage debt into long-term debt. At present, Switzerland remains the most heavily mortgaged nation in the world in terms of per capita mortgage debt, and the Pfandbriefzentralen, along with the country's low inflation rate, have contributed a great deal toward this.

### 3.2.6 Foreign-Owned Banks

After World War II Switzerland experienced a sudden growth in the number of foreign-owned banks and foreign branches. In addition, foreigners purchases interests in established Swiss banks. This activity accelerated in the years between 1950 and the early 1970s. Potential regulatory difficulties were perceived by the Swiss National Bank, which works closely with Swiss banks to achieved stability in monetary policy. Voluntary credit restraint was more difficult to obtain from foreign entities. As a result, a permit system for the establishment of banks by foreigners was introduced by the Federal Council. In addition, special requirements were established as a condition for granting a license to foreign-control banks.

Foreign-control means that over half of the company's votes are held by foreigners with qualified interests. Origin of banks: Europe, predominantly EU (over 50%), Japan (around 20%). Field of activity: foreign business (share of foreign assets in the balance sheet total is 70%), asset management.

### 3.2.7 Swiss Banking Regulatory Bodies

The regulatory bodies that supervise various sectors of the Swiss bank system include the Swiss National Bank, the Federal Council, the Federal Banking Commission, and the Bank for International Settlement (BIS).

### **3.2.8 Swiss National Bank**

Switzerland was one of the last industrialized nations in Europe to establish a central bank. Carefully monitoring the overall banking environment, the Swiss National Bank (SNB) is a central bank of unusual structure. The SNB was organized as a corporation under special Federal Law in 1905, the capital shares of the Swiss Bank are held by private Swiss citizens and entities as well as by cantons, cantonal banks, and other public entities. The Federal Government, which does not subscribe to SNB capital shares, nevertheless retains statutory power to influence the composition of the Bank's direction and management.

The Swiss National Bank is similar in function to the Central Bank of Nigeria and United States Federal Reserve. First, it is responsible for the issuance and maintenance of currency. The SNB has been granted certain powers to regulate the domestic volume of money. Furthermore, the SNB sets annual money supply targets with the federal government.

Second, the SNB acts as a clearing bank both in conventional sense and in its clearing of securities and giro (checks and payments of the Swiss banking sector) accounts. Certain reporting requirements call for the submission of certain reports to the SNB does not, however, strictly supervise the banks of Switzerland. Instead, it issues advice. Thus, the Swiss system is very much a voluntary one, maintained by agreement and harmonious functioning with a common goal in mind. nevertheless, the 'advice' issued by the Swiss National Bank are strictly followed by the Swiss banks.

### **3.2.9 Federal Banking Commission**

The Banking Law of 1934 also gave limited amounts of supervision to the Federal Banking Commission. Its members are chosen by the Federal Council to whom they are responsible and to whom yearly reports must be filed. The commission performs two functions. First, it is charged with overseeing compliance with the Banking Law. Second, the Commission of the Commission is required to establish a bank in Switzerland. This Commission was originally established in order to remove responsibility for the control of the banking system from the Government. However, due to its link with the Federal Council there is still a connection with the government.

### **3.2.10 Federal Council**

The Federal Council is the executive branch of the Swiss Government whose members are elected for four-year terms by the Federal Assembly. Each of the seven Council members represents a separate department of the government. The Federal Council has promulgated orders affecting the maintenance of adequate reserves with the SNB. The Federal Council now directly controls liquidity rates and regulation of interest rates.

### **3.2.11 Bank for International Settlement**

Even though it is not part of the Swiss banking system, the bank for International Settlement (BIS) in Basel is an important institution.

Established in 1930 to facilitate international transactions and to assist in the collection of war reparation payment, the BIS is somewhat similar to the International Monetary Fund, which Switzerland does not participate. Much of the Swiss National Bank's contact with the World's other central banks is done through the BIS.

### **3.2.12 Self Regulation**

In addition to the regulatory bodies discussed, it should be mentioned that much of the regulation of Swiss bank occurs through trade associations of which the banks are members. This self-regulation covers areas frequently considered to be within the government's responsibility. One of the most important of these associations is the Swiss Bankers' Association, which generally protects the interest of both banks and their customers. Furthermore, the Association serves as the banking industry's main link with the Swiss Government.

## **3.3 Swiss Banking Secrecy**

A great attraction to foreign capital has been Switzerland's highly regarded bank secrecy laws. Far from reflecting an effort to confound foreign law enforcement or to circumvent foreign tax or exchange control legislation, these principles reflect a Swiss concern for the economic liberties of the individual. The logical premises of treating bank secrecy with such respect have much to recommend themselves and go beyond the single observance of customer. Article 47(b) of the Banking Law of 1934 makes the violation of banking secrecy an offense punishable by fine or criminal prison term. Furthermore, negligent as well as intentional violations are covered by its provisions.

It should be mentioned, however, that certain limitations on bank secrecy do exist under Swiss law. For example, banking secrecy will not extend to activities, either in Switzerland or abroad, that would constitute a crime under Swiss law. In addition, provision is made in certain specific instances for authorities to have access to bank records in case of inheritance or bankruptcy proceedings. Nevertheless, these limitations are narrowly defined to assure that the secrecy of individual banking matter is left intact. Similarly, certain provisions of the Swiss Law protecting confidential business information have also been invoked in connection with banking matters. Related to the concept of bank secrecy is the existence of numbered accounts. A great deal of mystery surrounds this relatively routine denomination of accounts by number code rather than by name. Rather than is commonly assumed, total anonymity is not provided by numbered accounts. Although true ownership of such accounts is concealed from the bank staff, a minimum of two bank officers are required to know the true identity of the beneficial owner of numbered account. Thereafter, the client's name is kept off papers generated in the servicing of the account, thus guarding the secrecy of the account-holder from staff and third parties.

### **SELF ASSESSMENT EXERCISES**

- i. List the various components of Swiss Banking.
- ii. State the various agencies responsible for regulating activities of Swiss Banking

### **4.0 CONCLUSION**

Students have learned about the unique features of Swiss banking system which tend to differentiate them from other countries banking operations. They have also learned about the principles of secrecy upon which Swiss banking is based.

### **5.0 SUMMARY**

Switzerland operates one of the most successful banking systems in the world. The system is based on high reputations and excellence. The success of banking system is attributed to the concept of secrecy. The various components of Swiss banking system include; National Banks, Cantonal Banks, Credit Cooperatives Private Banks, Mortgage Bond Banks, and Foreign-owned Banks. The regulatory agencies responsible for monitoring Swiss Banking activities include; Swiss National Bank, Federal Banking Commission, Federal Council and Self regulation.

### **6.0 TUTOR MARK ASSIGNMENTS**

Explain the concept of Swiss Bank Secrecy.



### **ANSWER TO SELF ASSESSMENT EXERCISE**

- i. The various components of Swiss banking system include:

National Banks, Cantonal Banks, Credit Cooperatives Private Banks, Miscellaneous Swiss-held Banks, Mortgage Bond Banks, and Foreign-owned Banks as well as Investment trusts or mutual funds.

- ii. The regulatory agencies responsible for monitoring Swiss Banking activities include:

Swiss National Bank, Federal Banking Commission, Federal Council. The banks also institute Self regulation as mechanism of monitoring its own activities.

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## **MODULE 3**

Unit 1	International Monetary System
Unit 2	International Liquidity
Unit 3	The World Bank
Unit 4	International Financial and Lending Institutions
Unit 5	Corporate Governance and Bank Operations

## **UNIT 1 INTERNATIONAL MONETARY SYSTEM**

### **CONTENTS**

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### **1.0 INTRODUCTION**

International monetary system is recognized as catalyst for the development of international trade and promotion of currency movements across national frontiers. In this unit we provide a comprehensive analysis of the various monetary systems that are available in ensuring and facilitating international business across the globe. The systems discussed in this unit include; Bretton Woods system and European monetary systems.

### **2.0 OBJECTIVES**

At the end of this study unit, you should be able to:

- Trace the origin of international monetary systems
- Discuss the Bretton wood and European monetary systems
- Identify the features of European monetary system

### **3.0 MAIN CONTENT**

#### **3.1 International Monetary System Defined**

International monetary system refers to the system prevailing in world foreign exchange markets through which international trade and capital movements are financed and exchange rates are determined.

