Unit - I | **Lesson No. 1**
C.No. M.COM-FC 412 | **SEM : Fourth**

STRUCTURE

1.1 INTRODUCTION

Most countries of the world which raced to the path of economic and industrial development had to depend on foreign capital to some extent. Under developed countries like India have to depend on foreign capital for financing their development programmes as they suffer from low level of income and low level of capital accumulation. The degree of dependence, however, varies from country to country depending upon its level of mobilization of domestic capital, technology development, attitude of the government, etc. But the fact cannot be denied that foreign capital contributes in many ways to the process of rapid economic growth and industrialization. Like international trade and business, **international finance** exists due to the fact that economic activities of businesses, governments, and organizations get affected by the existence of nations. It is a known fact that countries often borrow and lend from each other. In such trades, many countries use their own currencies. Therefore, we must understand how the currencies compare with each other. Moreover, it is always beneficial to have a good understanding of how these goods are paid for and what is the determining factor of the prices that the currencies trade at.

1.2 OBJECTIVES

After studying this lesson, you will be able to:

- explain the meaning of international finance;
- determine scope of international finance;
- discuss the need for foreign capital;
- understand the nature of international finance.

1.3 OVERVIEW OF INTERNATIONAL FINANCE

We live in a globalized world. Every country is dependent on another country in some other means. Developed countries look for the cheap workforce from developing countries and developing countries look for services and products from developing countries. When a trade happened between two countries as in this case, there are many factors that come into the picture and have to be considered while the execution of the trade so that no violation of regulation happens. For any economy international finance is a significant critical factor, the local government should accordingly execute the policies so that the local players are not facing severe competition from the non-local players.

International trade is one of the most important factors of growth and prosperity of participating economies. Its importance has got magnified many times due to globalization. Moreover, the resurgence of the US from being the biggest international creditor to become the largest international debtor is an important issue. These issues are a part of international macroeconomics, which is popularly known as international finance.

1.3.1 CONCEPT OF INTERNATIONAL FINANCE

International Finance deals with the management of finances in a global business. It explains how to trade in international markets and how to exchange foreign currency, and earn profit through such activities. In fact, international Finance is an important part of financial economics. It mainly discusses the issues related with monetary interactions of at least two or more countries. International finance is concerned with subjects such as exchange rates of currencies, monetary systems of the world, foreign direct investment (FDI), and other important issues associated with international financial management.

International Finance is a section of financial economics which deals with the macro-economic relation between two countries and their monetary transactions. The concepts like interest rate, exchange rate, FDI, FPI and currency prevailing in the trade come under this type of finance.

Though it is very difficult to define the term international finance, because the domain of it, are very large and infinite. Since international finance involves MNCs, national government's rules and regulations, regarding flow of capital, across the borders of the country, the international finance discipline is vivid and complex.

The term international finance is defined on the basis of various parameters:

(a) It is a discipline of financing the international economic and commercial relations between countries.

(b) It includes international markets (such as international banking, euro currency market, euro bond, international stock exchanges, American Depository Receipts, GDRs, international institutions viz., IMF, World Bank, Asian Development Bank, Brics Bank, China, WTO, UNCTAD, Letters of Credit, Bill of Lading, factoring and the like, international financial instruments foreign exchange markets, Balance of Payments and International risk management.

(c) It is related to management, economic, commercial and accounting activities of MNCs, governments and private individuals.

(d) It involves conversion of one currency into another.

(e) It coordinates all financial and non-financial operations with the objectives of maximization of the shareholders' wealth.

In case of India, the period after 1991 has been one of liberalization and integration with the world economy. Now India has got the policy of "export and prosper".

1.3.2 NATURE OF INTERNATIONAL FINANCE

Finance is an art and science of handling and managing monetary resources of the concern efficiently and effectively. Finance is very important part of any business and hence most of the decisions are taken accordingly. International finance records and monitors not only local finance of the nation but it refers to international level or global level. In short, international finance can be said to be focused on financial decisions, allocation decisions and profit distribution or dividend decisions .

Some of the features of international financing management are listed below as international finance management has some certain distinguished features when compared with domestic finance managing they are,

a. **Foreign exchange risks**: An understanding of foreign exchange is very important for the investors and managers in today's world of unforeseen changes in exchange rates. This rates is generally ignored and is lesser in domestic economies as it extends to only that particular economy , but when it comes to global level it should be very seriously taken as there is risk of violation foreign exchange rates. It may be regarded as most serious international problem.

b. **Political risks:** One of the major risk which an company may encounter in international finance is political risk. It may result in loss. As new acts and laws may be enforced or may change decisions taken by prior person. For example, In 1992, Eron development corporation signed a contract to build India's longest power plant , but it was later cancelled in 1995 by politicians in Maharashtra , who argued that India does not need power plant . The company spent nearly $300million on that project.

c. **Market imperfections**: Market imperfections is in trend nowadays, and this is one of major demerit for the concern . These are various changes in nation's law, taxation , rules and regulations and culture etc.

1.4 NEED FOR FOREIGN CAPITAL

The need for foreign capital in a developing country like India arises on account of the following reasons:

a. **Inadequacy of domestic capital**: In view of the inadequacy of domestic capital, foreign capital is needed to meet the huge requirements of development projects in the path of rapid economic development and industrialisation.

b. **The technology gap**: As compared to the advanced countries there is a lot of technology gap which necessitates import of foreign technology. Such technology usually comes along with foreign capital in the form of private foreign investment or foreign collaborations. Thus, there is utmost need of foreign capital.

c. **The initial risk**: Due to lack of experience, expertise and heavy initial risk, there is always a lack of flow of domestic capital into lines of production. The foreign capital taking initial risk stimulates the flow of domestic capital and stock entrepreneurship.

d. **Development of basic infrastructure:** There is also a lack of basic infrastructure which is very essential for the economic development of the underdeveloped countries. Foreign capital helps in the development of infrastructural facilities such as transport, communication, power etc.

e. **Balance of payment support:** During the process of economic development, the underdeveloped countries usually face a crisis of balance of payments due to heavy imports of capital goods, technical know-how, spare parts and even industrial raw materials. Thus, foreign capital is needed to face the crisis during this period.

1.5 SCOPE OF INTERNATIONAL FINANCE

Traditionally, international finance has been viewed as management of MNCs that engage in some form of international business. (A business firm is considered an international player according to Fortune Magazine, when its international sales exceed 20% of total). These MNCs continuously devise strategies to improve their cash flows and enhance shareholder wealth. Penetration of foreign market creates opportunities for improving the company's cash flows. The dismantling of barriers to entry encourage companies to pursue international business. Liberal trade is the principal driver of internationalisation which encompasses unimpeded flows of capital labour and technology across national boundaries. Free trade is always beneficial because it encourages nations to specialise in the products they are best at and import those they are less good at. This results in efficient allocation of resources and maximisation of welfare. Corporates go through different stages in this pursuit, export products or import supplies from foreign manufacturer initially to establishing subsidiaries in foreign countries.

The extent, pattern and modes of international companies' activity have been greatly influenced by the political, technological and economic events in the last three decades. The mobility aided by computer technologies and wireless is offering international companies' wider options in respect of both the creation and use of these assets and products.

The data on stock of outward foreign direct investment by large companies and inbound foreign investments by major host countries, show that foreign based activities of international companies, is the method for serving foreign markets. In all major economies, viz., USA, Germany, U.K., Japan and European countries, the role of domestic and/or foreign based companies is increasing. Inwards FDI in 2004 was, 3.4% of GDP in India and 1.4% of outward FDIs of GDP. While the world as a whole, the percentage share in 2004 was 7.5% of inward FDI as against 8.7% of outward FDIs Outward direct investment has been influenced by the opening up of erstwhile communist countries especially China.

1.6 SUMMARY

International finance is defined as the set of relations for the creation and using of funds (assets), needed for foreign economic activity of international companies and countries. Like international trade and business, **international finance** exists due to the fact that economic activities of businesses, governments, and organizations get affected by the existence of nations. It is a known fact that countries often borrow and lend from each other. In such trades, many countries use their own currencies. Therefore, we must understand how the currencies compare with each other. Moreover, we should also have a good understanding of how these goods are paid for and what is the determining factor of the prices that the currencies trade at.Liberal trade is the principal driver of internationalisation which encompasses unimpeded flows of capital labour and technology across national boundaries. Free trade is always beneficial because it encourages nations to specialise in the products they are best at and import those they are less good at. This results in efficient allocation of resources and maximisation of welfare.

1.7 GLOSSARY

· **International business**.: Any business transaction between parties from more than one country is a part of international business.

· **International trade** : International trade is the exchange of goods and services between countries.

· **International finance :** International finance is the study of monetary interactions that transpire between two or more countries.

· **Foreign exchange risk :** Foreign exchange risk refers to the losses that an international financial transaction may incur due to currency fluctuations.

· **Political risk:** Political risk is the risk an investment's returns could suffer as a result of political changes or instability in a country.

