UNIT 3. INTERNATIONAL ECONOMY AND BUSINESS

3.1 Getting started.

Since the 1970s the global environment has become increasingly unstable. In the 1960s a business could assume stable inflation, fixed exchange rates and stable oil prices. The governments of the major industrial economies successfully pursued macroeconomic policies, in the search of full and stable employment. These comfortable conditions no longer exist, and business must be prepared to respond to constant changes and fluctuations in all these variables, as well as fast changing consumer tastes.

National economies can no longer be isolated from change elsewhere, and in this sense every business, however small, is operating in global environment. It must be prepared for the sudden appearance of a new competing product or service, probably from another country, at any time. It follows that business planning must take international factors into account. Thus senior managers must be aware of changes in the following variables:

- the national economy's performance in the world economy;
- major changes occurring in world markets;
- major changes in key economic variables, e.g. oil prices, exchange rates, etc.
- nature and role of multinational firms, and their current strategies;
- government economic policy on exchange rate and Balance of Payments issues, etc.

Discuss the following points.

1. What do you think were the reasons for the great changes in the global environment which has become increasingly unstable since the 1970s?
2. Why do you think business planning must take international factors into account?

3.2 Look through the following vocabulary notes which will help you understand the text and discuss the topic.

an exchange rate a fixed exchange rate a floating exchange rate	обменный (валютный) курс фиксированный обменный курс плавающий обменный курс
stable ant. unstable	стабильный нестабильный
a taste	вкус, предпочтение
to take into account	принять во внимание, учесть
global environment	глобальная среда
a balance of payments	платежный баланс
an advance, advances in advance to advance advanced	увеличение, аванс, достижения заранее двигать(ся) вперед продвинутый
to compare in comparison with a comparative advantage	сравнивать по сравнению с сравнительное преимущество
free trade	свободная торговля
artificial barriers	искусственные барьеры
a flow of smth	движение, поток, перемещение
GATT	Генеральное соглашение по тарифам и торговле
WTO	Всемирная торговая организация
to result in smth	привести к чему-либо
to protect protection protectionism	защитить защита протекционизм
a cost advantage	преимущество по затратам
to penetrate	проникать
fair ant. unfair	честный, справедливый нечестный, несправедливый
a means, means by means of	средство, средства с помощью, посредством
dumping	дэмпинг
at below cost	ниже себестоимости

a hard currency	твердая валюта
to induce, syn. to encourage	побуждать, стимулировать
to be a case in point	послужить примером, демонстрировать
to run smth down	снижать, уменьшать, ликвидировать
overt, ant. covert	открытый, скрытый
to procure procurement	обеспечить обеспечение
the Current Account the Capital Account	текущий счет счет движения капиталов
visibles, syn. goods invisibles, syn. services	товары услуги
an asset a real asset a financial asset	актив материальный актив финансовый актив
a Balance of Payments surplus a Balance of Payments deficit	профицит платежного баланса дефицит платежного баланса
to sustain	поддерживать, выдерживать
to exhaust	исчерпать, истощить
to withdraw a withdrawal of money	снять, потребовать, отозвать снятие денег
deflation	дефляция
devaluation	девальвация
depreciation	обесценивание
voluntary export restraint	добровольное ограничение экспорта
a facility, facilities to facilitate	возможность, возможности, (банк.) услуги; облегчить, способствовать
to anticipate anticipation	ожидать, предчувствовать ожидание, предположение
a forward market	форвардный рынок, срочные сделки
on equal terms	на равных условиях

3.3 Reading

The Essential Principles of International Trade

The basic economic process is the allocation of scarce resources to different uses in order to satisfy wants and needs. Advances in technology and transport have made possible the use of more kinds of resources, from all parts of the world. The growth of advanced economies has been based on the exploitation of resources on a global scale, in other words on the process of international trade.

There are potential benefits from specialization and trade. International trade has the effect of enabling countries to consume some goods and services cheaply by importing them, as well as gaining access to some products which would otherwise be unavailable. It also has the effect of encouraging the reallocation of resources away from activities best served by imports into activities where the country has achieved a comparative cost advantage.

The benefits of world trade are optimized in conditions of Free Trade, where no artificial barriers to the flow of goods, services, labor or capital occur. Completely free trade conditions have never existed, but since 1945, as a result of the work of the General Agreement on Tariffs and Trade (GATT) and successively the World Trade Organization (WTO), relatively free conditions have existed, resulting in the growth of trade and of world GDP.

Governments seek to protect key industries from competition by imports from countries with a cost advantage. It is undertaken particularly when such industries are seen as having key strategic or political significance. Such significance may be military or in terms of employment. Protectionism will also be undertaken when a country feels that its competitors are penetrating its markets by “unfair” means. One example is “dumping” products at below cost in order to earn hard currency. Protectionism is also often undertaken to protect “infant” industries. These are newly developed industries which are unable to compete on equal terms in world trade due to a lack of economies of scale. Third world countries may seek to induce growth by industrialization. India has been a case in point. Conversely mature economies may seek to protect old and inefficient industries either for strategic reasons, or to lessen the pains of structural change involved in running them down; European textile industries are a case in point.