#### **3.2 Bretton Woods System**

During the period preceding World War I almost all the major national currencies were on a system of fixed exchange rates under the international gold standard. This system had to be abandoned during World War I. There were fluctuating exchange rates from the end of the War to 1925. Efforts were made to return to the gold standard from 1925.

But it collapsed with the coming of the Great Depression. Many countries resorted to protectionism and competitive devaluations-with the result that world trade was reduced to almost half. But depression completely disappeared during World War II.

In July 1944, the allied countries met at Bretton Woods in the USA to avoid the rigidity of the gold standard and the chaos of the 1930s in international trade and finance and to encourage free trade. The new system was the present International Monetary Fund (IMF) which worked out an adjustable peg system.

Under the Breton Woods system exchange rates between countries were set or pegged in terms of gold or the US dollar at \$35 per puce of gold.

This related to a fixed exchange rate regime with changes in the exchange within a band or rage from 1 per cent above to 1 per cent below the par value. But these adjustments were not available to US which has to maintain the gold value of dollar. If the exchange rate hit either of the bands, the monetary authorities were obliged to buy or sell dollars against their currencies. Large adjustments could be made where there were <sup>3</sup>fundamental disequilibrLXP' (i.e. persistent and large deficits or surpluses) in BOP with the approval of the IMF and other countries. Member countries were forbidden to impose restrictions on payments and trade, except for a transitional period. They were allowed to hold foreign reserves partly in gold and partly in dollars. These reserves were meant to incur temporary deficits or surpluses by member countries, while keeping their exchange rates stable. In case of a BOP deficit, there was a reserve outflow by selling dollar and reserve inflow in case of a BOP surplus.

Reserve outflows were a matter of concern under the Bretton Woods system. So the IMF insisted on expenditure reducing policies and evaluation to correct BOP deficit. Temporary BOP deficits were also met by borrowing from the Fund for a period of 3 to 5 years. A country could borrow from the Fund on the basis of the size of its quota with it.

The loans by the IMF were in convertible currencies.

The first 25 per cent of its quota was in gold tranche which was automatic and the remaining under the credit tranches which carried high interest rates. To provide a long-term loan the World Bank (or IBRD) was set up in 1946 and subsequently it two affiliates, the International Finance Corporation (IFC) in 1956 and International Development Association (IDA), in 1960, for the removal of trade restrictions, the General Agreement on Tariffs and Trades (GATT) came into force from January 1948. To supplement its resources, the Fund started borrowing from the ten industrialised countries in order to meet the requirements of the international monetary system under General Agreement to Borrow (GAB) from October 1962. Further, it created special Drawing Rights (SDRs) in January 1970 to supplement international reserves to meet the liquidity requirement of its members.

The Bretton Woods system worked smoothly from 1950s to mid 1960s.

During this period world output increase and with the reduction of tariffs under the GAFT, world trade also rose.

### **3.3 Collapse of Bretton Woods System**

The following are the principal causes sequences of the breakdown of the Bretton Woods system:

#### **1. Built-in Instability**

The Bretton Woods System had a built-in instability that ultimately led to its breakdown. It was an adjustable peg system within plus or minus 1 per cent of the par value of \$ 35. In case of fundamental disequilibrium, a country could devalue its currency with the approval of the IMF. But countries were reluctant to devalue their currencies because they had to export more goods in order to pay for their imports from other countries. This led countries to rely on deflation in order to cure BOP deficits through expenditure-reducing monetary fiscal policies.

## **2. The Tariff in Dilemma**

Since the dollar acted as a medium of exchange, a unit of account and a store of value of the IMF system, every country wanted to increase its reserves of dollar which led to dollar holdings to a greater extent than needed. Consequently, the US gold stock continued to decline and the US balance of payment continued to deteriorate. This is the Tariff in Dilemma which actually led to the collapse of the Bretton Woods System in 1971.

## **3. Lack of International Liquidity**

There was a growing lack of international liquidity due to increasing demand for the dollar in world monetary markets. With the expansion of world trade, BOP deficits (and surpluses) of countries increased. This necessitated the supply of gold and of the dollar. But the production of gold in Africa was increasing every little. This led to larger demand and holdings of the dollar. Countries also wanted to have more dollar holdings because they earned interest. As the supply of dollars was inadequate in relation to the liquidity needs of countries, the US printed more dollars to pay for its deficits which other countries accepted as reserves.

## **4. Mistakes in US Policies**

The BOP deficits of the US became steadily worse in the 1960s. To overcome them, the policies adopted by the US government ultimately led to the world crises. Rising US government expenditure in the Vietnam War, the financing of US space programme and the establishment of the 'Great Society' (social welfare) programme in the 1960s led to large outflow of dollar from the US. But the US monetary authority did not devalue the dollar. Rather, it adopted monetary and fiscal measures to cut its BOP deficit.

## **5. De-stabilising Speculation**

Since countries with 'fundamental disequilibrium' in BOP were reluctant to devalue their currencies and also took time to get the approval of the IMF, it provided speculators an opportunity to resort to speculation in dollars. When devaluations were actually made, there were large doses of devaluation than originally anticipated. This was due to de-stabilising speculation which made controls over capital flows even through monetary-fiscal measures ineffective.

## **6. Crisis of Confidence and Collapse**

The immediate cause of the collapse of the Bretton Woods System was the eruption of a crisis of confidence in the US dollar. The pound had been devalued in 1967. There was no control over the world gold market with the appearance of a separate price in the open market. The immediate cause for the collapse of the Bretton Woods System was the rumour in 1971 that the US would devalue the dollar. This led to a huge outflow of capital from the US. The US in the order hand, suspended the conversion of dollars into gold when some small European central banks wanted to convert their dollar reserves into gold at the US. It refused to intervene in the foreign exchange markets to maintain exchange rate stability and imposed a 10% import surcharge.

### **3.4 European Monetary System**

The European Monetary System (EMS) was officially launched in 1979 under the sponsorship of German Chancellor Helmut Schmidt and French President Valery Giscard d'Estaing. The nine European Community members who fully participate in the EMS include: Britain, Belgium, Denmark, France, West Germany, Ireland, Luxembourg, Netherlands and of course Italy also later agrees to participate in the system under modified conditions due to difficulties it experienced with its currency. The European Monetary System, commonly referred to as the EMS, is an arrangement among the member nations to limited fluctuations in their currencies and achieves monetary stability. It was taught that international trade between the participating nations would be improved if exchange rates were stable and predictable.

### **3.5 Features of European Monetary System**

The European Monetary System (EMS) consists of a number of special features, such as a common currency unit, detailed regulation of permissible currency fluctuations among member nations, mutual credit facilities for participating countries, and the creation of a central reserve fund consisting of Gold, Dollars, and the currencies of the participating countries.

### **3.6 Suggestions for Monetary System Reform**

Economists have suggested a number of measures in order to avoid the excessive fluctuations and large disequilibria in exchange rates for reforming the present world monetary system.

## **1. Coordination and Cooperation of Policies**

Experts suggested that there should be international co-operation and co-ordination of policies among the leading developed countries for exchange rate stability. The most industrialized countries of the world such as the US, Germany and Japan should have the optimal degree of exchange rate stability by fixing the exchange rates among their currencies at the equilibrium level based on the purchasing power parity.

## **2. Establishing Target Zones**

A call had also been made for the establishment of target zones within which fluctuations in exchange rates of major currencies may be permitted. According to experts, the forces of demand and supply should determine the equilibrium exchange rate. There should be an upper target zone of 10% above the equilibrium rate and a lower target zone of 10% below the equilibrium exchange rate. The exchange rate should not be allowed to move outside the two target zones by official intervention.

## **3. Improving Global Liquidity**

The reform package of the present world monetary system should improve global liquidity. As a first step, both BOP deficit and surplus countries should take step to reduce a persistent imbalance through exchange rate changes via internal policy measures.

Second, they should also cooperate in curbing large flows of <sup>3</sup>hot PRQH\ that de-stabilise their currencies. Third, they should be willing to settle their BOP imbalances through SDRs rather than through gold or dollar as reserve assets. Fourth, there should be increasing flow of resources to the developing countries.