1.8 SELF ASSESSMENT QUESTIONS

1. **What do you mean by international finance?**

2. **Briefly explain scope of international finance.**

3. Elucidate the need for foreign capital.

1.9 SUGGESTED READINGS

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INTERNATIONAL FINANCE- SIGNIFICANCE, ROLE OF FINANCE MANAGER AND FINANCE FUNCTION

Unit - I **Lesson No. 2**
C.No. M.COM-FC 412 **SEM : Fourth**

STRUCTURE

2.1 INTRODUCTION

Global finance has assumed greater relevance in the new economic world order. The phenomenal changes that have occurred drastically after the advent of international institutions, international markets, currency convertibility, gave a rigorous boost to international finance. The modern way of penetrating into the new markets by hitherto restricted markets catapulted the domain of international finance. The massive growth of multinational companies from international company to global company, to transnational company, gave way to the renewed and necessary significance to international finance. Every country, on the growth path, transverse to financial aspects to a great extent to increase their economic growth and GDP. The main players in the international finance are multinational corporations, who are, more stronger than the national governments. International finance is the talk of the town or nation or world because finance is the lifeblood of every organisation, the economy and the running of world-trade. International finance encompasses, other than MNCs, the foreign exchange markets, international methods of payments, international financial markets, exchange rates, international risk management and so on.

The financial management globally necessitates the international movement of FDI and capital inflows through foreign institutional investors. The world has entered an era of unprecedented internationalisation and globalisation of economic activity. Each nation is economically related to the nations of the world through a complex network of international finance has also become increasingly important as it links world trade and foreign investments.

2.2 OBJECTIVES

After studying this lesson, you will be able to:

- explain the importance of international finance;
- differentiate between domestic finance and international finance;
- analyse the role of finance manager;
- understand the finance function

2.3 SIGNIFICANCE OF INTERNATIONAL FINANCE

An international finance system maintains peace among the nations. Without a solid finance measure, all nations would work for their self-interest. International finance helps in keeping that issue at bay. Without international finance, chances of conflicts and thereby, a resultant mess, is apparent. International finance helps keep international issues in a disciplined state. International finance organizations, such as IMF, the World Bank, etc., provide a mediators' role in managing international finance disputes. Thus, international finance plays a critical role in international trade and inter-economy exchange of goods and services. The following are the points explaining the importance of international finance:

a. Higher rate of profits: International companies search for foreign markets that hold promise for higher rate of profits. Thus, the objective of profit affects and motivates the business to expand its operations to foreign countries.

b. Expansion of production capacities: Some of the domestic companies expanded their production capacities more than the demand for the product in the domestic countries. These companies in such cases, are forced to sell their excess production in foreign developed countries. Toyota of Japan is an example.

c. Severe competition in the home country: The weak companies which could not meet the competition of the strong companies in the domestic country started entering the markets of the developing countries.

d. **Limited home market:** When the size of the home market is limited due to the smaller size of the population or due to lower purchasing power of the people or both, the companies internalise their operations. For example, most of the Japanese automobile and electronic firms entered the U.S., Europe and even African markets due to the smaller size of the home market. I.T.C. entered the European market due to the lower purchasing power of Indians with regard to high quality cigarettes. Similarly, the mere six million population of Switzerland, is the reason for Ciba-Geigy to internationalise its operations. In fact, this company was forced to concentrate on global market and establish manufacturing facilities in foreign countries.

e. **Political stability:** Political stability does not simply mean that continuation of the same party in power, but it does not mean that continuation of the same policies of the Government for a quieter longer period. It is viewed that the U.S.A. is a politically stable country. Similarly, UK, France, Germany, Italy and Japan are also politically stable countries. International companies prefer, to enter the politically stable countries and are restrained from locating their business operations in politically instable countries. In fact, business companies shift their operations from politically instable countries to politically stable countries.

f. **Availability of technology and skilled human resources:** Availability of advanced technology and competent human resources, in some countries act as pulling factors for international companies. The developed countries due to these reasons attract companies from the developing world American and European companies, depended on Indian companies for software products and services through their BPOs. The cost of professionals in India is 10 to 15 times less compared to US and European markets. These factors helped Indian software industry to grow at a faster rate with world class standards. Added to this, satellite communications help Indian companies to serve the global business without going globally.

g. **High cost of transportation**: The major factor in lower profit margins to international companies, is the cost of transportation of the products. Under such conditions, the foreign companies are inclined to increase their profit margin by locating their manufacturing facilities in foreign countries, where there is enough demand either in one country or in a group of neighbouring countries. For example, Mobil, which was supplying the petroleum products to Ethiopia, Kenya, Eritrea, Sudan, etc. from its refineries, in Saudi Arabia, established its refinery facility in Eritrea, in order to reduce the cost of transportation.

h. **Nearness to raw materials:** The source of highly qualitative raw materials and bulk raw materials is a major factor for attracting the companies from various foreign countries. Most of the US based and European based companies located their manufacturing facilities in Saudi Arabia, Bahrain, Qatar, Iran etc. due to availability of petroleum.

i. **Availability of quality human resources:** This is a major factor for software, high technology and telecommunication companies to locate their operations in India. India is a major source for high quality and low cost human resources.

j. Increased market share: Some of the large scale international companies like to enhance their market share in the world market by expanding and intensifying their operations in various foreign countries. Foe example, Ball Corporation, the third largest beverage cans manufacturer in the USA, bought the European Packaging operations of continental can company. Then it expanded its operations in Europe and met the Europe demand, which is 200 per cent more than that of USA. Thus, it increased its global market share of soft drink cans.

k. Higher rate of economic development: International companies help the governments to achieve higher growth rate of the economy, increase the total and per capita GDP, industrial growth, employment and income levels.

l. Tariffs and import quotas: It was quite common before globalisation that governments imposed tariffs or duty on imports to protect the domestic companies. Sometimes government also fixes import quotas to reduce the competition to the domestic companies from competent foreign companies. To avoid high tariffs and quotas companies prefer direct investments to go globally. For example, companies like Sony, Honda and Toyota preferred direct foreign investment in various countries by establishing subsidiaries or through joint ventures.

m. Calculate exchange rates: International finance is an important tool to find the exchange rates, compare inflation rates, get an idea about investing in international debt securities, ascertain the economic status of other countries and judge the foreign markets. Exchange rates are very important in international finance, as they let us determine the relative values of currencies. International finance helps in calculating these rates.

n. Financial Safety: Various economic factors help in making international investment decisions. Economic factors of economies help in determining whether or not investors' money is safe with foreign debt securities. Utilizing IFRS is an important factor for many stages of international finance. Financial statements made by the countries that have adopted IFRS are similar. It helps many countries to follow similar reporting systems. It also helps in saving money by following the rules of reporting on a single accounting standard.

2.4 DRIVING FORCES OF FINANCIAL GLOBALISATION

In the last two decades, the financial economies have increasingly got interconnected around the world. The impact of globalisation has been felt in every aspect of economy. Financial globalization has offered substantial benefits to the national economies and to both investors and wealth creators. However, it has a wreaking effect on financial markets as well. It helps understand the basics of all international organizations and keeps the balance intact among them. The following are the four major factors to be considered in financial globalisation:

a. **Advancement in information and communication technologies** " Technological advancements have made market players and governments far more efficient in collecting the information needed to manage financial risks.

b. **Globalisation of national economies** ” Economic globalization has made production, consumption, and investments dispersed over various geographic locations. As barriers to international trade have been lowered, international flows of goods and services have dramatically increased.

c. **Liberalisation of national financial and capital markets** ” Liberalization and fast improvements in IT and the globalization of national economies have resulted in highly spread financial innovations. It has increased the growth of international capital movements.

d. **Competition among intermediary services providers** ” Competition has increased manifold due to technological advancements and financial liberalization. A new class of nonbank financial entities, including institutional investors, have also emerged.

Changes in Capital Markets due to financial globalization

The driving forces of financial globalization have led to four dramatic changes in the structure of national and international capital markets:

a. First, banking systems have been under a process of **disintermediation**. Financial intermediation is happening more through tradable securities and not through bank loans and deposits.

b. Second, **cross-border financing** has increased. Investors are now trying to enhance their returns by diversifying their portfolios internationally. They are now seeking the best investment opportunities from around the world.

c. Third, the non-banking financial institutions are **competing with banks** in national and international markets, decreasing the prices of financial instruments. They are taking advantage of economies of scale.

d. Fourth, banks have accessed a market beyond their traditional businesses. It has enabled the **banks to diversify their sources of income and the risks**.

2.5 DIFFERENCE BETWEEN INTERNATIONAL FINANCE AND DOMESTIC FINANCE

a. When all the business and economic transaction occur within a domestic boundary of the country, it is said to be domestic finance and if the transactions occur across the international borders, refers to international finance.

b. There are more than taxation, cultural, economic environment in international finance whereas it will same in domestic finance.

c. Currency rate and derivatives of currency are involved usually in international finance whereas in domestic finance not many financial instruments as such are used.

d. The stakeholders in domestic finance are usually uniform with a similar culture, language, and beliefs but in international finance, we can see diversity among the culture, language, and values of their stakeholders.

e. There are literally numerous options to raise capital from international finance, hence the challenge will be high. Whereas in domestic finance not many options to raise capital will be there thus resulting in fewer challenges.

f. The accounting standards need to be as per GAAP in terms of international finance, whereas there is no need to maintain separate ones in d.