Protection takes a number of forms. The most obvious is the use of tariffs on imports and quotas. In manufacturing industries these are less easy to use as a result of GATT and WTO agreements. Tariffs and quotas have been largely replaced by “covert” measures which are not covered by agreements. Such measures include the use of direct government subsidies to industries, government procurement policies favoring domestic suppliers and other measures. Protectionism is motivated by self interest, and is damaging to trading partners. If continued, it could stifle world trade and economic growth.

A country's balance of payments is the financial record of trade and capital flows between this country and the rest of the world. It is divided into Current and Capital accounts. The Current Account is a summary of trade transactions with other countries in goods (visibles) and services (invisibles). The Capital Account records all transactions in assets, real or financial. Movements of official reserves and other official currency flows are the total of Official Financing, which is required after the summation of the current and capital accounts.

A balance of payments surplus is effectively an injection of money into the economy. A balance of payments deficit is a withdrawal of money from the economy. A balance of payments deficit cannot be sustained indefinitely. In the short term it will be financed by running down reserves or borrowing from abroad. But persistent deficits will soon exhaust these resources and other measures will have to be taken, e.g. deflation, devaluation or depreciation. Among other measures are those we have already mentioned: tariffs, quotas, voluntary export restraint agreements (VERs). Governments also try to make it more difficult for capital to leave the country or encourage exports by generous credit facilities.

International trade requires buyers to make payments in different currencies: in the seller's currency, in the buyer's currency or in a third hard currency. Here comes the problem of exchange rates. An exchange rate is the rate at which one country's currency is exchanged for another. It is clearly of great importance to all businesses, but especially to those dependent on exports or using imported inputs. Movements in the exchange rate may wipe out profit margins, even where a firm has sought to anticipate or limit such fluctuations by using the forward markets.

3.4 Comprehension

3.4.1 Answer the questions using the active vocabulary.

1. How can you define the basic economic process?
2. What do you think facilitated the development of international trade?
3. W hat are the reasons for international trade?
4. What are the benefits of specialization and trade?
5. How can you define the concept of ‘comparative cost advantage’?
6. What is Free Trade? Describe the main features of it.
7. Does Free Trade really exist? Why or why not?
8. What was the mission of GATT? What organization succeeded to it?
9. How can you define the concept of ‘protectionism’?
10. What are the reasons for governments’ seeking to protect domestic industries?
11. What is dumping? Do you think it is legal to use dumping in free trade?
12. Could you give your own examples of protectionism in different countries?
13. What are the most widely used forms of protectionism?
14. Protectionism is ‘a mixed blessing’, isn’t it? Sum up the advantages and disadvantages of it.
15. What is a country’s Balance of Payments?
16. What is the difference between the Current Account and the Capital Account?
17. Does the balance of payments surplus mean that there is a net inflow of money into the economy?
18. How can a balance of payments deficit be eliminated?

19. What measures can governments take to remove the balance of payments deficit after the reserves have been exhausted?
20. What currencies can be used to make payments in international trade?
21. What is an exchange rate? Why is it of great importance to all businesses?

3.4.2 Mark these statements T(true) or F(false) according to the information in the text. If they are false say why.

1. All nations have sufficient amounts of resources to satisfy their wants and needs.
2. Exploitation of resources on a global scale is impossible without international trade.
3. The more the country is involved in international trade the less advanced it is.
4. International trade is impossible without specialization.
5. Different economies specialize in what they can do best and cheapest. Thus they derive a comparative cost advantage and benefit from it.
6. International trade has the effect of enabling countries to import some expensive goods and services rather than export them cheaply.
7. Since 1945, as a result of the work of the General Agreement on Tariffs and Trade (GATT) and successively the World Trade Organization (WTO), completely free conditions have existed, resulting in the growth of trade and of world GDP.
8. Governments with a cost advantage seek to protect key industries from competition by imports from other countries.
9. Dumping is an example of protectionism.
10. Dumping is an example of ‘unfair’ competition.
11. Third world countries may seek to induce growth by protecting their ‘infant’ industries.
12. European textile industries have been protected by governments for strategic reasons.
13. Tariffs and quotas have been largely covered by the WTO agreements.

14. Direct government subsidies to industries, government procurement policies favoring domestic suppliers and other ‘covert’ measures have replaced tariffs on imports and quotas.
15. The Current Account is a summary of all transactions in assets, real or financial.
16. A balance of payments deficit is an imbalance in a nation's balance of payments in which payments made by the country exceed payments received by the country.
17. A balance of payments proficit is considered unfavorable because more currency is flowing out of the country than is flowing in.
18. Deflation, devaluation or depreciation are used to fight against a persistent balance of payments deficit.
19. Governments also try to make it more difficult for capital to leave the country or encourage exports by generous credit facilities to fight against a persistent balance of payments deficit.
20. An exchange rate is the price of one currency expressed in another currency.
21. Movements in the exchange rate facilitate international trade.