## **4. Leaning against the Wind**

To reduce the fluctuations in exchange rates, the IMF Guidelines for the Management of Floating Exchange Rate, 1974 suggested the idea of leaning against the wind. It means that the central banks should intervene to reduce short-term fluctuations in exchange rates but leave the long-term fluctuations to be adjusted by the market forces.

## **5. Establishment of Global Central Bank**

There should be a global central bank with a global currency which should be a global lender of last resort.

## **6. Creation of International Bankruptcy Court**

It was also proposed by experts that International Bankruptcy Court should be created which should deal with countries.

## **7. Objective Indicators**

To iron out exchange rate fluctuations, the IMF Interim Committee suggested the adoption of such objective indicators as inflation unemployment, growth of money supply, growth of GNP, fiscal balance, balance of trade and international reserves. The variations in these indicators require the adoption of restrictive monetary-fiscal measures to bring stability in exchange rates.

## **SELF ASSESSMENT EXERCISES**

- i. Discuss the Bretton Woods Monetary System.
- ii. Identify the factors responsible for the collapse of Bretton Woods System.

## **4.0 CONCLUSION**

Students have learned about the development Bretton Woods and European Monetary systems. The reasons for the spectacular collapse of Bretton Woods's monetary system were also learned as well as the common features of European Monetary System.

## **5.0 SUMMARY**

International monetary system is a system prevailing in foreign exchange market through which international trade and capital movements are finance and exchange rates are determined. Under Bretton Woods system exchange rates between countries were pegged in terms of gold or the United States dollar. However, the system collapse for lack of international liquidity and the fact that the overall system was built on instability. Formed in 1979, the European monetary system created the European Currency Unit (ECU).

## **6.0 TUTOR MARKED ASSIGNMENT**

Enumerate the features of European Monetary System.

## **ANSWER TO SELF ASSESSMENT EXERCISES**

- i.. After the World War in 1944, the allied countries met at Bretton Woods in the USA to avoid the rigidity of the gold standard and



the chaos of the 1930s in international trade and finance and to encourage free trade. The new system was the present International Monetary Fund (IMF) which worked out an adjustable peg system. Under the Bretton Woods system exchange rates between countries were set or pegged in terms of gold or the US dollar. The formation of Bretton Woods Monetary System was followed by the establishment of many financial agencies and agreements. For example; to provide a long-term loan the World Bank (or IBRD) was set up in 1946 and for the removal of trade restrictions, the General Agreement on Tariffs and Trades (GATT) came into force from 1948.

- ii. Some of the arguments advanced for the spectacular collapsed of Bretton Woods Monetary System include; Built-in Instability, Tariffin Dilemma, Lack of International Liquidity, Mistakes in US Policies, Destabilizing Speculation, Crisis of Confidence and Collapse.

## **7.0 REFERENCES/ FURTHER READINGS**

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## **UNIT 2 INTERNATIONAL LIQUIDITY**

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- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 International Liquidity Defined
  - 3.2 Problems of International Liquidity
  - 3.3 International Liquidity Problem in Developing Countries
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    - 3.4.2 Features of SDRs
    - 3.4.3 Workings of SDRs
- 4.0 Conclusion
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### **1.0 INTRODUCTION**

International liquidity is crucial to the development of country's economy as it is a yield stick for participating in the world monetary system. This unit provides detailed analysis of the importance of International liquidity.

### **2.0 OBJECTIVES**

At the end of this study unit, you should be able to:

- Define the meaning of international liquidity
- Identify the problems associated with international liquidity
- Discuss the concept of Special Drawing Rights

### **3.0 MAIN CONTENT**

#### **3.1 International Liquidity Defined**

International liquidity refers to the availability of internationally acceptable means of payment. It comprises all types of generally acceptable assets available to the countries for financing the deficits in their international balance of payments. In common language, international liquidity means international reserves. International reserves have been defined to include official holdings of gold, foreign exchange, special drawing rights (SDRs), reserve position in the IMF.

Private holdings of foreign assets are not included in international liquidity.

Therefore, international liquidity is the sum total of the international reserves of all nations participating in the world monetary system. The world's need for international liquidity depends upon; the volume of international commercial and financial transactions, and the imbalances that characterize these transactions. Given the volume of world trade and payments, the greater the collective payments imbalances of the participating countries, the more pronounced will be the overall need for international liquidity.

### **3.2 Problems of International Liquidity**

The problem of international liquidity is concerned with the imbalances in the demand for and supply of international liquidity. International liquidity shortage (i.e., the demand exceeding the supply) leads to recession in the world economy. On the contrary, international liquidity surplus (i.e., supply exceeding demand) tends to have inflationary impact on the international economy. Solution to the problem of international liquidity relates to the attempt to ensure that there exists neither a liquidity shortage nor a liquidity surplus. The supply of and demand for international liquidity must be balanced so that the contraction or expansionary pressures do not disturb the world economy.

The international liquidity should play a neutral role of lubricating international trade and the mechanism without generating destructive forces of its own.

In summary, the international liquidity problem refers to the problem of nature and availability of means of international payments. In the present world situation, the liquidity problem has two aspects: quantitative and qualitative. The quantitative aspect relates to the problem of adequacy of international liquidity. The qualitative aspect relates to the nature and composition of international reserves.

#### **Quantitative Aspect of the problem**

International liquidity problem is the problem of inadequacy of international reserves. The following are the reasons for the inadequacy of international reserve:

1. Inadequate Growth of Reserves.
2. Uneven expansion of Reserves
3. No conscious policy
4. Slow Growth of gold

5. No Solution by Rising IMP Quotas.
6. Liquidity Problem of Developing countries.

### **Qualitative Aspect of the Problem (or the confidence problem)**

The qualitative aspect of the liquidity problem is concerned with the use of reserve currencies. The U.S. dollar and the pound sterling are the key currencies. However, since World War II, dollar has been widely accepted as the major international currency for carrying out international trade and investment transactions. In the composition of international liquidity, gold and reserve currencies play a dominant role.

But, since gold reserves cannot be increased much, the growing requirements of international liquidity are to be met by increasing the reserve currency holding. Now the process of increasing the reserve currency (dollar) holdings means creating balance of payment deficits in the reserve currency centre country (America), if the other countries tend to accumulate the reserve currency. Thus leads to the confidence problem.

The confidence problem is primarily concerned with the inherent defect in the reserve currency system and is related to the value of a reserve currency as an asset. This problem arises from the need for increased reserves of the reserve.

### **3.3 International Liquidity Problem in Developing Countries**

The liquidity problem is all the more serious and is of different nature in the developing and less developed countries. These countries experience chronic deficiency of capital and technology and have to depend largely on the developed countries for their scarce resources. They require resources for; covering their short-term balance of payments resources, and for meeting long-term capital requirement of economic growth. The liquidity problem of the developing countries has the following features which are quite different from those of the developed countries.

#### **1. Undeveloped Financial Markets**

Domestic financial markets in the developing countries are undeveloped and are subject to heavy government control. These characteristics have the following effects:

Lending often takes place at artificially low interest rates fixed by the government to favour certain industries or sectors of the economy. This means an implicit subsidy to the recipients of the loans and an implicit tax on the banking system,

Few and not very attractive assets are available to the savers. Government controls prevent domestic savers from holding foreign assets all these effects indicate discouragement to domestic saving which is already at the low level because of low income levels.

## **2. Heavy Government Expenditures**

Government spending in the developing countries forms a very high percentage of national income. In order to finance its budget deficits, the government resorts to the printing of new money (i.e. deficit financing) which usually result in high rates of inflation.

## **3. Exchange Control**

In the developing countries, exchange rates are set by the central bank rather than determined in the foreign exchange market. Private international borrowing and lending are strictly restricted. The residents are allowed to purchase foreign exchange only for certain selected purposes.

## **4. Primary Exports**

Most of the developing countries mostly rely for their export earnings on a small number of natural resources or agricultural products. Dependence on such primary products makes these countries vulnerable to shocks in the international markets because the prices of these goods are highly variable relative to those of manufactured goods.