2.6 EMERGING CHALLENGES IN INTERNATIONAL FINANCE

The players in international business, who are multinational companies are beset with many number of difficulties and road blocks. These challenges have hampered international companies' business considerably. The following are the important challenges in international finance:

a) **Varied Economic Systems:** Economic system refers to the kind of governance of a country. It may be on the basis of the principles of communism, capitalism, socialism and mixed economy, rules and ideologies. The international companies have to navigate with country specific economic systems. American companies are looked with scepticism by Japan, European and gulf countries and vice versa. The economic system issue is not possible to address but MNCs may harness for their economic gains.

b) **Tariff and non-tariff trade barriers:** The progress of the world trade is dependent on free trade policy. Many countries distorted the free trade among themselves and this trade restriction is called trade barrier. The opposite of free trade is trade barrier. These barriers are of two kinds: Tariff and Non-tariff. By imposing a high tariff (a kind of duty or customs imposed on imports or exports) rates, foreign trade is scuttled. The other reason to restrain the imports is rejecting the goods for the reasons of environmental safety, health hazards, labour standards, subsidy and so on. This is called protectionism or non-tariff barriers World Trade Organisation provides a more powerful organisation, with 164 member countries, to solve disputes over trade among the member countries.

c) **Political Risks:** The instability in the governance by political system in different countries is a major setback for international companies. The draconian rules and policies of some countries restrict market access.

d) **Environmental safeguards:** One of the major challenges today in the world is global warming. The carbon dioxide emissions by different countries and the green house effect therein resulted in depletion of ozone layer. The relentless use of natural resources is the route cause for environmental delay. The international trade and environmental protection should go hand in hand in the interest of the future generation.

e) **Dumping:** It refers to selling a product at a high price in the home currency and relatively at a low price in the host country by an international company. This practice ruins industries and employment opportunities in the host country especially micro and small scale industries. For example, the Chinese goods like goods sold in Dipawali, Holi and other festivals are sold, at very low prices in India.

f) Cultural differences: Every country has unique cultural heritage that shape values and influence the conduct of business. Even within geographic regions that are considered relatively homogeneous, different sub-cultures are prevailing. International companies have to cope with these differences and adopt to the culture and sub-culture of the countries, where they operate. MNCs find that matters such as defining the appropriate goals of the company, attitudes toward risk, dealing with employees and the ability to curtail and profitable operations vary dramatically from one country to the next.

g) Language differences: The ability to communicate is critical in all business, including international transactions. The Indian and US citizens are often at a disadvantage because they are generally fluent in English, while European and German people are usually fluent in several languages including English.

h) Intellectual property rights: The trinity of intellectual properties are patents (for inventions) trade marks (for brand name, image etc.) and copyright (for author, musicians, lyrics, filmmakers). The invention of the new things require world class research and development set up by foreign firms. The problem of privacy is haunting several leading companies and brands. India, after a great fight with USA has registered the patent protection for Basmati rice, turmeric and tomato. In case of pharma products, a large number of patent infringements is happening around the world especially the life savings drugs. This is a vital issue in international business and finance.

i) Cyber crimes: Cyber crime is a crime committed with the use of computer and internet. Today, all around the world e-commerce and e-business, e-governance, are flourishing. The flip side of the e-commerce, is cyber crimestantalising the international finance. The privacy is interrupted, money in some others accounts are withdrawn, manipulated and transferred. The cyber crimes if unabated will pose a great danger to the world business. The WTO has asked all the member-countries to have in place a proper and comprehensive cyber law in place to check the maladies and anomalies of cyber crimes. We in India, have the first cyber law, styled Information Technology Act, 2000.

j) Transfer Pricing: In any international business there are normally a large number of transfers of goods, services, technology and other resources between the parent company and foreign subsidiaries. The price at which goods, services and others are transferred between affiliates within the company is called transfer price. Transfer price also affects an international company's ability to monitor the performance of individual corporate subsidiaries and to reward or punish managers responsible for their performance. Further, transfer price affects the taxes an international company pays both its home country and to various host countries in which it operates. Transfer price is also used to avoid exchange controls, to increase the international company's share of profits from a joint-venture and to distinguish an affiliate's true profitability. Nevertheless, there are problems associated with Transfer Pricing. Many governments do not like transfer pricing strategy. When transfer prices are used to reduce a firm's tax liabilities or import duties, most governments feel they are being cheated of their legitimate income. Several governments limit the ability of an international business to manipulate transfer prices.

k) **International Taxation:** Taxes have a significant impact on areas, as diverse as making foreign investment decisions, managing exchange risks, planning capital structures, determining financing costs and managing inter affiliate funds flows. For the international business with activities in many countries, the various treaties have important implications for how the international company should structure its internal payments system among the foreign subsidiaries and the parent company.

l) **Economic and Currency Crisis:** The Asian crisis, Malaysian crisis, Pacific-Rim country crisis are in relation to economic crisis wherein they have experienced recession and adverse, balance of payments position. The same countries along with Japan experienced currency crisis in that the value of currencies were either depreciated or devalued and further they were exposed to shortage of foreign exchange reserves.

m) **Interest Rates Charging:** The rate of interest charged by World Bank on its loans disbursed is different as compare to Asian Development Bank's concessional interest rate. The equity cost of capital is less when compared to debt funds in the global capital market. The increasing interest rate raises cost of capital and profitability of the company is lessened interest rate is a parameter in global finance which plays a dominant role in production and operational risks of global corporates.

n) **Foreign Exchange Risk:** Exchange Rate refers to the price of one currency against another currency. The exchange of currency happens in two ways namely fixed exchange rate and floating exchange rate. The exchange rate risk is more pronounced under flexible or floating exchange rate. This is because floating exchange rate is based on market forces of demand for and supply of foreign currencies, at a particular time Trade surplus/deficit vis-a-vis the currencies of the countries, a host of economic factors like GNP, fiscal deficit, balance of payments position. Industrial production data, and employment data, inflation rate differentials and interest rate differentials.

o) **Cold war between countries:** The enmity, animosity, difference of opinion between and among countries be routed out at the surface level. Hatred is external while jealousy is internal. The cold war among nations is because of the twin pests — hatred and jealousy between the countries in the world.

p) **International business cycle:** Countries are subject to the times of good trade and bad trade. Goal trade is characterised by increased economic activities, production, profitability and revenue. The opposites are low economic activities, production and other parameters representing the bad trade. Business or trade cycle is international in character, recurring in nature and time period of each stage of the cycle such as inflation, deflation, revival and recession are uncertain.

q) **Operational risks:** The operational risk encompasses commercial risks, foreign exchange risk, political risks and country specific risks. Different currencies, payments and receipts socioeconomic systems, laws, habits, tasks preferences, and environmental aspects lead to higher risks in the form of credit, market access, currency and exchange risks.

r) **International terrorism:** The growing menance of international terrorism is ruining international business. Terrorism obstructs the smooth flow of economic activities. It pushes the economy into bankruptcy and insolvency. It worsens import and export trade. The countries which want to have cordial business relations with other countries will rethink and hesitate to have relationship with terror hit countries. The free flow of foreign investment is affected due to terrorism.

s) **International Cash Management:** One major task of an international financial manager relates to the management of cash. This task is more complicated for international companies. For example, Cathay Pacific uses over 30 currencies in its operations. While managing cash, the international financial manager needs to address three issues namely, minimising cash balances, minimising currency conversion costs, and minimising foreign exchange risks.

t) **Creditworthiness:** International business and finance stands on and runs through the credibility, trustworthy and credentials of the borrowers of goods, services technology or information. As the risks are high in the international finance, creditworthiness is an essential part of entering into any trade or payment agreement.

u) **Methods of Payment:** Every shipment abroad requires some kind of financing while in transit. The exporter also needs funds to buy or manufacture its good. Similarly the importer has to carry these goods in inventory until they are sold. There are 6 methods of payments in international market namely cash in advance, letter of credit, international business bank drafts, consignments, open account and electronic fund transfer.

2.7 ROLE OF FINANCIAL MANAGER

There are two essential aspects of finance function – one, procurement of funds and two, an effective utilization of these funds in the business. In respect of these two aspects, the role of the finance manager is described below:

The traditional role of the finance manager is to confine to the raising of funds in order to meet operating requirements of the business. This traditional approach has been criticized by modern scholars on the following grounds. It was prevalent till the mid-1950s.

a) The traditional approach of raising funds alone is too narrow and thus it is outsider looking-in approach.

b) It viewed finance as a staff specialty.

c) It has little concern how the funds are utilized.

d) It over-emphasized episodic events and non-recurring problems like the securities and its markets, incorporation, merger, consolidation, reorganization, recapitalization and liquidation etc.

e) It ignored the importance of working capital management.

f) It concentrated on corporate finance only and ignored the financial problems of sole trader and partnership firms.

g) Traditional approach concentrated on the problems of long-term financing and ignored the problems of short-term financing.

There was a change from traditional approach to the **modern concept** of finance function since the mid-1950s. the industrialization, technological innovations and inventions and a change in economic and environment factors since the mid-1950s necessitated the efficient and effective utilization of financial resources. Since then, finance has been viewed as an integral part of the management. The finance manager is, therefore, concerned with all financial activities of planning, raising, allocating and controlling the funds in an efficient manner. In addition, profit planning is another important function of the finance manager.