3.5 Language practice

3.5.1 Match the English terms in the left-hand column with the definition in the right-hand column.

1	An exchange rate	A	It refers to a globally traded currency that can serve as a reliable and stable store of value.
2	A cost advantage	B	An accounting record of all monetary transactions between a country and the rest of the world.
3	A forward market	C	An imbalance in a nation's balance of payments in which payments made by the country exceed payments received by the country.
4	A real asset	D	A type of exchange rate

			regime wherein a currency's value is allowed to fluctuate according to the foreign exchange market.
5	A hard currency	E	A decrease in the value of a particular currency relative to other currencies.
6	A financial asset	F	Price for which the currency of a country can be exchanged for another country’s currency.
7	A comparative cost advantage	G	A reduction in the value of a currency with respect to those goods, services or other monetary units with which that currency can be exchanged.
8	Deflation	H	The pricing of a product below its cost of production.
9	A balance of payments deficit	I	A system of trade policy that allows traders to act and or transact without interference from government.
10	A floating exchange rate	J	Physical or identifiable assets such as gold, land, equipment, patents, etc.
11	Depreciation	K	A decrease in the general price level of goods and services.
12	Free trade	L	Superiority achieved through factors such as access to cheaper inputs, efficient processes, favorable location, skilled workforce, superior technology, and / or waste reduction.
13	A Balance of Payments	M	An asset that derives value because of a contractual

			claim e.g. stocks, bonds, bank deposits, and the like.
14	Dumping	N	The over-the-counter financial market in contracts for future delivery, so called forward contracts.
15	Devaluation	O	The ability of an individual, country, region, or group to produce a good or service at a lower opportunity cost than that of a competing group/individual.

3.5.2 Complete the following text using suitable words or phrases from the box below.

A	supply of money	F	currency
B	balance of payments	G	deficit
C	inflation	H	source
D	imbalance	I	economy
E	trade	J	exchange rate

Unfavorable Balance of Payments

It is described as an ____1____ in a nation's balance of payments in which payments made by the country exceed payments received by the country. This is also termed a balance of payments ____2____. It's considered unfavorable because more ____3____ is flowing out of the country than is flowing in. Such an unequal flow of currency will reduce the ____4____ in the nation and subsequently cause an increase in the ____5____ relative to the currencies of other nations. This then has implications for ____6____, unemployment, production, and other facets of the domestic ____7____. A balance of ____8____ deficit is often the ____9____ of a balance of payments deficit, but other payments can turn a balance of trade deficit into a ____10____ surplus.

3.5.3 Complete the text. Replace the Russian words and phrases by English equivalents.

Fixed and Floating Rates

For 25 years after World War II, the levels of most major currencies ***определялись правительствами***. They were fixed against the US dollar, and the dollar was fixed against gold. One dollar was worth one thirty-fifth of an ounce of gold, and the US Federal Reserve ***гарантировала*** that they could ***обменять*** an ounce of gold for $35. ***Эта система была известна*** as gold convertability. Fixing against the dollar ended in 1971, because following ***инфляция*** in the USA, the Federal Reserve did not have enough ***золота*** to guarantee the ***американскую валюту***.

Since the early 1970s, there has been ***система плавающих валютных курсов*** in most western countries. This means that ***валютные курсы определяются*** by people ***покупающими и продающими валюту*** in the foreign exchange markets. A freely ***плавающий валютный курс*** means one which is determined by ***рыночными силами***: the level of ***спроса и предложения***. If there are more ***покупателей*** of a currency than ***продавцов***, its price ***поднимется***; if there are more sellers, it ***упадет***.

3.5.4 Text for discussion.

a. Look up the dictionary for the meaning and pronunciation of the following words and word-combinations and use them to discuss the problems outlined in the text.

Assessment, currency fluctuations, relative inflation rates, currency supply, to pursue policies, gradual reduction in the value of the currency, to be retarded, capital investments, to be deterred, speculators, to guess wrongly, to guess correctly, adjustment of a balance of payments, volatility of currencies, capital movements.

b. Briefly scan the text and outline the list of major points.

c. Read the text more carefully and comment on the following items:

-The major benefits of floating exchange rates.

-The major problems of floating exchange rates.

-The process of balance of payments adjustment under floating exchange rates.