## **5. Dependence of Foreign Borrowing**

Since most of the developing countries have low saving rates and very high investment opportunities, they largely rely on capital inflow from abroad to finance their domestic investment. Recently, these countries have borrowed on a large scale from rich countries and have built up a large debt to the rest of the world.

### **3.4 IMF and International Liquidity**

The International Monetary Fund (IMF) has been established with an objective of extending short-term financial assistance to its members to overcome the balance of payments difficulties as well as emergency situations. It contributes to the international liquidity in two ways: by providing conditional liquidity; and by providing unconditional liquidity.

#### **1. Conditional Liquidity**

The IMF provides conditional liquidity under its various lending schemes. The credit provided to the members is generally subject to certain conditions. Most of the IMF loans require an adjustment programme to be undertaken by the member country for improving its balance of payments position. Moreover, obtaining funds from the IMF under agreed conditions increases the member's access to international capital market.

Important credit facilities provided by the IMF are: basic credit facility, extended fund facility, compensatory financing facility, buffer stock facility, supplementary financing facility, trust fund, and structural adjustment facility amongst others. In order to make the resources easily and more adequately available, the IMF has been introducing various procedure changes from time to time.

## **2. Unconditional Liquidity**

The supply of unconditional liquidity takes the form of reserve assets that can be used for balance of payments financing. The IMF provides unconditional liquidity through the allocation of Special Drawing Right (SDRs), and also in the form of reserve positions in the Fund to member countries without having to enter into policy commitments with the Fund.

### **3.5 Concept of Special Drawing Rights**

The establishment of the scheme of Special Drawing Right (SDRs) is a significant attempt of the International Monetary Fund (IMF) to reform the international monetary system and to solve the problem of international liquidity. After the World War II, the gold standard was replaced by the currency standard. But the continued use of the pound sterling and the U.S. dollar as the key reserve currencies proved unsatisfactory because of the deficits in the balances of payments of the U.S. and the U.K. There was a serious problem of the international liquidity, i.e. the inadequate growth of monetary reserves. In such conditions, the need arose for a new reserve asset thus leading to the introduction of SDR as a new international reserve asset by the IMF.

The scheme for creating Special drawing Rights (SDRs) was outlined at Annual Meeting of the IMF in October 1967 at Rio de Janeiro (Brazil).

The detailed proposals of the scheme were approved by the Board of Governors in April 1968 and the Special Drawing Account came into being on August 6, 1969. The basic idea behind the SDR scheme was to establish a new reserve asset whose quantity could be consciously

adjusted in response to the world's need for international reserves. The objective of creation of the SDR was to assure an adequate, but not excessive, growth of monetary reserves.

Under this scheme, the IMF has the power to grant SDRs to member nations on a specified basis. Allocation of SDRs is made annually by the collective decision of the participating countries on the basis of their quotas. Possession of SDRs entitles a country to obtain a defined equivalent of currency from other participating countries. The IMF can create new SDRs from time to time in response to the need for additional international reserves. The newly created SDRs are allocated among member nations in proportion to their IMF quotas. When a member's SDR balance falls below its total allocation, it must pay interest to the IMF on the difference. Similarly, the members are paid interest by the IMF on SDR holdings in excess of allocations. Thus, by creating SDRs, the IMF aims at increasing the availability of resources to the member countries without putting additional strain on its own resources.

### **3.5.1 Features of SDRs**

The following are the salient features of SDRs:

#### **1. Additional Reserve Asset**

The SDRs scheme provides a new international asset, in addition to the traditional assets, i.e., gold, key currencies. Now, the member countries of the IMF can hold and use SDRs along with gold and key currencies as international reserves.

#### **2. Cheque Book Currency**

In the physical sense, SDRs are a cheque-book currency and are created with the strokes of pen. They are simply book keeping entries at the IMF in accounts for the member countries and the Fund itself. They are just like coupons which can be exchanged for currencies needed by the holder of SDRs for making international payments.

#### **3. Transferable Assets**

SDRs are transferable assets. The member countries are required to provide their currencies in exchange for SDRs. A country can acquire convertible currency in exchange for SDRs. A country can acquire convertible currency from the designated country in exchange for SDRs. Designated country is that which has strong balance of payments or large reserves.

#### **4. Backing of SDRs**

SDRs are a liability of the IMF and asset of the holders. There is no backing for SDRs in the form of an asset like key currency. The real backing is the undertaking given by the member countries to abide by the SDR regulations. The country which agrees to the creation of SDRs is obliged to permit drawal and other countries are obliged to accept them as unit of adjustment.

#### **5. Basis of SDRS**

The creation of SDRs is based on the fundamental principle of credit creation in the banking system. The SDR scheme is an extension of this principle to the international level. The IMF can create new SDRs without any increase in deposits of gold or currency by the participating countries. Thus, issue of SDRs means an increase in world's monetary reserves.

#### **6. Allocation of SDRs**

The SDRs are allocated to the member countries in proportion to their quotas in the IMF. The lion's share goes to the developed countries and the developing countries get only about a quarter.

#### **7. Special Drawing Account**

Under the changed rules, the IMF maintains two separate accounts: General Account which deals with the general transactions of the IMF relating to quotas, subscriptions, ordinary drawings, etc. and Special Drawing Account which deals with SDRs are created as a percentage of existing resources (quotas).

#### **8. Paper Gold**

Initially the scheme envisaged that the SDRs would be a sort of paper gold. Their value was fixed in terms of gold. But, since 1974, the SDR has been valued on the basis of a currency basket.

#### **9. Fiduciary Reserve System**

The SDR scheme proposes a purely fiduciary reserve system. SDRs are regularly created by the IMF, accepted by the number countries as paper gold reserves and used for the settlement of international payments.

#### **10. Interest-Bearing Asset**



SDRs are interest-bearing assets. The IMF pays interest to the countries holding SDRs and charge interest from the countries using SDRs.

### **11. Use of SDRs**

Under the SDR scheme, the participating countries will use SDRs to meet their balance of payments requirements nor to improve their adverse reserve position. SDRs are not to be used for exchange with other currencies to reinforce foreign exchange reserves.

### **12. Limited Use of SDRS**

Ordinarily, a country can use SDRs up to 70% of the allotted authorization during a given five years. The remaining 30% is to be held for emergencies. Thus, a restraint has been put on the member countries so that they do not rush into using SDRs without drawing upon their other forms of resources.

### **13. Units of Account**

Use of SDRs as a unit of account has also started. Some countries have pegged their currencies to SDRs. OPEC countries, and some airlines, monetary organizations and banks are using SDRs as unit of account.

## **3.5.2 Working of SDRs**

There have been two major ways in which the members could use SDRs:

### **1. Transactions by Agreement**

A member country may use its SDRs to obtain balances of its own currency held by another participant country by agreement with that participant. Under these two uses, the member nations are expected to utilize their SDRs to meet adverse balance of payments, and not to change the composition of exchange reserves.

### **2. Transactions with General Account**

SDRs can be used by member countries in operations and transaction conducted through the IMF's General Account (i.e., in settling transactions with the IMF).

## **SELF ASSESSMENT EXERCISES**

- i. Explain the term <sup>3</sup>International Liquidity.
- ii. What are the reasons for inadequacy in International reserves?

#### **4.0 CONCLUSION**

Students have learned about international liquidity and its basic compositions as well as the feature associated with the liquidity problem in developing countries like Nigeria. Special Drawing Rights (SDR) and its features were also studied.

#### **5.0 SUMMARY**

International liquidity consists of all total reserves of all nations participating in the world monetary system. The inadequacy of international liquidity is caused by inadequate growth of reserves, uneven expansion of reserves, slow growth of gold, and the lack of solution by rising IMF Quota. However, the problem of liquidity in developing countries is caused by factors such as undeveloped financial markets, heavy government expenditures, exchange control, primary exports, dependency of foreign borrowing and forms of foreign borrowing.

#### **6.0 TUTOR MARKED ASSIGNMENT**

Identify the features of liquidity problems in Nigeria as a developing country.