This can be done by decision making in respect of the following areas:

a) Investment Decisions for obtaining maximum profitability after taking the time value of the money into account.

b) Financing decisions through a balanced capital structure of Debt-Equity ratio, sources of finance, EBIT/EPS computations and interest coverage ratio etc.

c) Dividend decisions, issue of Bonus Shares and retention of profits with objective of maximization of market value of the equity share.

d) Best utilization of fixed assets.

e) Efficient working capital management (inventory, debtors, cash marketable securities and current liabilities).

f) Taking the cost of capital, risk, return and control aspects into account.

g) Tax administration and tax planning.

h) Pricing, volume of output, product-mix and cost-volume-profit analysis (CVP Analysis).

i) Cost control.

j) Stock Market— Analyse the trends in the stock market and their impact on the price of Company's share and share buy-back.

Additionally, financial managers perform data analysis and advise senior managers on profit-maximizing ideas. Financial managers are responsible for the financial health of an organization. They produce financial reports, direct investment activities, and develop strategies and plans for the long-term financial goals of their organization. Thus, the role of the financial manager, particularly in business, is changing in response to technological advances that have significantly reduced the amount of time it takes to produce financial reports. Financial managers' main responsibility used to be monitoring a company's finances, but they now do more data analysis and advise senior managers on ideas to maximize profits. They often work on teams, acting as business advisors to top executives.

2.8 FINANCE FUNCTION: FINANCIAL FIRM AND NON-FINANCIAL FIRM

Finance function is the most important of all business functions. It remains a focus of all activities. It is not possible to substitute or eliminate this function because the business will close down in the absence of finance. The need for money is continuous. It starts with the setting up of an enterprise and remains at all times. The development and expansion of business rather needs more commitment for funds. The funds will have to be raised from various sources. The sources will be selected in relation to the implications attached with them. The receiving of money is not enough, its utilization is more important. The money once received will have to be returned also. If its use is judicious then its return will be easy otherwise it will create difficulties for repayment. The management should have an idea of using the money profitably. It may be easy to raise funds but it may be difficult to repay them. The inflows and outflows of funds should be properly matched. International finance function refers to the financial function of an overseas business.

As finance is the lifeblood of business, in overseas and international business also, the finance function involves the acquiring and utilization of funds necessary for efficient operations. It is the source to run every firm may it be financial firm or non- financial firm.

A financial firm or company is an organization that makes loans to individuals and businesses. Unlike a bank, a financial company does not receive cash deposits from clients, nor does it provide some other services common to banks, such as checking accounts. Finance companies make a profit from the interest rates (the fees charged for the use of borrowed money) they charge on their loans, which are normally higher than the interest rates that banks charge their clients. whereas, a non-financial firm is a firm engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business etc. In other words, the main difference between a finance and a non-finance company is that a finance company is allowed to take give loans to general public and a non-finance company is not allowed to give loans to general public.

Specifically the finance function of financial and non financial firms deals with the following points:

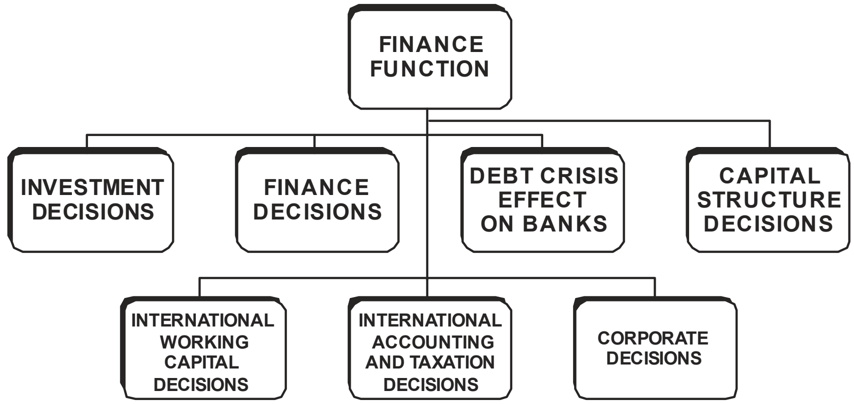

Table 2.8

a) **Investment decisions:** When a company innovate a specific technology and its product is mature in the markets abroad or when the company wants to reap the location advantage in a foreign country it sets up an affiliate there. Whatever the motivation behind foreign investment or foreign manufacturing the company evaluates the cash inflow and outflow during the life of the project and makes investment only when the net present value of cash flows is positive. International finance thus studies the different theories of oversees production, the various strategies of investment capital budgeting decision and evaluation of foreign exchange and political risks pertaining to overseas investment.

b) **International working capital decisions:** When foreign operations begin the parent company evaluates different sources of working capital so that the cost of financing is the cheapest. In this context an international company maintains an edge over a domestic company insofar as it can easily reach the international financial market or can siphon resources from one subsidiary to another. International finance helps in taking correct decisions regarding the size of working capital and suggests a mechanism for its management. It also deals with how foreign trade is finished.

c) **Financial decisions:** Any investment needs rising of funds. The MNCs take advantage of the many innovations which have taken place in the international financial market and international finance function guides them on how to take advantage of these. It deals with how different instruments are issued to raise funds and how swaps are used for minimizing the cost of funds. The nature and management of interest rate exposure to form a part of IFM.

d) **International accounting and taxation decisions:** International accounting forms an integral part of IFM. It analyses the techniques for consolidation of financial statements of the various affiliates international audit international financial reporting and international taxation. Transfer pricing is an important area of international accounting as it is used lowering the overall burden of taxes and tariff as well as for working capital management. Similarly international tax system should be so designed that it fosters economic efficiency and does not come in the way of the cross border movement of goods and factors of production

e) **Debt crisis effect on banks:** International Banks were the victims of debt default of many governments in the 80s. When loans are given to international finance corporates, they can be forced into liquidation but not so in the case of the Governments. The Banks have therefore spent time and money to reschedule and recover the money in installments and some debts are written off. The debt crisis weakened the banks but the banking system didn't collapse. The banks have become more cautious and started lending only to countries with market oriented economies and undergoing structural reforms. The development in International Debt market gave rise to the new instruments and secondary market in many instruments such as scrutinized debt. Debt repaying capacity and foreign exchange earnings and production use of capital are all taken into account it is also one of the important functions of international finance.

f) **Corporate decision:** Another important function of international finance is foremost decision is the amount of debt for a given level of equity. The leverage and tax deductibility of Interest Payment and Debt would make the company prefer as much debt as possible. But debt increases the risk and hence there is a trade off between leverage and risk because of the debt risk. The questions that any Corporation Management asks itself are the proper mix of equity and debt, composition of debt, show medium and long term debt, nature of debt secured and unsecured. Fixed Vs Floating Debt and maturity and terms of debt, what currency or currencies in which debt should be taken etc. The firm should keep its debt should be taken etc. The firm should keep its debt at the optimum level. The debt should be self-liquidating through the returns that it generated. It should be in currencies in which it earns it exporting earnings. One should borrow in currencies, which are likely to be weakened and depreciated. The value of the company's shareholders will increase with the leverage enjoyed by debt but the risk associated with the debt is to be hedged to improve the value of the firm.

g) **Capital Structure decisions:** The composition of capital structure influences the cost of Capital and returns and thus the shareholders value. The composition of debt, its currency, interest rate, maturity and other terms of debts, its currency, interest rate maturity and other terms of debt are relevant valuables to be considered. Hedging of the debt risk reduces the risk of financial stress and even crisis. The firms have to match the composition debt to the payment and characteristics of the assets created so as to minimize the probability of financial distress. It pays a company to deviate from the maximum risk debt composition of only the firm can beat the market.

2.9 SUMMARY

International finance is defined as the set of relations for the creation and using of funds (assets), needed for foreign economic activity of international companies and countries. Like international trade and business, international finance exists due to the fact that economic activities of businesses, governments, and organizations get affected by the existence of nations. It is a known fact that countries often borrow and lend from each other. In such trades, many countries use their own currencies. Therefore, we must understand how the currencies compare with each other. Moreover, we should also have a good understanding of how these goods are paid for and what is the determining factor of the prices that the currencies trade at. Liberal trade is the principal driver of internationalisation which encompasses unimpeded flows of capital labour and technology across national boundaries. Free trade is always beneficial because it encourages nations to specialise in the products they are best at and import those they are less good at. This results in efficient allocation of resources and maximisation of welfare.

2.10 GLOSSARY

- Domestic finance- When all the business and economic transaction occur within a domestic boundary of the country.
- Transfer pricing- The price at which goods, services and others are transferred between affiliates within the company.
- Exchange rate- It refers to the price of one currency against another currency.
- Cyber crime- It is a crime committed with the use of computer and internet.

2.11 SELF ASSESSMENT QUESTIONS

1. Differentiate between domestic finance and international finance.

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2. Briefly explain significance of international finance.

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3. Elucidate the role of finance manager.

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4. Explain in detail the international finance function.

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INTERNATIONAL FINANCIAL INSTITUTIONS : ROLE OF IMF, WTO AND ROLE OF WORLD BANK

Unit - I	**Lesson No. 3**
C.No. M.COM-FC 412	**SEM : Fourth**

STRUCTURE

3.1 INTRODUCTION

At the Bretton Woods Conference in 1944 it was decided to establish a new monetary order that would expand international trade, promote international capiborne out of this Conference of the end of World War II. The World Bank was established to help the restoration of economies disrupted by War by facilitating the investment of capital for productive purposes and to promote the long-range balanced growth of international trade. On the other hand, the IMF is primarily a supervisory institution for coordinating the efforts of member countries to achieve greater cooperation in the formulation of economic policies. It helps to promote exchange stability and orderly exchange relations among its member countries. It is in this context that the present chapter reviews the purpose and working of some of the international financial institutions and the contributions made by them in promoting economic and social progress in developing countries by helping raise standards of living and productivity to the point of which development becomes self-sustaining.