Assessment of Floating Exchange Rates

With floating exchange rates, currency fluctuations take the place of balance of payments problems. If a country's relative inflation rates rise it becomes less competitive than before and suffers a balance of payments deficit. As imports increase and exports decrease, the supply of the domestic currency increases and the demand for it decreases too. Thus the value of the domestic currency falls, raising the price of imports and reducing the price of exports. The fall will continue until the value of imports and exports is once again the same. In this way, balance of payments problems are corrected automatically. This allows a government to pursue those domestic policies which they believe are most useful for employment and economic growth. Besides, floating exchange rates allow for gradual reduction in the value of a currency.

The development of international trade may be retarded by fluctuations in exchange rates. Even small changes may turn a profit on export into a loss. Long term international capital investments may also be deterred by uncertainties over the future levels of exchange rates. Speculation on exchange rate movements may rise, not fall, due to volatility of currencies. Although speculators may now 'lose' if they guess a future change in the exchange rate wrongly, there will be more changes and so more opportunities for 'gains' if they guess correctly. The activities of such speculators can actually help to stabilize the market. Fluctuations in exchange rates may occur for reasons other than the flow of goods in international trade; for example, due to large capital movements.

3.6 Render the passage in English using the English equivalents of the italicized phrases given in Russian. Express the main idea of the passage in one sentence.

Почему меняются валютные курсы?

Валютный курс – это цена одной валюты, *выраженная* **(expressed)** в другой валюте. В теории валютные курсы должны быть на уровне, который дает *паритет покупательной способности* **(purchasing power parity)**. Это означает, что стоимость *данного набора* **(a given selection)** товаров и услуг должна быть *одинаковой* **(the same)** в разных странах. *На самом деле* **(in fact)**, механизм, дающий паритет покупательной способности, не работает, так как валютные курсы могут менятся *вследствие* **(due to)** *валютных спекуляций* **(currency speculation)** **–** покупка валют *в надежде* **(in the hope of)** сделать прибыль. Финансовые институты, компании и богатые физические лица – все покупают валюты *в расчете на* **(looking for)** высокие процентные ставки или *краткосрочный прирост капитала* **(short-term capital gains)**, если валюта *подорожает* **(increases in value)**. Это *означает* **(means)**, что валютные курсы меняются *вследствие* **(due to)** спекуляций *скорее чем* **(rather than)** паритета покупательной способности. *Более* **(over)** 95% *валютных операций* **(currency transactions)** в мире *являются чисто спекулятивными* **(are purely speculative)** и *не имеют отношения к* **(are not related to)** международной торговле. Банки и *валютные трейдеры* **(currency traders)** зарабатывают большую прибыль *на разнице* **(from the spread)** между *ценой покупки* **(the buying price)** и *ценой продажи* **(the selling price)** валюты.

Unit 3 Reading Self – Control Test
The Essential Principles of International Trade

1. Which of the following is the main idea of the text?

(A) Patterns of trade
(B) Benefits of trade
(C) Freeing trade
(D) World trade basics

2. Judging by the economic information in the text which you have familiarized yourself with international trade is

(A) unrestricted trade generally beneficial to a trading country.

(B) considered the first of four levels of integration among nations (see common market, customs union, economic union for the other levels).

(C) buying an asset with the intent of reselling it later at a higher price.

(D) is exchange of capital, goods, and services across international borders or territories.

3. It can be derived from the text that free trade is

(A) considered the first of four levels of integration among nations (see common market, customs union, economic union for the other levels).

(B) the process of trading one item for another.

(C) unrestricted trade generally beneficial to a trading country.

(D) is exchange of capital, goods, and services across international borders or territories.

4. It can be inferred from the text that protectionism

(A) is the process of dividing up and distributing available, limited resources to competing, alternative uses that satisfy unlimited wants and needs.

(B) is the economic policy of restraining trade between states through methods such as tariffs, quotas on imported goods, and a variety of other government regulations designed to prevent foreign take-over of domestic markets and companies.

(C) is the condition in which resources are primarily devoted to specific tasks.

(D) is limiting macroeconomic fluctuations in prices, employment, and production.

5. Which measure according to the information in the text is not meant to help domestic producers?

(A) government procurement policies favoring foreign suppliers with a cost advantage.

(B) the use of tariffs on imports and quotas.

(C) “dumping” products at below cost in order to earn hard currency.

(D) the use of direct government subsidies to industries.

6. It can be derived from the text that a balance of payments surplus is

(A) a leakage of money out of the economy.

(B) a withdrawal of money from the economy.

(C) running down reserves or borrowing from abroad.

(D) effectively an injection of money into the economy.

7. It can be conferred from the text that the Current Account

(A) records all transactions in assets, real or financial.

(B) is a summary of import and export transactions of the country.

(C) is a record of all purchases of physical and financial assets between a nation and the rest of the world in a given period, usually one year.

(D) is referred to as a trading account.

8. Which of the following statements would the author most probably agree with?

(A) A balance of payments proficit is considered unfavorable because more currency is flowing out of the country than is flowing in.

(B) The Current Account is a summary of all transactions in assets, real or financial.