#### **ANSWER TO SELF ASSESSMENT EXERCISE**

- i. International liquidity can be defined as the availability of internationally acceptable means of payments. International liquidity is determined by the capacity of the country's foreign reserves. For those countries that are participating in international monetary system, international liquidity is the total reserve of members' nations.
- ii. Some of the reasons advanced for inadequacy of international reserves includes; inadequate growth of reserves, uneven expansion of reserves, slow growth of gold, and the lack of solution by rising IMF Quotas.

#### **7.0 REFERENCES/ FURTHER READINGS**

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## **UNIT 3 THE WORLD BANK**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Functions of The World Bank
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  - 3.5 Borrowing and Lending Activities
    - 3.5.1 Modes of Lending
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### **1.0 INTRODUCTION**

The need to bring about a smooth transition from Wartime to Peace time led to the formation of the International Bank for Reconstruction and Development (IBRD) commonly known as the World Bank in 1945 under the Bretton Wood Agreement of 1944. This provides a detailed explanation about the functions, membership, funding strategy as well as lending/borrowing activities of the World Bank.

### **2.0 OBJECTIVES**

At the end of this study unit, you should be able to:

- Explain the function and membership structure of IBRD
- Identify the funding strategy of the World Bank
- Critically appraisal of the Bank and its Activities

### **3.0 MAIN CONTENT**

#### **3.1 Functions of the World Bank**

The IBRD, also called World Bank, performs the following functions:

1. To assist in the reconstruction and development of territories of its members by facilitating the investment of capital for productive purpose, and the encouragement of the development of productive facilities and resources in less developed countries.
2. To promote private foreign investment by means of guarantees on participation in loans and other investment made by private investors, and when capital is not available on reasonable terms, to supplement private investment by providing finance for productive purpose out of its own resources or from borrowed funds.
3. To promote the long-range balance growth of international trade and the maintenance of equilibrium in the balance of payments of member countries by encouraging international investment for the development of their productive resources, thereby assisting in raising productivity, the standard of living and conditions of workers in their territories.
4. To arrange the loans made or guaranteed by it in relation to international loans through other channels so that more useful and urgent small and large projects are dealt with first.

### **3.2 Membership**

The members of the International Monetary Fund (IMF) are the members of the IBRD. It had 181 members in June 1996. If a country resigns its membership, it is required to pay back all loans with interest on due dates. If the Bank incurs a financial loss in the year in which a member resigns, it is required to pay its share of the loss on demand.

### **3.3 Organizational Structure**

Like the IMF, the IBRD has a three-tier structure with a President, Executive Directors and Board of Governors. At present, Paul Wolfowitz is the President of the World Bank Group (IBRD, IDA and IFC). He was elected by the Bank's Executive Directors whose number is twenty-one. Of these, 5 are appointed by the five largest shareholders of the World Bank. They are the US, UK, Germany, France and Japan.

The remaining 16 are elected by the Board of Governors. There are also Alternate Directors. The first five belong to the same permanent member countries to which the Executive Directors belong. But the remaining Alternate Directors are elected from among the group of countries who cast their votes to choose the 16 Executive Directors belonging to their regions. The President of the World Bank presides over the meetings of the Board of Executive Directors regularly once a month. The Executive Directors decide about policy within the framework of the Articles of Agreement. They consider and decide on

the loan and credit proposals made by the President. They also present to the Board of Governors at its annual meetings audited accounts, an administrative budget, and the Annual Report on the operations and policies of the Bank. The President has a staff of more than 6,000 persons who carry on the working of the World Bank. He is assisted by a number of Senior Vice-Presidents and Directors of various departments and regions. The Board of Governors is the supreme body. Every member country appoints one Governor and an Alternate Governor for a period of five years. The voting power of each Governor is related to the financial contribution of its government.

### 3.4 Objectives of Funding Strategy

The IBRD's funding strategy has the following four basic objectives:

1. The first is to ensure the **availability of funds** to the Bank. For this purpose, the IBRD seeks to maintain un-utilised access to funds in the markets in which it borrows.
2. The second objective is to **minimise the effective cost** of those funds to its borrowers. This is done through the currency mix of its borrowings and the time of borrowings. In the former case, it tends to maximise borrowings in currencies with low nominal interest rates. This time of borrowings is manipulated in two ways: (a) when interest rates are expected to rise, the Bank seeks to increase its borrowings; and (b) when interest rates are expected to fall, it seeks to defer borrowings.
3. The third objective is **control volatility in net income and overall loans charges**. For this purpose, the Bank started in July 1982 a pool-based variable lending rate system than uniformly adjusts interest charges applicable to the outstanding balance on all loans made under it. The existing loans were not affected by this lending system. When the majority of loans and borrowings are incorporated into the new lending rate system in future, the volatility of interest rates will be much reduced.
4. The fourth objective of the funding strategy is to provide an appropriate degree of **maturity transformation** between its borrowing and lending. Maturity transformation refers to the Bank's capacity to lend at longer maturities than it borrows. At the same time, it provides its borrowers with a modest degree of maturity transformation.

### 3.5 Borrowing and Lending Activities

The IBRD is a corporate institution whose capital is subscribed by its members. It finances its lending operations primarily from its own

medium and long-term borrowings in the international capital markets, and currency swap agreements (CSA).

Under the CSA proceeds of a borrowing country are converted into a different currency, and simultaneously, a forward exchange agreement is executed providing for a schedule of future exchange of the two currencies in order to recover the currency converted. The effect of currency swaps is to transform the cost of original borrowing to a cost, which reflects the market yield of the currency obtained in the conversion. The Bank also borrows under the Discount-Note Programme. First, it places bonds and notes directly with its member governments, government agencies and central banks. Second, it offers issues to investors and in the public market through investing banking firms, merchant banks and commercial banks.

The IBRD has evolved two new borrowing instruments. First, Central Bank Facility (CBF) is a one-year, US dollar dominated facility for borrowing from official sources, particularly central banks. It is designed to reverse the declining trend in the IBRD's borrowing from such sources since the 1970s. Second, borrowings in Floating Rate Notes (FRNs) are meant to help the IBRD to meet some of the objectives of its funding strategy. The FRN market enables the Bank to gain access to a set of investors like commercial banks and certain other financial institutions which have not traditionally bought IBRD notes.

The FRNs carry a medium/long-term maturity. A substantial amount of its resources also comes from its retained earnings and the flow of payments on its resources also comes from its retained earnings and the flow of payment on its loans.

### **3.5.1 Modes of Lending**

The banks lends to member countries in any of the following ways:

- By marketing or participating loans out of its own funds;
- By making or participating in direct loans out of funds raised in the market of a member or otherwise borrowed by the Bank;
- By guaranteeing in whole or in part loans made by private investors through the usual investment channels.

### **3.5.2 Conditions for Lending**

The bank guarantees, participates in or makes loans to its members on the following conditions:

- (i) If it is satisfied that in the prevailing market conditions the borrowers would be unable to obtain the loan under conditions which in the opinion of the Bank are reasonable to the borrowers.
- (ii) Loans are for specific projects of reconstruction or development, except in special circumstances.
- (iii) If the member in whose territory the project is located is not itself the borrower, the member or its central bank fully guarantees the repayment of the principal, the payment of interest and other charge on the loan.
- (iv) The project for which the loan is required has been recommended by a competent committee in the form of a written report after a careful study of the proposal.
- (v) The borrower or the guarantor is in a position to meet its obligation under the loan.

### **3.6 World Bank Facilities**

The bank provides the following facilities to member countries:

#### **Structural Adjustment Facility (SAF)**

Since 1985, the IBRD has introduced SAF to borrowing countries in order to reduce their balance of payments deficits while maintaining or regaining their economic growth. SAF funds are used to finance general imports with a few agreed exceptions such as luxury and military imports. SAFs are released in two parts and are based on stiffer conditions laid down by the Bank. The Bank aims at providing support to programmes running from 5 to 7 years through a series of up to five SAFs to a borrowing country.

#### **Enhanced Structural Adjustment Facility (ESAF)**

In 1987, the Bank has set up the ESAF to increase the availability of concessional resources to low-income member countries. It provides new concessional resources totalling SDR 6 billion which will be financed by special loans and contribution from developed and OPEC countries. Like the SAF, ESAF is meant to help the borrowing countries reduce their balance of payments deficits and encourage growth. Its financial terms are similar to the SAF. The interest rate is 0.5 per cent with repayments in ten semi-annual instalments beginning after 5-1/2 years of disbursements.