3.2 OBJECTIVES

After studying this lesson, you will be able to:

• Describe the working and objectives of some of the international financial institutions;
• Explain the various dimensions of World Bank and IMF; and
• Know how the international financial institutions are regulated.
explain the nature and functions of the WTO;
• describe the basic principles that underlie WTO agreements ;
• list the major multilateral and plurilateral agreements of the WTO;
• elaborate on the exceptional circumstances under which a country is permitted to act contrary to the basic principles of the WTO; and
• describe the IP related issues in the Doha Development Agenda

3.3 INTERNATIONAL SOURCES OF FINANCE

One major source of financing is international non-profit agencies. There are several regional development banks such as the Asian Development Bank, the African Development Bank and Fund and the Caribbean Development Bank. The primary purpose of these agencies is to finance productive development projects or to promote economic development in a particular region. The Inter-American Development Bank, for example, has the principal purpose of accelerating the economic development of its Latin American member countries. In general, both public and private entities are eligible to borrow money from such agencies as long as private funds are not available at reasonable rates and terms. Although the interest rate can vary from agency to agency, these loan rates are very attractive and very much in demand.

Of all the international financial organisations, the most familiar is the World Bank, formally known as the International BankforReconstruction and Development (IBRD). The World

Bank has two affiliates that are legally and financially distinct entities, the International Development Association (IDA) and the International Finance Corporation (IFC). Exhibit 1 provides a comparison among IBRD, IDA and IFC in terms of their objectives, member countries, lending terms, lending qualifications as well as other details. All three organisations have the same central goals: to promote economic and FM-305 476 social progress in poor or developing countries by helping raise standards of living and productivity to the point at which development becomes self-sustaining.

Toward this common objective, the World Bank, IDA and IFC have three interrelated functions and these are to lend funds, to provide advice and to serve as a catalyst in order to stimulate investments by others. In the process, financial resources are channelled from developed countries to the developing world with the hope that developing countries, through this assistance, will progress to a level that will permit them, in turn, to contribute to the development process of other less fortunate countries. Japan is a prime example of a country that has come full circle. From being a borrower, Japan is now a major lender to these three organisations. South Korea is moving in a direction similar to that of Japan nearly a quarter of a century ago.

3.4 INTERNATIONAL MONETARY FUND

The International Monetary Fund (IMF) came into official existence on December 27, 1945, when 29 countries signed its Articles of Agreement (its Charter) agreed at a conference held in Bretton Woods, New Hampshire, USA, from July 1-22, 1944. The IMF commenced financial operations on March 1, 1947. Its current membership is 182 countries. Its Total Quotas are SDR 212 billion (almost US$300 billion), following a 45 per cent quota increase effective from January 22,1999.

• Staff: approximately 2,700 from 110 countries.

• Accounting Unit: Special Drawing Right (SDR). As of August 23, 1999, SDR I equalled US $1.370280.

IMF is a cooperative institution that 182 countries have voluntarily joined because they see the advantage of consulting with one another on this forum to maintain a stable system of buying and selling their currencies so that payments in foreign currency can take place between countries smoothly and without delay. Its policies and activities are guided by its Charter known as the Articles of Agreement.

IMF lends money to members having trouble meeting financial obligations to other members, but only on the condition that they undertake economic reforms to eliminate these difficulties for their own good and that of the entire membership. Contrary to widespread perception, the IMF has no effective authority over the domestic economic policies of its members. What authority the IMF does possess is confined to requiring the member to disclose information on its monetary and fiscal policies and to avoid, as far as possible, putting restrictions on exchange of domestic for foreign currency and on making payments to other members.

There are several major accomplishments to the credit of the International Monetary System. For example, it

• sustained a rapidly increasing volume of trade and investment;
• displayed flexibility in adapting to changes in international commerce;
• proved to be efficient (even when there were decreasing percentages of reserves to trade);
• proved to be hardy (it survived a number of pre-1971 crises, speculative and otherwise, and the down-and-up swings of several business cycles);
• allowed for a growing degree or international cooperation;
• established a capacity to accommodate reforms and improvements.

To an extent, the fund served as an international central bank to help countries during periods of temporary balance of payments difficulties by protecting their rates of exchange. Because of that, countries did not need to resort to exchange controls and other barriers to restrict world trade.

3.4.1 ORIGIN OF IMF

The need for an organisation like the IMF became evident during the great depression that ravaged the world economy in the 1930s. A widespread lack of confidence in paper money led to a spurt in the demand for gold and severe devaluation in the national currencies. The relation between money and the value of goods became confused as did the relation between the value of one national currency and another.

In the 1940s, Harry Dexter (US) and John Maynard Keynes (UK) put forward proposals for a system that would encourage the unrestricted conversion of one currency into another, establish a clear and unequivocal value for each currency and eliminate restrictions and practices such as competitive devaluations. The system required cooperation on a previously unattempted scale by all nations in establishing an. innovative monetary system and an international institution to monitor it. After much negotiations in the difficult war time conditions, the international community accepted the system and an organisation was formed to supervise it.

The IMF began operations in Washington DC in May 1946. It then had 39 members. The IMF's membership now is 190 after the **Principality of Andorra** virtually joined IMF on October 16, 2020.

3.4.2 MEMBERS AND ADMINISTRATION

On joining the IMF, each member country contributes a certain sum of money called a 'quota subscription', as a sort of credit union deposit. Quotas serve various purposes.

· They form a pool of money that the IMF can draw from to lend to members in times of financial difficulty.
· They form the basis of determining the Special Drawing Rights (SDR).
· They determine the voting power of the member.

3.4.3 STATUTORY PURPOSES

The main purposes of the International Monetary Fund are:

a. To promote international monetary cooperation through a permanent institution that provides the machinery for consultation and collaboration on international monetary problems.

b. 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 economic policy.

c. To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.

d. 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.

e. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive to national or international prosperity.

f. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

3.4.4 FINANCIAL ASSISTANCE

The IMF lends money only to member countries with balance of payments problems. A member country with a payments problem can immediately withdraw from the IMF the 25 per cent of its quota. A member in greater difficulty may request for more money from the IMFand can borrow up to three times its quota provided the member country undertakes to initiate a series of reforms and uses the borrowed money effectively. The frequently used mechanisms by the IMF to lend money are:

a. Standby Arrangements

b. Extended Arrangements

c. Structural Adjustment Mechanism (With low interest rates)

Regular IMF facilities

a. **Standby Arrangements (SBA)** are designed to provide short-term balance of payments assistance for deficits of a temporary or cyclical nature, such arrangements are typically for 12 to 18 months. Drawings are phased on a quarterly basis, with their release made conditional on meeting performance criteria and the completion of periodic programme reviews. Repurchases are made $3^{1/4}$ to 5 years after each purchase.

b. Extended Fund Facility (EFF) is designed to support medium-term programmes that generally run for three years. The EFF aims at overcoming balance of payments difficulties stemming from macroeconomic and structural problems. Performance criteria are applied, similar to those in standby arrangements and repurchases are made in 4½ to 10 years.

Concessional IMF facility

a. Enhanced Structural Adjustment Facility (ESAF) was established in 1987 and enlarged and extended in 1994. Designed for low-income member countries with protracted balance of payments problems, ESAF drawings are loans and not purchases of other members' currencies. They are made in support of three year programmes and carry an annual interest rate of 0.5 per cent, with a 51h year grace period and a 10 year maturity. Quarterly benchmarks and semi-annual performance criteria apply; 80 low income countries are currently eligible to use the ESAF.

3.4.5 RESPONSIBILITIES OF THE INTERNATIONAL MONETARY FUND

i. Promoting international monetary cooperation

ii. Facilitating the expansion and balanced growth of international trade

iii. Promoting exchange stability

iv. Assisting in the establishment of a multilateral system of payments.

v. Making its resources available, under adequate safeguards to members experiencing balance of payments difficulties

The Fund seeks to promote economic stability and prevent crises; to help resolve crises when they do occur, and to promote growth and alleviate poverty. To meet these objectives, it employs three main functions, as discussed here.

3.4.6 ROLE OF THE INTERNATIONAL MONETARY FUND

(IMF) played a significant role in stabilizing the exchange rates thereby facilitating international payment adjustments. Economists across the world have commended its role in enforcing monetary discipline among its members.

a. IMF brings stability in exchange rate: The IMF has laid down a clear guidance of exchange rate policies. Its policies prevent the member countries from making competitive devaluation to boost up exports. As a result of all these, the system of exchange under the IMF is stable.

b. IMF's role in development of international trade: The IMF has been instrumental to the growth of international trade. It acts as the reservoir of the currencies of all the member countries. A borrowing country can borrow the currency of another country out of this reservoir. It extends loans in foreign exchange to the member countries for financing the current transactions. It also provides technical advice on monetary and fiscal matters. It conducts research studies and publishes them. This multilateral assistance helps members in solving their problems in trade, thereby promoting international trade.

c. **IMF is strict on multiple exchange rates:** The IMF does not permit the member countries to adopt multiple exchange rates leading to restrictive practices. The system of exchange rate combines the element of stability with flexibility. It maintains stability in exchange rates.

d. **IMF's elaborate lending operations:** The main operation of the fund is lending to member countries. It has introduced a variety of loan facilities to its members. Initially, the lending operations were confined only for solving the problems of deficit payments. But now they have been remarkably extended. Member countries can have regular facilities, concessional facilities and special facilities. Credit Tranches and extended fund facility are some of the regular facilities. Structural adjustment facility and enhanced structural adjustment facility are some concessional schemes offered to the member countries. The special facilities offered by the IMF fund include compensatory and contingency financing facility, systematic transformation facility and contingency credit line.

e. **IMF's role in currency convertibility:** With the charges introduced after 1973 in the international monetary system, a member can peg its currency to

- either a single major currency or
- a basket of currencies or
- allow it to float independently.