(C) A balance of payments deficit is an imbalance in a nation's balance of payments in which payments made by the country exceed payments received by the country.

(D) A country’s balance of payments Current Account can be referred to as an active trading account.

9. Which of the following statements would the author most probably disagree with?

(A) Movements in the exchange rate facilitate international trade.

(B) The exchange rate is specified as the amount of one currency that can be traded per unit of another.

(C) International division of labor lays the basis for international trade.

(D) International trade arises for a number of reasons: scarcity of resources, innovation and style, reallocation of resources, etc.

10. What is most likely the subject of the extract which is missing from this text?

(A) the political environment

(B) remedies for balance of payments problems

(C) the social environment

(D) consumer protection

Unit 3 Glossary

ALLOCATION: The process of distributing resources for the production of goods and services, and of distributing goods and services for consumption by households. This process of allocation is essential to an economy's effort to address the problem of scarcity. An allocation is efficient if the resources, goods, and services are distributed according to the economy's highest valued uses.

ASSET: Something that you own. For a person, assets can be financial, like money, stocks, bonds, bank accounts, and government securities, or they can be physical things, like cars, boats, houses, clothes, food, and land. The important assets for our economy are the output we have produced and the resources, capital, and natural resources used to produce that output.

Foreign currencies deposited in banks outside the home country.

BOND RATING: A measure of the ability of a firm to meet its debt obligations or credit worthiness. Basically, a bond rating summarizes the assessment of a firm's net worth, cash flow and viability of projects so that investors can assign the size of the default-risk premium to the bond. These measurements are so important that investors frequently pay professional analysts to collect, monitor and process information about firms.

BUY-SELL SPREAD: (also known as **bid/ask** or **bid/offer spread**) for securities (such as stocks, futures contracts, options, or currency pairs) is the difference between the prices quoted (either by a single market maker or in a limit order book) for an immediate sale (ask) and an immediate purchase (bid). The size of the bid-offer spread in a security is one measure of the liquidity of the market and of the size of the transaction cost.

CAPITAL ACCOUNT: One of two parts of a nation's balance of payments. The capital account is a record of all purchases of physical and financial assets between a nation and the rest of the world in a given period, usually one year. On one side of the balance of payments ledger account are all of the foreign assets purchase by our domestic economy. On the other side of the ledger are all of our domestic assets purchased by foreign countries. The capital account is said to have a surplus if a nation's investments abroad are greater than foreign investments at home. In other words, if the good old U. S. of A. is buying up more assets in Mexico, Brazil, and Hungry, than Japanese, Germany, and Canada investors are buying up of good old U. S. assets, then we have a surplus. A deficit is the reverse.

CAPITAL ACCOUNT DEFICIT: An imbalance in a nation's balance of payments capital account in which payments made by the country for purchasing foreign assets exceed payments received by the country for selling domestic assets. In other words, investment by the domestic economy in foreign assets is less than foreign investment in domestic assets. This is generally not a desirable situation for a domestic economy. However, in the wacky world of international economics, a capital account deficit is often balanced by a current account surplus, which is generally considered a desirable situation. If, however, the current account does not balance out the capital account, then a capital account deficit contributes to a balance of payments deficit.

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COMPETITION: In general, the actions of two or more rivals in pursuit of the same objective. In the context of markets, the specific objective is either selling goods to buyers or alternatively buying goods from sellers. Competition tends to come in two varieties -- competition among the few, which is market with a small number of sellers (or buyers), such that each seller (or buyer) has some degree of market control, and competition among the many, which is a market with so many buyers and sellers that none is able to influence the market price or quantity exchanged.

COST: Best referred to as opportunity cost, this is the highest valued alternative foregone in the pursuit of an activity. This is a hallmark of anything dealing with economics -- or life for that matter -- because any action that you take prevents you from doing something else. The value expressed in terms of satisfaction of the foregone activity is your opportunity cost. Because there are usually several alternatives that aren't pursued, opportunity cost is the highest-valued one. An opportunity cost is sometimes compensated with some form of payment, like a wage. However, the existence of an opportunity cost is independent of any actual cash outlay.

CURRENCY: Paper usually issued by the national government that is used as money. Metal coins are also frequently included under the generic heading of currency. Currency in the U.S. economy is issued by the Federal Reserve System (paper) and the U.S. Treasury (coins). This constitutes about 30 to 40 percent of the M1 money supply.

CURRENT ACCOUNT: One of two parts of a nation's balance of payments (the other is capital account). It is a record of all trade, exports and imports, between a nation and the rest of the world. The current account is separated into merchandise, services, and what's called unilateral transfers. The merchandise part is nothing other than the well-known balance of trade. There's also a lesser known balance of services -- the difference between services imported and exported.