#### **Special Action Programme (SAP)**



The Special Action Programme (SAP) has been started in 1983 to strengthen the IBRD's ability to assist member countries in adjusting to the current economic environment. It has four major elements:

An expansion in lending for high-priority operations that support structural adjustment, policy changes, production for export, fuller use of existing capacity, and the maintenance of crucial infrastructure.

Accelerated disbursements under existing and new investment commitments to ensure timely implementation of high priority projects.

Expanded advisory services on the design and implementation of appropriate policies. These include reviews of state enterprises studies to strengthen development-orientation and project-implementation capabilities, studies to increase the mobilisation of domestic resources; reviews of incentives for export diversification, and exploration of ways to strengthen debt-management capabilities.

Enlisting familiar efforts by other donors for fast-disbursing assistance in support of programmes of the Bank and IMF.

### **3.7 Critical Appraisal of World Bank**

The IBRD has been quite successful in achieving its principal objective of reconstruction and development. It helped in the reconstruction of Europe after its destruction in the Second World War. It has also been helping the developed and developing countries alike in the process of growth. Since the 1970s, it has been lending more to developing countries not only for infrastructure investment but also for raising the productivity and standard of living of the poor people. Still critics are not lacking in pointing out certain criticisms of its lending policies. Some of them are discussed as follows:

1. It is argued that the bank charges a very high rate of interest on loans, as also an annual commitment charge on undistributed balances and a front-end fee. Recently the Bank has adopted a new procedure related to the cost of borrowing for calculating the interest rate and front-end fee. So they are no longer fixed arbitrarily at a high level. Still the interest rate continues to be high.
2. The Bank has also been criticised for its failure to meet the financial needs of the developing countries fully. Its loans have just touched the fringes of the total capital requirements for their economic and social uplift. In order to increase the Bank funds to such countries, it established the International Development Association (IDA) in 1960. Despite this, the Bank has not been

successful in raising the productivity and standard of living of their people. Its lending operations account for only a small proportion of the total net aid to developing countries.

3. The Bank's lending procedure is faulty because it lays emphasis on the repaying capacity of the borrowing country before granting any loan. Such a condition is very harsh and discriminatory for developing countries which are poor and need financial help on the large scale. In fact, the repaying capacity of a poor country follows the utilisation of a loan.
4. The Bank has been criticised for being discriminatory in its purpose-wise and region-wise assistance to its members. It is from the fiscal year 1990 that the lending policy of the Bank has been directed more towards the developing countries and, for the development of agriculture and rural development, energy, transportation, communications, water supply, sewerage, human resources development, and environment amongst others.
5. The introduction of SAF and ESAF has made IBRD loans terms tighter. The borrowing country is required to follow an action programme set out in a letter of development policies such as open trade, reform in public budgeting and debt management, revision of price policies, etc. The second instalment of SAF is only released after a review of the reform programmes that are date-bound.

### **SELF ASSESSMENT EXERCISES**

- i. What are the Functions of World Bank?
- ii. Enumerate the Objectives behind Funding Strategy of the Bank.

### **4.0 CONCLUSION**

Students have learned the objective behind the establishment of World Bank, its functions and the organizational structures. Various lending strategy that are occasionally used by the bank was also covered. The students are also aware of the lending conditions usually imposed by the bank as well as the modes of lending.

### **5.0 SUMMARY**

World Bank as international financial institution was formed with aim of reconstruction and development of war toned regions of the world just after the world war in 1945. The banks membership is drawn from all the members of International Monetary Fund (IMF). Some of the bank facilities apart from financial lending include; Structural Adjustment Facility (SAF), Enhanced Structural Adjustment Facility (ESAF) and Special Action Programme (SAP).

## **6.0 TUTOR MARKED ASSIGNMENT**

Identify the various modes of lending in World Bank.

### **ANSWER TO SELF ASSESSMENT EXERCISE**

- i. World Bank performs the following functions:
  - To assist in the reconstruction and development of territories of member countries by facilitating the investment of capital.
  - To promote private foreign investment by means of guarantees on participation in loans and other investment made by private investors.
  - To promote the long-range balance growth of international trade and the maintenance of equilibrium in the balance of payments of member countries by encouraging international investment for the development of their productive resources.
  - To arrange the loans made or guaranteed by it in relation to international loans through other channels.
  
- ii. World Bank funding strategy has the following objectives:
  - To ensure the availability of funds to the Bank.
  - To minimise the effective cost of those funds to its borrowers.
  - To control volatility in net income and overall loans charges.
  - To provide an appropriate degree of maturity transformation between its borrowing and lending.

## **7.0 REFERENCES/ FURTHER READINGS**

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## **UNIT 4 INTERNATIONAL FINANCIAL AND LENDING INSTITUTIONS**

### **CONTENTS**

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- 2.0 Objectives
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  - 3.2 International Development Association
  - 3.3 International Financial Corporation
  - 3.4 African Development Bank
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- 5.0 Summary
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### **1.0 INTRODUCTION**

The need for financial assistance for developing nations is great and generates a higher degree of risk than normally encountered in traditional commercial lending situations. International Lending agencies have been established to fill the needs of developing and other countries. Although these agencies are numerous, this unit traces the origin, objectives as well as the working structure of major ones among them.

### **2.0 OBJECTIVES**

At the end of this study unit, you should be able to:

- Identify the various International Financing and Lending agencies
- State the objectives behind each of agencies.
- Explain the working organization or structures of these agencies.

### **3.0 MAIN CONTENT**

#### **3.1 International Monetary Fund**

International Monetary Fund (IMF) is an international monetary institution established by different countries after the World War II with an objective of providing exchange stability throughout the world and increasing liquidity so that balanced multilateral trade is promoted through the cooperation of the member nations. Various historical

conditions and events that led to the establishment of IMF are summarised below:

- (i) Gold standard functioned with reasonable success and provided a medium of international payments before World War I.
- (ii) The onset of World War I forced most of the countries to abandon gold standard and put restrictions on the movement of gold as well as goods.
- (iii) After the World War I, some countries came back on the gold standard but the gold standard could not work well between the periods 1919 ±1931.
- (iv) The world faced the Great Depression of the thirties between 1929 and 1936. Prices, profits, share prices, production, employment and income of the leading countries fell very low. Competitive devaluation, tariffs and exchange controls were adopted by the nations.
- (v) World War II (1939-45) further disrupted the pattern of international trade and dislocated the economies of the world.

After the world-wide depression and the World War II, it was recognised that; the gold standard could not be restored in future; and lack of any mechanism like the gold standard would generate instability of exchange rates and discourage international trade and investment.

Therefore, the monetary authorities of the world felt the need for international cooperation to establish a stable international monetary order. With this objective, a conference of 44 major countries was held at Bretton Woods, New Hampshire, in 1944. The result of this conference was the establishment of the International Monetary Fund (IMF) and the International Bank for reconstruction and Development (IBRD). These two institutions are known as Bretton Woods's twins.

### **Objectives of IMF**

Basically, the purpose of the IMF was to; achieve the international advantages of the gold standard without subjecting nations to its internal disadvantages; and achieve internal advantages of paper standard while avoiding its international disadvantages. The main objectives of the Fund, as summarised in the Article of Agreement, are as follows:

- (i) To promote international monetary cooperation through a permanent institution that provides the machinery for consultation and collaboration on international monetary problems.
- (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and

maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economy policy.

- (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciations.
- (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- (v) To give confidence to members by the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibria in the international balance of payments of members.

### **Organisation of IMF**

The IMF came into existence in December 1945 and started functioning in March 1947. It is an autonomous organisation and is affiliated to the U.N.O. It has its main office in Washington. Initially, the IMF had 30 countries as its members. As on April 30, 1986, the membership of the Fund was 149, covering nearly all the non-communist nations of the world.