A currency is said to be floating when its is left free to find its own parity in the international market. The IMF is the catalyst in the convertibility of currencies. It endeavors to achieve full global convertibility of currencies in the next decade. All developing countries will achieve full convertibility.

f. **IMF's role in Consultation and guidance:** The IMF provides the necessary machinery for consultation and collaboration on international monetary problems. Monetary, fiscal and financial problems and also matters relating to exchange and trade affecting international payments are clearly studied. It deputes experts to member countries to deal with the balance of payments problems. It also conducts short term training courses on fiscal, monetary and balance of payments for personnel from member nations.

g. **Boon to developing countries:** The IMF is a boon to developing countries. Less developed countries get enormous assistance from IMF like

- Financial assistance to get rid of balance of payment deficits
- concessional financial assistance for promotion of exports
- suggestions for overcoming constraints in the development process
- Assistance in the formulation of development oriented monetary, fiscal, exchange and trade policies
- extension of central banking advisory services to less developed countries towards the improvement of functioning of their central banks
- institutional training for the personnel in member countries; and
- Special Drawing Rights (SDRs) to resolve the problem of international liquidity.

3.4.7 FUNCTIONS OF THE INTERNATIONAL MONETARY FUND

a. **Surveillance:** A core responsibility of the IMF is to encourage a dialogue among its member countries about the national and international consequences of their economic and financial policies, to promote external stability. This process of monitoring and consultation, normally referred to as 'surveillance', has evolved rapidly as the world economy has changed. IMF surveillance has also become increasingly open and transparent in recent years. The initiatives used to inform bilateral surveillance and aimed at promoting global economic stability are as follows:

· The IMF works to improve its ability to assess the member countries' vulner-abilities to crisis, identifying and promoting effective responses to risks to economic stability, including risks from payments imbalances, currency misalign-ment, and financial market disturbances.

· In collaboration with the World Bank, the IMF conducts in-depth assessments of countries' financial sectors under the Financial Sector Assessment Programme (FSAP). The Fund is further deepening financial and capital market surveillance, particularly in its analysis of emerging market members.

· The IMF has developed and actively promotes standards and codes of good practice in economic policy making. It is also involved in international efforts to combat money laundering and the financing of terrorism.

The importance of effective surveillance was underscored by the financial crises of the late 1990s. In response, the IMF has undertaken many initiatives to strengthen its capacity to detect vulnerabilities and risks at an early stage, to help member countries strengthen their policy frameworks and institutions, and to improve transparency and accountability.

b. **Technical Assistance:** The objective of IMF technical assistance is to contribute to the development of the productive resources of member countries by enhancing the effectiveness of economic policy and financial management. The IMF helps countries strengthen their capacity to design and implement sound economic policies. The IMF helps its member countries build their human and institutional capacity to design and implement effective macroeconomic and structural policies, put in place reforms that strengthen their financial sectors, and reduce vulnerability to crises. The IMF generally provides technical assistance free of charge to any requesting member country within the IMF resource constraints. About three-quarters of the Fund's technical assistance go to low- and lower-middle income countries, particularly in sub-Saharan Africa and Asia, and post-conflict countries. The IMF provides technical assistance in its areas of expertise: namely macroeco-nomic policy, tax policy and revenue administration, expenditure management, monetary policy, the exchange rate system, financial sector sustainability, and macro- economic and financial statistics.

Since the demand for technical assistance far exceeds supply, the IMF gives priority in providing assistance where it complements and enhances the IMF's other key forms of assistance, i.e., surveillance and lending.

c. Lending: Even the best economic policies cannot eradicate instability or avert crises. In the event that a member country does experience financing difficulties, the IMF can provide financial assistance to support policy programmes that will correct underlying macroeconomic problems, limit disruptions to the domestic and global economies, and help restore confidence, stability, and growth. IMF financing instruments can also support crisis prevention. The IMF is accountable to the governments of its member countries. At the apex of its organizational structure is its board of governors, which consists of one governor from each of the IMF's 190 member countries. All governors meet once a year at the IMF-World Bank Annual Meetings.

The IMF's resources are provided by its member countries, primarily through payment of quotas, which broadly reflect each country's economic size. The annual expenses of running the Fund are met mainly by the difference between interest receipts on outstanding loans and interest payments on quota 'deposits'.

3.5 INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT(IBRD) / WORLD BANK

The IBRD was set up in 1945 along with the IMF to aid in rebuilding the world economy. It was owned by the governments of 151 countries and its capital is subscribed by those governments; it provides funds to borrowers by borrowing funds in the world capital markets, from the proceeds of loan repayments as well as retained earnings. At its funding, the bank's major objective was to serve as an international financing facility to function in reconstruction and development. With Marshall Plan providing the impetus for European reconstruction, the Bank was able to turn its efforts towards the developing countries.

Generally, the IBRD lends money to a government for the purpose of developing that country's economic infrastructure such as roads and power generating facilities. Funds are directed towards developing countries at more advanced stages of economic and social growth. Also, funds are lent only to members of the IMF, usually when private capital is unavailable at reasonable terms. Loans generally have a grace period of five years and are repayable over a period of fifteen or fewer years. The projects receiving IBRD assistance usually require importing heavy industrial equipment and this provides an export market ror many US goods. Generally bank loans are made to cover only import needs in foreign convertible currencies and must be repaid in those currencies at long-term rates.

The government assisted in formulating and implementing an effective and comprehensive strategy for the development of new industrial free zones and the expansion of existing ones; reducing unemployment, increasing foreign-exchange earnings and strengthening backward linkages with the domestic economy; alleviating scarcity in term financing; and improving the capacity of institutions involved in financing, regulating and promoting free zones.

The World Bank lays special operational emphasis on environmental and women's issues. Given that the Bank's primary mission is to support the quality of life of people in developing member countries, it is easy to see why environmental and women's issues are receiving increasing attention. On the environmental side, it is the Bank's concern that its development funds are used by the recipient countries in an environmentally responsible way. Internal concerns, as well as pressure by external groups, are responsible for significant research and projects relating to the environment.

The women's issues category, specifically known as Women In Development (WID) is part of a larger emphasis on human resources. The importance of improving human capital and improving the welfare of families is perceived as a key aspect of development. The WID initiative was established in 1988 and it is oriented to increasing women's productivity and income. Bank lending for women's issues is most pronounced in education, population, health and nutrition and agriculture.

3.5.1 PURPOSE OF WORLD BANK

The World Bank group is a multinational financial institution established at the end of World War II (1944) to help provide long-term capital for the reconstruction and development of member countries. The group is important to multinational corporations because it provides much of the planning and financing for economic development projects involving billions of dollars for which private businesses can act as contractors and suppliers of goods and engineering related services.

The purpose for the setting up of the Bank are

a. To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peacetime needs and encouragement of the development or productive facilities and resources in less developed countries.

b. To promote private foreign investment by means of guarantees or participation in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources.

c. To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and condition of labour in their territories.

d. To arrange the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, can be dealt with first.

e. To conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a wartime to a peacetime economy. The World Bank is the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). The IBRD has two affiliates, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA). The Bank, the IFC and the MIGA are sometimes referred to as the "World Bank Group".

3.5.2 FUNCTIONS OF THE WORLD BANK

The principal functions of the IBRD are set forth in Article I of the agreement as follows:

a. To assist in the reconstruction and development of the territories of its members by facilitating the investment of capital for productive purposes.

b. To promote private foreign investment by means of guarantee of participation in loans and other investments made by private investors and when private capital is not available on reasonable terms, to make loans for productive purposes out of its own resources or from funds borrowed by it.

c. To promote the long-term balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members.

d. To arrange loans made or guaranteed by it in relation to international loans through other channels so that more useful and urgent projects, large and small alike, will be dealt with first. It appears that the World Bank was created to promote and not to replace private foreign investment. The Bank considers its role to be a marginal one, to supplement and assist foreign investment in the member countries.

e. A little consideration will show that the objectives of the IMF and IBRD are complementary. Both aim at increasing the level of national income and standard of living of the member nations. Both serve as lending institutions, the IMF for short-term and the IBRD for long-term capital. Both aim at promoting the balanced growth of international trade.