CURRENT ACCOUNT DEFICIT: An imbalance in a nation's balance of payments current account in which payments received by the country for selling domestic exports are less than payments made by the country for purchasing imports. In other words, imports (of goods and services) by the domestic economy are greater than exports (of goods and services). This is generally a not desirable situation for a domestic economy. However, in the wacky world of international economics, a current account deficit is often balanced by a capital account surplus, which is generally considered a desirable situation. If, however, the capital account does not balance out the current account, then a current account deficit contributes to a balance of payments deficit.

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DEFLATION: An extended decline in the average level of prices. This is the exact opposite of inflation--in which prices are rising over an extended period, and it should be contrasted with disinflation--which is a decline in the inflation rate. Like inflation, deflation occurs when the AVERAGE price level decreases over time. While some prices might decrease, other prices could increase or remain unchanged, so long as the AVERAGE follows a downward trend. Deflation is a rare bird indeed in our economy and typically happens only when we're in a prolonged period of stagnation. We might see some deflation during a fairly lengthy recession, but more than likely deflation saves itself for the occasional depression that dots our economic landscape.

DEPRECIATION: A more or less permanent decrease in value or price. "More or less permanent" doesn't include temporary, short-term drops in price that are common in many markets. It's only those price declines that reflect a reduction in consumer satisfaction. While all sorts of stuff can depreciate in value, some of the more common ones are capital, real estate, corporate stock, and money. The depreciation of capital results from the rigors of production and affects our economy's ability to produce stuff. A sizable portion of our annual investment is thus needed to replace depreciated capital. The depreciation of a nation's money is seen as an increase in the exchange rate. This process is described in detail in the entry on the J curve.

DEVALUATION: It is a reduction in the value of a currency with respect to those goods, services or other monetary units with which that currency can be exchanged. In common modern usage, it specifically implies an official lowering of the value of a country's currency within a fixed exchange rate system, by which the monetary authority formally sets a new fixed rate with respect to a foreign reference currency. In contrast, depreciation is used for the unofficial decrease in the exchange rate in a floating exchange rate system. The opposite of devaluation is called revaluation.

EXCHANGE RATE: The price of one nation's currency in terms of another nation's currency. This is often called the foreign exchange rate in that it is the price determined in the foreign exchange market when people buy and sell foreign exchange. The exchange rate is specified as the amount of one currency that can be traded per unit of another.

EXCHANGE: The process of trading one item for another. Exchange is fundamental to the study of economics, markets, and market-oriented economies. Most exchanges in a modern, complex market-oriented economy involve a commodity on one side and a monetary payment (that is, price) on the other. In essence, a buyer gives up money and gets a good, while a seller gives up a good and gets money.

EXPORT: The sale of goods to a foreign country. The United States, for example, sells a lot of the stuff produced within our boundaries to other countries, including wheat, beef, cars, furniture, and, well, almost every variety of product you care to name. In general, domestic producers (and their workers) are elated with the prospect of selling their goods to foreign countries--leading to more buyers, a higher price, and more profit. The higher price, however, is bad for domestic consumers. In that domestic consumers tend to have far less political clout than producers, very few criticisms of exports can be heard. On the positive side, though, exports do tend to add to the multiplicative, cumulatively reinforcing expansion of production and income (that is, the multiplier).

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FAVOURABLE BALANCE OF PAYMENTS: An imbalance in a nation's balance of payments in which payments made by the country are less than payments received by the country. This is also termed a balance of payments surplus. It's considered favorable because more currency is flowing into the country than is flowing out. Such an unequal flow of currency will expand the supply of money in the nation and subsequently cause a decrease in the exchange rate relative to the currencies of other nations. This then has implications for inflation, unemployment, production, and other facets of the domestic economy. A balance of trade surplus is often the source of a balance of payments surplus, but other payments can turn a balance of trade surplus into a balance of payments deficit.

FEDERAL RESERVE SYSTEM (also known as the **Federal Reserve**, and informally as **The Fed**): It is the central banking system of the United States. It was created in 1913 with the enactment of the Federal Reserve Act, largely in response to a series of financial panics, particularly a severe panic in 1907. Over time, the roles and responsibilities of the Federal Reserve System have expanded and its structure has evolved. Events such as the Great Depression were major factors leading to changes in the system. Its duties today, according to official Federal Reserve documentation, are to conduct the nation's monetary policy, supervise and regulate banking institutions, maintain the stability of the financial system and provide financial services to depository institutions, the US government, and foreign official institutions.

FINANCIAL ASSETS: These are assets that derive value because of a contractual claim. Stocks, bonds, bank deposits, and the like are all examples of financial assets. Unlike land and property--which are tangible, physical assets--financial assets do not necessarily have physical worth.

FIXED EXCHANGE RATE: A country's exchange rate regime under which the government or central bank ties the official exchange rate to another country's currency (or the price of gold). The purpose of a fixed exchange rate system is to maintain a country's currency value within a very narrow band. Also known as pegged exchange rate.