The management of the Fund is under the control of two bodies: Board of Governors and Board of Executive Directors. The Board of Governors is the general body of management consisting of one Governor and an Alternate Governor for each member country. The Board of Governors has the responsibility of formulating the general policies of the Fund. The Board of Executive Directors controls the day-to-day activities of the Fund. Currently, it consists of 22 directors; six of these directors are appointed by the members having the largest quotas, namely, the United States, the United Kingdom, West Germany, France, Japan and Saudi Arabia, and the remaining sixteen directors are elected by other nations. The Managing Director is the chairman of the Board of Executive Directors as well as the head of the staff of the Fund.

### **Resources of IMF**

The resources of the IMF are subscribed by the members. The subscription quota of each member is based on its national income and its position in the international trade. Every member nation must

contribute 25% of its quota in international reserve assets and the remaining 75% in its own currency. The payment of 25% part of the quota was originally in gold, but now it is in Special Drawing Rights (SDRs). SDRs are an international reserve asset created by the IMF in 1969. The Fund may also enlarge its resources by borrowing, by selling gold to the public and by receiving fee from the borrowing members.

### **3.2 International Development Association**

The International Development Association (IDA) was established in 1960 as an affiliate to the World Bank. As matter of policy, the World Bank's finance is conditional and inadequately meets the credit requirements of the underdeveloped countries. Its loans are for specific development purposes; bear relatively high rate of interest and are for relatively short period. There are many projects (such as irrigation, railway construction, education, public health, housing etc.) in the underdeveloped countries which are vital to general economic development, which have longer gestation period and which do not yield sufficient returns to meet the amortisation charges. As per rules of the World Bank, loan cannot be given for such general development projects. The IDA was started to supplement the World Bank's development assistance and to make available loans to the developing countries on softer terms and for longer periods. Thus, the IDA has been aptly regarded as the soft Loans Window of the World Bank.

Objectives of IDA: The main objectives of the IDA are as follows:

- (i) To provide development finance to the less developed countries on easy and flexible terms.
- (ii) To promote economic development, increase productivity, and thus, raise the standard of living in the less developed countries.
- (iii) To supplement the objectives and activities of the World Bank.

#### **Organisational Structure of IDA**

The membership of the IDA is open to all the members of the World Bank. The members of the IDA are divided into two parts. Part I countries are developed countries which are required to pay their subscription in gold or freely convertible currencies. Part II countries are less developed countries which are required to pay on 10% of their subscription in gold or freely convertible currencies and the remaining 90% is payable in their domestic currencies. Nigeria falls in Part II. Legally and financially, IDA is a distinct entity from the World Bank, but is administratively managed by the same staff.

## **Financing Policy of IDA**

The IDA loans are different from the conventional loans, the following are the distinctive features of the financing policy of the IDA:

- (i) The IDA grants loans for projects whether they are directly productive or not.
- (ii) The IDA loans are interest free; only a nominal annual rate of 3.4% on the amounts withdrawn and outstanding is charged to meet the administrative expenses.
- (iii) The IDA loans are for long periods, i.e., for 50 years.
- (iv) There is a 10 years of grace and no amount is repayable during this period of grace. After this only 1% of the principal is to be repaid annually for 10 years and 3% annually for the remaining 30 years.
- (v) IDA loans are generally repayable in foreign exchange.
- (vi) IDA loans are granted to the government of the country concerned.

### **3.3 International Financial Corporation**

International Finance Corporation (IFC) was established in July 1956 as an affiliate of the World Bank to provide finance to the private sector.

The World Bank grants loans to the governments of the member countries or provides loan capital to the private enterprises out of the guarantee of the member governments. Moreover the World Bank does not provide risk capital. The IFC was established with the specific purpose of providing risk capital to the private enterprises in the less developed countries without government guarantee.

#### **IFC Organisation Structure**

Though the IFC is affiliated to the World Bank, but it is a separate legal entity with separate fund and functions. The membership of the Corporation is open only to the members of the World Bank. The organization of the Corporation is the same as that of the World Bank. The Board of Governors and the Executive Directors of the World Bank also function as the Board of Governors and the Executive Directors of the IFC. The Corporation started with the initial authorised capital of \$100 million which has been increased from time to time. The subscription quota of each member is proportionate to its share of subscription to the capital of the World Bank.



## **IFC Investment Policy**

The following are the main features of the investment policy of the IFC:

- (i) The IFC considers only those enterprises which are predominantly industrial and contribute to economic development of the country.
- (ii) The project to be financed by the IFC must be in the private sector and must be productive in nature
- (iii) Before making any investment, the Corporation satisfies itself that the enterprise has experienced and competent management.
- (iv) The IFC's loan will not be more than half of the capital needed for an enterprise.
- (v) The minimum investment to be made by the IFC to a single enterprise is fixed at \$ 100,000: no upper limit is fixed.
- (vi) The rate of interest for the IFC loan is determined by mutual negotiation, depending upon the degree of risk involved and other terms of investment.
- (vii) The IFC's loans are disbursed in lump-sum or in instalments and are repayable in a period of 5 to 15 years.

## **3.4 African Development Bank**

The African Development was formed under the auspices of the Economic Commission for Africa. Although the agreement establishing the bank was signed in Khartoum, Sudan on 4<sup>th</sup> August, 1963 and came into force about a year later, the actual operation commenced only in July, 1966. Its head office is located at Abidjan, Cote D'Ivoire.

### **Functions**

The bank's main functions as set forth in the statute establishing it are:

To use the resources at its disposal for financing of investment projects relating to the economic and social development of its members.

To undertake and participate in the selection, study and preparation of projects enterprises and activities contributing to such development

To mobilize both within Africa and outside Africa, resources for the financing of such investment programmes.

To promote investment in Africa of public and private capital in projects or programmes

To provide such technical assistance as may be needed in Africa for the study, preparation, financing and execution of development projects or programmes and

To undertake such other activities and provide such other activities as may advance its purpose

Sources of Finances: More specifically, the bank's ordinary capital resources come from the following sources:

- Subscribed capital by members
- Fund raised through borrowing by the bank
- Fund received in repayment of past loans
- Income derived from the bank's loans and guarantees
- Any other funds received that do not constitute special sources

### **Organizational Structure of ADB**

The consist of a Board of Governors , Board of Directors, a President, at least one Vice-President and other officers and staff. All powers of the bank are vested in the board of governors appointed by each member of the bank who exercises the voting power to which that member state is entitled. Each governor is entitled to a five year term, but can be re-appointed for another term.

### **SELF ASSESSMENT EXERCISES**

- i. Identify the objectives of IMF as an International Monetary Institution.
- ii. State the various Source of finance of African Development Bank.

## **4.0 CONCLUSION**

The students have learned in this unit various International financing agencies and their respective functions. We have also identified the various objectives the agencies are established to achieve. One of such objectives includes the provision of access for investment capital needed for infrastructure development in the member countries.

## **5.0 SUMMARY**

In this unit we have discuss and provides comprehensive explanation of the various International Financing agencies such as the International Monetary Fund (IMF), International Finance Corporation (IFC), International Development Association (IDA), and the African Development Bank (ADB). This analysis includes the objective, working structure as well as the sources of funding available.

## 6.0 TUTOR MARKED ASSIGNMENT

Briefly explain the IMF resources are generated.

### ANSWER TO SELF ASSESSMENT EXERCISES

- i. The main objectives of the International Monetary Fund are as follows:

To promote international monetary cooperation through a permanent institution that provides the machinery for consultation and collaboration on international monetary problems.

To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economy policy.

To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciations.

To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade

To give confidence to members by the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

In accordance with the above, to shorten the duration and lessen the degree of disequilibria in the international balance of payments of members.

- ii. The African Development Bank (ADB), source it finances from; subscribed capital by members, Fund raised through borrowing by the bank, Fund received in repayment of past loans, Income derived from the bank's loans and guarantees, and Any other funds received that do not constitute special sources

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## **UNIT 5 CORPORATE GOVERNANCE AND BANK OPERATIONS**

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### **1.0 INTRODUCTION**

This unit provides an introductory approach to the concept of Corporate Governance as relates to banking activities across the national frontiers. Explanations of the basic terms and mechanism for corporate governance enforcement were highlighted.