3.5.3 ROLE OF THE WORLD BANK

The World Bank is internationally recognised and supported that provides technical & financial assistance to many developing countries in the world. It also aids their advancement, in an economy with a primary goal of reducing poverty. World Bank has the largest knowledge of developing countries. Also, they are the largest source of funding. The role of world bank is

a) To help the war-devasted countries by granting them loan for reconstruction.

b) To provide extensive experience & the financial resources of the bank to help the poor countries increase their economic growth, reducing poverty & a better standard of living.

c) To grant development loan to the under-developed countries

d) To provide loans to various governments for irrigation, agriculture, water supply, heath, educations etc.

e) To promote foreign investments to other organisations by guaranteeing the loans.

f)` To provide economic, monetary & technical advice to the member countries for any of their projects.

g) To encourage the development of industries in under-developed countries by introducing the various economic reforms.

3.5.4 FUNCTIONING OF THE WORLD BANK

The World Bank is the world's largest source of development assistance, providing nearly $30 billion in loans, annually, to its client countries. The Bank uses its financial resources, its highly trained staff and its extensive knowledge base to individually help each developing country onto a path of stable, sustainable and equitable growth. The main focus is on helping the poorest people and the poorest countries hut for all its clients, the Bank emphasises the need for: investing in people, particularly through basic health and education; protecting the environment; supporting and encouraging private business development; strengthening the ability of the governments to deliver quality services efficiently and transparently; promoting reforms to create a stable macroeconomic environment conducive to investment and long-term planning; focusing on social development, inclusion, governance and institution building as key elements of poverty reduction. The Bank is also helping countries to strengthen and sustain the fundamental conditions that help to attract and retain private investment. With Bank support- both lending and advice- governments are reforming their overall economies and strengthening banking systems. They are investing in human resources, infrastructure and environmental protection which enhance the attractiveness and productivity of private investment. Through World Bank guarantees, MICA's political risk insurance and in partnership with IFC's equity investments, investors are minimising their risks and finding the comfort to invest in developing countries and countries undergoing transition to market-based economies.

How World bank raises money?

The World Bank raises money for its development programmes by tapping the world's capital markets and in the case of the IDA, through contributions from wealthier member governments. IBRD, which accounts for about three-fourths of the Bank's annual lending, raises almost all its money in financial markets. One of the world's most prudent and conservatively managed financial institutions, the IBRD sells AAA-rated bonds and other debt securities to pension funds, insurance companies, corporations, other banks and individuals around the globe. IBRD charges interest from its borrowers at rates, which reflect its cost of borrowing. Loans must be repaid in 15 to 20 years; there is a three to five year grace period before repayment of principal begins. IDA helps to promote growth and reduce poverty in the same ways as does the IBRD but using interest free loans (which are known as IDA "credits"), technical assistance and policy advice. IDA credits account for about one-fourth of all Bank lendings. Borrowers pay a fee of less than 1 per cent of the loan to cover administrative costs. Repayment is required in 35 to 40 years with a 10 years grace period. Nearly 40 countries contribute to IDA's funding, which is replenished every three years. IDA's funding is managed in the same prudent, conservative and cautious way as is the IBRD's. Like the IBRD, there has never been default on an IDA credit.

Who runs the World Bank?

Like the Fund, the Bank's structure is organised on a three-tier basis; a Board of Governors, Executive Directors and a President. The Board of Governors is the supreme governing authority. It consists of one governor (usually the Finance Minister) and one alternate governor (usually the governor of a central bank), appointed for five years by each member.

The Board is required to meet once every year. It reserves to itself the power to decide important matters such as new admissions, changes in the bank's stock of capital, ways and means of distributing the net income, its ultimate liquidation, etc. For all technical purposes, however, the Board delegates its powers to the Executive Directors in the day-to-day administration.

At present, the Executive Directors are 19 in number, of which five are nominated by the five largest shareholders — the USA, the UK, Germany, France and India. The rest are elected by the other members.

The Executive Directors elect the President who becomes their Ex-officio Chairman holding office during their presence. He is the chief of the operating staff of the Bank and is subject to the direction of the Executive Directors on questions of policy and is responsible for the conduct of the ordinary business of the Bank and its organisation.

Lending Operations

Loans are granted to member countries only after the Bank is fully satisfied about the economic position of the borrowing country as well as the soundness of the specified projects for which assistance is sought. In granting loans, the Bank is prepared to take reasonable risks but insists that funds obtained from it should be used for purposes which are constructive and practical.

The Bank has powers of supervision and control to ensure that funds are used for the purposes for which the loan is granted. Normally, the Bank makes medium or long-term loans, the term being related to the estimated useful life of the equipment or plant being financed.

The Bank makes or facilitates loans in any one or more out of its own following ways:

(a) By making or participating in direct loans out of its own funds; or

(b) Out of the funds raised in the market of a member, or otherwise borrowed by the Bank; or

(c) By guaranteeing, in whole or in part, loans made by private investors through the investment channels.

The total outstanding amount of the loans made or guaranteed by the Bank is not to exceed 100 per cent of its total unimpaired subscribed capital resources and surplus. The interest rate charged by the Bank on its loans is the estimated cost to the Bank of borrowing money for a comparable term in the market and is uniform without distinction among borrowers In addition to the rate of interest, the Bank charges on all loans a commission of 1 per cent for the purpose of creating a special reserve against losses and ½ per cent for administrative expenses.

In recent years, the Bank has made loans mainly for specific development projects in the field of agriculture, power, transport and industry. Most of the loans have been made to the underdeveloped countries. India is the Bank's largest individual borrower.

Technical and Advisory Assistance

In addition to providing financial assistance to member countries, the Bank has been rendering signal service to its members by providing them suitable technical assistance to assess their total economic resources and to set up priorities to be followed in their development programmes.

Technical assistance on a boarder scale has also been provided, for instance, in development programming through Survey Missions, which make intensive studies of national resources and formulate recommendations to serve as the basis of long-term development programmes.

In addition to the training programme, the Bank, with financial assistance from the Rockefeller and Ford Foundations, has set up in Washington an Economic Development Institute to provide an opportunity to selected groups of senior officials from the less developed countries to participate annually in an international course of studies designed to give them a broad perspective of the problems of economic development and to increase their efficiency.

3.5.5 INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

The IDA was formed in 1960 as a part of the World Bank Group to provide financial support to LDCs on a more liberal basis than could be offered by the IBRD. The IDA has 173 shareholder countries, although all members of the IBRD are free to join the IDA. IDA's funds come from subscriptions from its developed members and from the earnings of the IBRD. Credit terms usually are extended to 40 to 50 years with no interest. Repayment begins after a ten-year grace period and can be paid in the local currency, as long as it is convertible. Eligibility for IDA support depends first and foremost on a country's relative poverty, defined as GNI per capita below an established threshold and updated annually ($1,185 in the fiscal year 2021). IDA also supports some countries, including several small island economies, that are above the operational cutoff but lack the creditworthiness needed to borrow from the International Bank for Reconstruction and Development (IBRD). Some countries, such as Nigeria and Pakistan, are IDA-eligible based on per capita income levels and are also creditworthy for some IBRD borrowing. They are referred to as "blend" countries. 74 countries are currently eligible to receive IDA resources. An example of an IDA project is a $8.3 million loan to Tanzania approved in 1989 to implement the first stage in the longer-term process of rehabilitating the country's agricultural research system.

Co-financing is expected from several countries as well as other multilateral lending institutions. Although the IDA's resources are separate from the IBRD, it has no separate staff. Loans are made for similar projects as those carried out by IBRD, but at easier and more favourable credit terms.

As mentioned earlier, World Bank/IDA assistance historically has been for developing infrastructure. The present emphasis seems to be on helping the masses of poor people in the developing countries become more productive and take an active part in the development process. Greater emphasis is being placed on improving urban living conditions and increasing productivity of small industries.

3.5.6 INTERNATIONAL FINANCE CORPORATION (IFC)

The IFC was established in 1956. There are 184 countries that are members of the IFC and it is legally and financially separate from the IBRD, although IBRD provides some administrative and other services to the IFC. The IFC's main responsibilities are

a. To provide risk capital in the form of equity and long-term loans for productive private enterprises in association with private investors and management;

b. To encourage the development of local capital markets by carrying out standby and underwriting arrangements; and

c. To stimulate the international flow of capital by providing financial and technical assistance to privately controlled finance companies. Loans are made to private firms in the developing member countries and are usually for a period of seven to twelve years.

The key feature of the IFC is that its loans are made to private enterprises and its investments are made in conjunction with private business. In addition to funds contributed by IFC, funds are also contributed to the same projects by local and foreign investors. IFC investments are for the establishment ne1x enterprises as well as for the expansion and modernization of existing ones. They cover a wide range of projects such as steel, textile production, mining, manufacturing, machinery production, food processing, tourism and local development finance companies. Some projects are locally owned, whereas others are joint ventures between investors in developing and developed countries. In a few cases, joint ventures are formed between investors of two or more developing countries. The IFC has also been instrumental in helping to develop emerging capital markets.

3.5.7 THE MULTILATERAL INVESTMENT GUARANTEE AGENCY (MIGA)

The MIGA was established in 1988 to encourage equity investment and other direct investment flows to developing countries by offering investors a variety of different services. It offers guarantees against noncommercial risks; advises developing member governments on the design and implementation of policies, programs and procedures related to foreign investments; and sponsors a dialogue between the international business community and host governments on investment issues.