FLOATING EXCHANGE RATE: A country's exchange rate regime where its currency is set by the foreign-exchange market through supply and demand for that particular currency relative to other currencies. Thus, floating exchange rates change freely and are determined by trading in the Forex market. This is in contrast to a "fixed exchange rate" regime.

FOREIGN EXCHANGE MARKET (**forex**, **FX**, or **currency market**): It is a worldwide decentralized over-the-counter financial market for the trading of currencies. Financial centers around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekends. The foreign exchange market determines the relative values of different currencies.

FORWARD MARKET: It is the over-the-counter financial market in contracts for future delivery, so called forward contracts. Forward contracts are personalized between parties (i.e., delivery time and amount are determined between seller and customer). The forward market is a general term used to describe the informal market by which these contracts are entered into. Standardized forward contracts are called futures contracts and traded on a futures exchange.

FREE TRADE: The absence of trade barriers, or restrictions on foreign trade. Based on the notion of comparative advantage, unrestricted trade is generally beneficial to a trading country. However, while consumers benefit through a greater selection of products and lower prices, producers in a country are on the receiving end of lower prices and stiffer competition. In that producers tend to have more political clout than consumers, completely, unhindered free trade is seldom seen in the real world. Numerous trade restrictions such as tariffs, nontariff barriers, and quotas are usually the rule of the day (also the rule of the week, year, decade and century).

FREE-TRADE AREA: An agreement among two or more nations to eliminate trade barriers with each other. There is no attempt, however, to adopt a common trade policy with other nations, to allow free movement of resources among the countries, or to adopt common monetary or fiscal policies. This is considered the first of four levels of integration among nations. See common market, customs union, economic union for the other levels.

GATT: The abbreviation for the General Agreement on Tariffs and Trade. A treaty, signed in 1947 by 23 countries including the United States, that was designed to reduce trade barriers. It now carries the signatures of about 100 countries and over the years has been pretty darn effective in reducing tariffs, eliminating some import quotas, and promoting commerce.

GOLD CONVERTABILITY: It is the ease with which a country's currency can be converted into gold or another currency. Convertibility is extremely important for international commerce. When a currency in inconvertible, it poses a risk and barrier to trade with foreigners who have no need for the domestic currency.

IMPORT: Goods and services produced by the foreign sector and purchased by the domestic economy. In other words, imports are goods purchased from other countries. The United States, for example, buys a lot of the stuff produced within the boundaries of other countries, including bananas, coffee, cars, chocolate, computers, and, well, a lot of other products. Imports, together with exports, are the essence of foreign trade--goods and services that are traded among the citizens of different nations. Imports and exports are frequently combined into a single term, net exports (exports minus imports).

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INDUSTRY: A group of firms producing goods or services that are close substitutes-in-consumption. The similarity of the products makes it possible to analyze the production in a market framework. An industry can be broadly defined, such as the manufacturing industry, or narrowly specified, such as the root beer industry. For most economic analysis the term industry is used interchangeably with the term market.

INFLATION: A persistent increase in the average price level in the economy. Inflation occurs when the AVERAGE price level (that is, prices IN GENERAL) increases over time. This does NOT mean that ALL prices increase the same, nor that ALL prices necessarily increase. Some prices might increase a lot, others a little, and still other prices decrease or remain unchanged. Inflation results when the AVERAGE of these assorted prices follows an upward trend. Inflation is the most common phenomenon associated with the price level.

PURCHASING POWER PARITY (PPP): It is a theory of long-term equilibrium exchange rates based on relative price levels of two countries. The idea originated in the 16th century and was developed in its modern form by Gustav Cassel in 1918. The concept is founded on the law of one price; the idea that in absence of transaction costs, identical goods will have the same price in different markets. In its "absolute" version, the purchasing power of different currencies is equalized for a given basket of goods.

QUOTA: A limit on the quantity of some sort of activity. Two of the more noted quotas are for employment and imports. Employment quotas have been used as a means of providing increased opportunities to blacks, hispanics, women, and other groups that have been historically subject to discrimination. Such quotas, however, tend to anger other groups, especially white males, who don't get favorable treatment. While employment or similar anti-discrimination quota systems might help address historical problems, they are not without cost. In particular, our economy's efficiency is likely to suffer if a less qualified member of an ethnic group is selected over someone who is more qualified. Import quotas have similar problems. They are one form of trade barriers that's usually intended to reduce the competition faced by a domestic producer.

REAL ASSETS: These are physical or identifiable assets such as gold, land, equipment, patents, etc. They are the opposite of a financial asset. Real assets tend to be most desirable during periods of high inflation.