### **2.0 OBJECTIVES**

At the end of this unit, student should be able to:

- Understand the meaning of corporate governance
- Mechanism of corporate governance
- Parties to corporate governance

### **3.0 MAIN CONTENT**

#### **3.1 International Banking Defined**

Corporate governance is an interactive term with many definitions with each reflecting different perspectives on what corporate governance is, what it should be used for and the problems it should address . For some

people, corporate governance is about <sup>3</sup> the whole set of legal, cultural, and institutional arrangements that determine what corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated (Blair, 1995).

Others narrow the focus of governance to <sup>3</sup>the relationship among various participants (chief executive officer, management, shareholders, and employees) in determining the direction and performance of corporations (Monks and Minow, 1995). Still others narrow the focus even more and say corporate governance deals with <sup>3</sup>the way suppliers of finance assure themselves of getting a return on their investments (Shleifer and Vishny, 1997).

These different definitions of corporate governance reflect different perspectives on what corporate governance is, what it should do, and the problems it should address.

However, for the purpose of this course notwithstanding the diversity of the concept, corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way in which a bank is directed, administered or controlled. Corporate governance also includes the relationship among the many players involved (the stockholders) and the goals for which the bank is governed.

Corporate governance implies that the banks would manage its affairs with diligence, transparency, responsibility, and accountability and would maximize shareholders' wealth.

The term corporate governance in banking sector has come to mean two things; the process by which banks are directed and controlled; and a field in economics, which studies the many issues arising from the separation of ownership and controlled.

The corporate governance structure specifies the rules and procedures for making decisions on corporate affairs. It also provides the structure through which the bank objectives are set, as well as the means of attaining and monitoring the performance of those objectives.

### **3.2 Parties to Corporate Governance**

Parties involved in corporate governance include the regulatory body such as chief executive officer CEO, the Board of directors, management, and shareholders. Other stakeholders who take part include suppliers, employees, creditors, customers and the community at large.

In banks, the shareholder delegates decision rights to the managers to act in the principals' best interests. This separation of ownership from control implies a loss of effective control by shareholders over management decisions. Partly as a result of this separation between the two parties, a system of corporate governance controls is implemented to assist in aligning the incentives of managers with those of shareholders. With the significant increase in equity holdings of investors, there has been an opportunity for a reversal of the separation of ownership and control problems because ownership is not so diffuse.

A board of directors often plays a key role in corporate governance. It is their responsibility to endorse the bank's strategy, develop directional policy, appoint, supervise and remunerate senior executives and to ensure accountability of the bank to owners and authorities.

All parties to corporate governance have an interest whether direct or indirect, in the effective performance of the bank. Directors, workers and management receive salaries, benefits and reputation, while shareholders receive capital return. Customers receive goods and services; suppliers receive compensation for their goods and services. In return these individuals provide value in the form of natural, human, social and other forms of capital.

A key factor in an individual's decision to participate in bank or any organization e.g. through providing financial capital and trust that they will receive a fair share of the banks returns. If some parties are receiving more than their fair return then participants may choose to not continue participating leading to organizational collapse.

### **3.3 Principles of Corporate Governance in Commercial Banks**

Key elements of good corporate principles include honesty, trust and integrity, openness, performance orientation, responsibility, accountability, mutual respect and commitment to the organization.

Of importance is how directors and management develop a model of governance that aligns the values of the corporate participants and then evaluate this model periodically for its effectiveness. In particular senior executives should conduct themselves honestly and ethically, especially concerning actual or apparent conflicts of interest, and disclosure in financial reports.

Commonly accepted principles of corporate governance are:

**Right and equitable treatment of shareholders:** Banks should respect the right of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by communicating information that is understandable and accessible and encouraging shareholders to participate in annual general meetings. Fairness ensures that shareholders irrespective of the size of their shareholding are treated equally.

**Interests of other stakeholders:** Banks should recognize that they have legal and other obligations to all legitimate stakeholders. This can be achieved through accountability which requires that two major corporate organs board and management are accountable to the stakeholders in all their actions, inactions or even reactions

**Roles and responsibilities of the board:** The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfil its responsibilities and duties. There are issues about the appropriate mix executive and non-executive directors. The key roles of chairperson and CEO should not be held by the same person. Responsibility is one's obligation to discharge the duties assigned to the best of one's ability and in accordance with laid down procedures as well as instruction received.

**Integrity and ethical behaviour:** Banks should develop a code of conduct for their directors and executives that promotes ethical and responsibility decision-making. It is important to understand, though, that systemic reliance on integrity and ethics is bound to eventual failure. Because of this many banks establish compliance and ethics programs to minimize the risk that the firm steps outside of ethical and legal boundaries.

### **3.3.1 Mechanism and Controls**

Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. For example to monitor managers' behaviour, an independent third party (the auditor) attests the accuracy of information provided by management to investors. An ideal control system should regulate both motivation and ability.

### **3.3.2 Internal Corporate Governance Control**



Internal corporate governance controls monitor activities and then take corrective action to accomplish banks' goals. Examples include:

**Monitoring by the Board of Directors:** The director with its legal authority to hire and fire and compensate top management, safeguard investors' capital. Regular board meetings allow potential problems to be identified, discussed and avoided. Whilst non-executive directors are thought to be more independent, they may not always result in more effective corporate governance and may not increase performance. Different structures are optimal for different banks. Moreover, the ability of the board to monitor the firm's executives is a function of its access to information, executive directors look beyond the financial criteria.

**Remunerations:** Performance based remuneration is designed to create some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and shares options or other benefits. Such incentive schemes however are reactive in the sense that they provide no mechanism for preventing mistakes or opportunistic behaviour and can elicit myopic behaviour. Remuneration should be sufficient to attract, retain, and motivate directors required by the bank. In fact the remuneration of the directors should be fair, transparent as well as disclosed.

### **3.4 External Corporate Governance Controls**

External corporate governance controls encompass the controls external stakeholders exercise over the banks. Examples include:

- Debt Covenants
- Government regulations
- Media pressure
- Customers
- Takeovers
- Competition

### **3.5 Systemic Problems of Corporate Governance**

#### **Supply of Accounting Information**

Financial accounts form a crucial link in enabling providers of finance to monitor directors. Imperfections in the financial reporting process will cause imperfections in the effectiveness of corporate governance. This should, ideally, be correlated by the working of the external auditing process.

### **Demand for Information**

A barrier to shareholders using good information is the cost of processing it, especially to a small shareholder. The traditional answer to this problem is the efficient market hypothesis asserts that financial markets are efficient which suggests that the shareholder will free ride on the judgment of larger professional investors.

### **Monitoring Costs**

In order to influence the director the shareholders must combine with others to form a significant voting group which can pose a real threat of carrying resolutions or appointing directors at general meetings.

### **SELF ASSESSMENT EXERCISES**

- i. What is corporate Governance?
- ii. List the principles of a good Corporate Governance

## **4.0 CONCLUSION**

The students have learned in this unit that corporate governance in commercial banks is essentially concerned with way banks are governed.

Corporate governance became a field of study and practice out of the necessity emerging from increasing number of high profile corporate failures. Good corporate governance is simply those mechanisms at work within a bank that conform to the principles of transparency, fairness, accountability and responsibility.

## **5.0 SUMMARY**

Corporate governance as we have learnt is a concept synonymous with the process by which banks are directed and controlled; and a field in economics, which studies the many issues arising from the separation of ownership and controlled. Mechanisms for effective corporate governance are made up of internal and external control mechanisms.

However, ensuring effective corporate governance may impede inadequate supply of accounting information, demand for information, and monitoring costs.

## 6.0 TUTOR MARKED ASSIGNMENT

Briefly highlight mechanism of Corporate Governance as it relates to commercial banks.

### ANSWER TO SELF-ASSESSMENT EXERCISES

- i. Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way in which a bank is directed, administered or controlled. Corporate governance also includes the relationship among the many players involved (the stockholders) and the goals for which the bank is governed.
- ii. Some principles of good corporate governance are as follows

- Right and equitable treatment of shareholders
- Interests of other stakeholders
- Roles and responsibilities of the board
- Integrity and ethical behaviour
- Accountability
- Transparency

## 7.0 REFERENCES/FURTHER READINGS

Agrawal, A. and Knoeber, C. (1996). 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders.' *Journal of Financial and Quantitative Analysis* 31: 377-397.

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