RESOURCE ALLOCATION: The process of dividing up and distributing available, limited resources to competing, alternative uses that satisfy unlimited wants and needs. Given that world is rampant with scarcity (unlimited wants and needs, but limited resources), every want and need cannot be satisfied with available resources. Choices have to be made. Some wants and needs are satisfied, some are not. These choices, these decisions are the resource allocation process. An efficient resource allocation exists if society has achieved the highest possible level of satisfaction of wants and needs from the available resources and resources cannot be allocated differently to achieve any greater satisfaction.

SPECIALIZATION: The condition in which resources are primarily devoted to specific tasks. This is one of THE most important and most fundamental notions in the study of economics. Civilized human beings have long recognized that limited resources can be more effectively used in the production the goods and services that satisfy unlimited wants and needs if those resources specialize. For example, three ice cream parlor workers, can be, in total, more productive if one runs the cash register, another scoops the ice cream, and a third adds the hot fudge topping. By devoting their energies to learning how to do their respective tasks really, really well, these three workers can produce more hot fudge sundaes than if each performed all required tasks.

SPECULATION: Buying an asset with the intent of reselling it later at a higher price. The purpose of speculation is simply to buy low today and sell high tomorrow. Those who engage in speculation have no reason for buying the asset, other than resale at a later time. Such speculation is quite common in most financial markets (futures markets are a particular favorite), but it's also a motive for those who have "investments" in fine art, baseball cards, coins, and real estate.

STABILITY: Limiting macroeconomic fluctuations in prices, employment, and production. This is one of the five economic goals, specifically one of the three macro goals (the other two are economic growth and full employment). One primary focus of this stability goal is to keep inflation in check. High or unpredictable inflation rates can cause uncertainty and haphazardly redistribute income and wealth.

SUBSIDY: A payment from government to individuals or businesses without any expectations of production. The best way of thinking about a subsidy is as a negative tax. Government extends subsidies for many different reasons. They go to students, unemployed workers, the poor, farmers, wealthy friends of political leaders, businesses trying to fend off foreign competitors, and the list could go on. Subsidies are frequently used to redirect resources from one good to another. Sometimes this is justified on efficiency grounds and other times it's just the result of political power.

TARIFF: A tax that's usually on imports, but occasionally (very rarely) on exports. This is one form of trade barrier that's intended to restrict imports into a country. Unlike nontariff barriers and quotas which increase prices and thus revenue received by domestic producers, a tariff generates revenue for the government. Most pointy-headed economists who spend their waking hours pondering the plight of foreign trade contend that the best way to restrict trade, if that's what you want to do, is through a tariff.

THIRD-WORLD COUNTRY: A country with a relatively low standard of living and which lacks the economic development of more advanced industrialized nations like the United States. Most third-world countries are in Africa, Asia, and South America and often rise to newsworthy prominence when they have a famine, are overthrown by a military dictator, or are invaded by a more developed country. They tend to have high rates of population growth and limited success in doing what's necessary to achieve economic growth.

UNFAIR COMPETITION: A wide assortment of business practices that are deceptive and dishonest, and usually hamper competition. Examples of unfair competition include false or misleading advertising, price discrimination, bribery, and even industrial espionage. These practices and many, many more are illegal according to antitrust law, specifically the Federal Trade Commission Act (1914).

UNFAVOURABLE BALANCE OF PAYMENTS: An imbalance in a nation's balance of payments in which payments made by the country exceed payments received by the country. This is also termed a balance of payments deficit. It's considered unfavorable because more currency is flowing out of the country than is flowing in. Such an unequal flow of currency will reduce the supply of money in the nation and subsequently cause an increase in the exchange rate relative to the currencies of other nations. This then has implications for inflation, unemployment, production, and other facets of the domestic economy. A balance of trade deficit is often the source of a balance of payments deficit, but other payments can turn a balance of trade deficit into a balance of payments surplus.

URUGUAY ROUND: The eighth and final round of General Agreement on Tariffs and Trade (GATT) negotiations that is most noted for establishing the World Trade Organization (WTO) to replace GATT. The Uruguay round began in 1986 and was concluded in 1994. In addition to establishing the WTO, the Uruguay round also sought to reduce tariffs and trade restrictions among member countries.

VOLATILITY: In finance, volatility most frequently refers to the standard deviation of the continuously compounded returns of a financial instrument within a specific time horizon. It is common for discussions to talk about the volatility of a security's price, even while it is the returns' volatility that is being measured. It is used to quantify the risk of the financial instrument over the specified time period. Volatility is normally expressed in annualized terms, and it may either be an absolute number (*$5*) or a fraction of the mean (*5%*).

WTO: The abbreviation for World Trade Organization, which is an international organization that oversees multilateral trade among nations. The WTO was established in 1995 by the Uruguay round of trade negotiations to replace the General Agreement on Tariffs and Trade (GATT) that had been in place for the preceding five decades. The WTO administers multilateral trade agreements, provides a forum for trade negotiations, handles trade disputes, monitors national trade policies, and provides technical assistance and training for developing countries. The WTO has about 150 member countries.