3.5.8 CRITICISM OF THE WORLD BANK

The modus operandi of the Bank has been criticised on various counts from different quarters:

a. It is alleged that the Bank charges a very high rate of interest on loans. For example, some of the loans which India has received in recent years bear an interest of 53.4 per cent including the commission at 1 per cent which is credited to the Bank's special reserves.

b. The Bank's insistence, prior to the actual grant of loan, on the country having the capacity to transfer or repay, is open to criticism. The Bank should not apply orthodox standards to judge the transfer capacity of any borrowing country. Transfer capacity follows rather than precedes the loan.

c. The financial help given by the Bank does no) amount to more than a drop in the big ocean of financial requirement so essential for various development projects.

It may be said that the World Bank has not come up to the expectations of many nations. Nevertheless, it has been instrumental to a very large extent in initiating and accelerating the work of economic reconstruction and development in different countries. No doubt, India has derived immense benefit from the World Bank.

3.6 DIFFERENCE BETWEEN WORLD BANK AND IMF

World Bank provides financial and technical aid to the developing nations of the world. On the other hand, IMF is formed to promote financial stability, international trade, high employment, reduce poverty and so on. The following are the points of difference between world bank and IMF:

S.No.	Basis of comparison	World Bank	International Monetary Fund
1	Meaning	An international organization maintaining the global monetary system is the International Monetary Fund.	A global organization established to finance and advice the developing nations, in order to make them economically developed is World Bank.
2	Focus	Economic Stability	Economic Growth
3	Organizational Structure	It is a single organization with four credit lines.	It has two major institutions, namely International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA).
4	Membership	190 countries	IBRD – 189 countries IDA - 173 countries IFC- 184 countries MIGA- 182countries
5	Operations	Provides assistance	Facilitates lending
6	Objective	To deal with all the issues related to the financial sector and macroeconomics.	To lessen poverty and promote the long term development of the economy.

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3.7 SUMMARY

Globalization has increased the need for closer cooperation between the multilateral institutions with key roles in the formulation and implementation of different elements of the framework for global economic policy, in particular the International Monetary Fund (IMF), the World Bank and the World Trade Organization. Each of these organizations has a mandate for such cooperation in the agreements under which they have been established. They also have signed agreements among themselves, for mutual cooperation and regular consultation, which identify mechanisms designed to foster greater coherence in global economic policy-making.

3.8 GLOSSARY

- **World bank-** With 189 member countries, staff from more than 170 countries, and offices in over 130 locations, the World Bank Group is a unique global partnership: five institutions working for sustainable solutions that reduce poverty and build shared prosperity in developing countries.
- **IMF-** an organization of 190 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.
- **WTO-** The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible
- **IDA-** It is part of the World Bank that helps the world's poorest countries.

3.9 SELF ASSESSMENT QUESTIONS

1. Differentiate between IMF and World bank.

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2. Briefly explain the role of WTO in international trade.

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3. Elucidate the World bank group.

4. Explain in detail the role and functions of IMF.

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INTERNATIONAL FINANCIAL INSTITUTIONS: ROLE OF WTO; INTERNATIONAL MONETARY REFORMS

Unit - I	Lesson No. 4
C.No. M.COM-FC 412	SEM : Fourth

STRUCTURE

4.1 INTRODUCTION

In many parts of the world, international financial institutions (IFIs) play a major role in the social and economic development programs of nations with developing or transitional economies. This role includes advising on development projects, funding them and assisting in their implementation. Characterized by AAA-credit ratings and a broad membership of borrowing and donor countries, each of these institutions operates independently.

Developed countries and international agencies projected intellectual property protection as the major factor in the growth of the world trade and made it an important item of discussion under GATT in what is known as the Uruguay Round of negotiations. The Uruguay Round began in 1986 and after intense debate spreading over eight years, concluded on April 18, 1994 with the signing of a Final Act in Marrakesh, Morocco. The

World Trade Organisation (WTO) was thus born at Marrakesh. The basic purpose of the WTO is to ensure a smooth and full flow of the world trade.

4.2 OBJECTIVES

After studying this lesson, you will be able to:
- explain the meaning of WTO;
- determine the functioning of WTO;
- discuss the reforms in international monetary system;

4.3 WORLD TRADE ORGANISATION (WTO)

Following the end of the Second World War, a General Agreement on Tariffs and Trade (GATT) came into force in 1947 to deal with issues concerning trade and tariff at the global level. In the 1980s, as technology became the dominant engine for economic growth, the clamour of multinational corporations, which are the principal generators of technology, for an effective mechanism for world-wide protection of intellectual property, and strict enforcement of IP rights gained momentum. They had full and active support of their governments. Developed countries and international agencies projected intellectual property protection as the major factor in the growth of the world trade and made it an important item of discussion under GATT in what is known as the Uruguay Round of negotiations. The Uruguay Round began in 1986 and after intense debate spreading over eight years, concluded on April 18, 1994 with the signing of a Final Act in Marrakesh, Morocco. The World Trade Organisation (WTO) was thus born at Marrakesh. The basic purpose of the WTO is to ensure a smooth and full flow of the world trade. The WTO is the only international Organization dealing with the global rules of trade between nations. The GATT which underwent a major revision as the result of negotiations is now the principal rule book of the WTO for trade in goods. New rules came into force for dealing with trade in services, trade related aspects of intellectual property, dispute settlement and trade policy reviews. All WTO members are subjected to periodic review of their trade policies to ensure transparency and adherence to the WTO agreement. As of October 2004, 148 countries were members of the WTO accounting for over 97% of world trade. Decisions in WTO are made by the entire membership, typically by consensus.

The WTO is concerned with trade between nations and strives to develop universally agreed rules of global trade. It stands for liberalization of trade, and serves as the forum where global trade agreements are negotiated and trade disputes between member nations are resolved and settled. The WTO Agreements are legal ground rules binding member countries in the conduct of international commerce – national trade policies have to honour and remain within the limits set in these agreements. The objectives of the Agreements are two fold: to enable free flow of global trade without undesirable side effects and to allow governments to meet social and environmental objectives. For free flow of trade, obstacles have to be removed and fast: custom duties are to be lowered, quotas have to be ended, subsidies are to be withdrawn and non-tariff barriers are not to be erected. The WTO seeks to establish a transparent, rule-based system for global trade, where everyone is to abide by the agreed rules. It has an effective disputes resolution system which is meant to inspire confidence among members about a fair mechanism and neutral procedures to ensure speedy resolution of disputes. It may be remembered how the WTO is different from its predecessor, the General Agreement on Tariffs and Trade (GATT). In the first place, as its name implied GATT was an agreement between contracting parties and not an international organisation regulating global trade in a compelling manner. Secondly, the GATT dealt with trade in goods, but the WTO agreements additionally cover trade in services, as also trade in intellectual property. The subject matters of various agreements under the WTO include: agriculture, textiles and clothing, banking, telecommunications, government purchases, industrial standards and product safety, food sanitation regulations, intellectual property.

4.3.1 TRADING PRINCIPLES UNDER THE WTO

A few fundamental principles serve as the bedrock for all WTO agreements. These underlying principles are:

- Trade without discrimination " Most-favoured-nation (MFN) treatment " National treatment
- Freer trade (bringing down trade barriers)
- Predictability, through binding commitment and transparency
- Promoting fair competition
- Encouraging development and economic reform

a. **Most favoured nation (MFN) treatment:** Despite its apparent, discriminating overtones, in the WTO parlance, the MFN means non-discrimination, where every WTO member is assured of getting the same treatment at the hands of a WTO member which it grants to any other WTO member. If a member country of WTO grants a special favour in trade to some favoured country, then all other WTO members will have to be given the same favour. Thus all countries, in the WTO system, become the most favoured nation in all other countries, making every country equal. The name, MFN, derives from the practice in earlier bilateral MFN treaties, where a country could create a club of most favoured trading partners. Under WTO it is no more possible. Every member is a most favoured trading partner. The principle of MFN treatment figures prominently in the Agreements for all three main areas of trade handled by the WTO, namely,

- the General Agreement on Tariffs and Trade (GATT)" deals with trade in goods
- the General Agreement on Trade in Services (GATS) " deals with trade in services
- the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement) " deals with intellectual property

There could be exceptions to the MFN principle. For example, a group of countries can enter into a free trade agreement in respect of goods that are traded within the group only; a country can give special access to its markets to developing countries; a country can raise barriers against goods from special countries on consideration of unfair trade practices. But the exceptions are permitted only under strict conditions.

b. **National Treatment:** In essence it means treating foreigners and locals equally by all members of the WTO. In the context of trade, this means that all WTO members are bound to give equal treatment to imported goods and locally produced goods, foreign services and domestic services, foreign and local trademarks, copyrights, patents, designs etc. under their national laws. The national treatment principle is emphasised in all three WIPO agreements i.e. GATT, GATS, and TRIPS, though it is handled slightly differently in each of them. A point to note is that the principle of national treatment is applicable only after a relevant item under any of the three WIPO agreements (a product, service or intellectual property) has entered the market. Its implication is that a custom duty can be levied on an item of import, even if its local counterpart attracts no tax, without violating the national treatment principle.

c. **Free Trade:** Countries are known to raise barriers to impede free flow of trade. Imposing customs duties (tariffs), selectively restricting quotas of import of various items, banning of imports altogether are some of the obvious barriers. There may be other measures which may not be so obvious but which would still have the same effect e.g. subsidies, red tape, artificially propped up exchange rates, etc. for freer trade, barriers have to be removed or lowered through negotiations. The WTO agreements encourage progressive liberalisation.

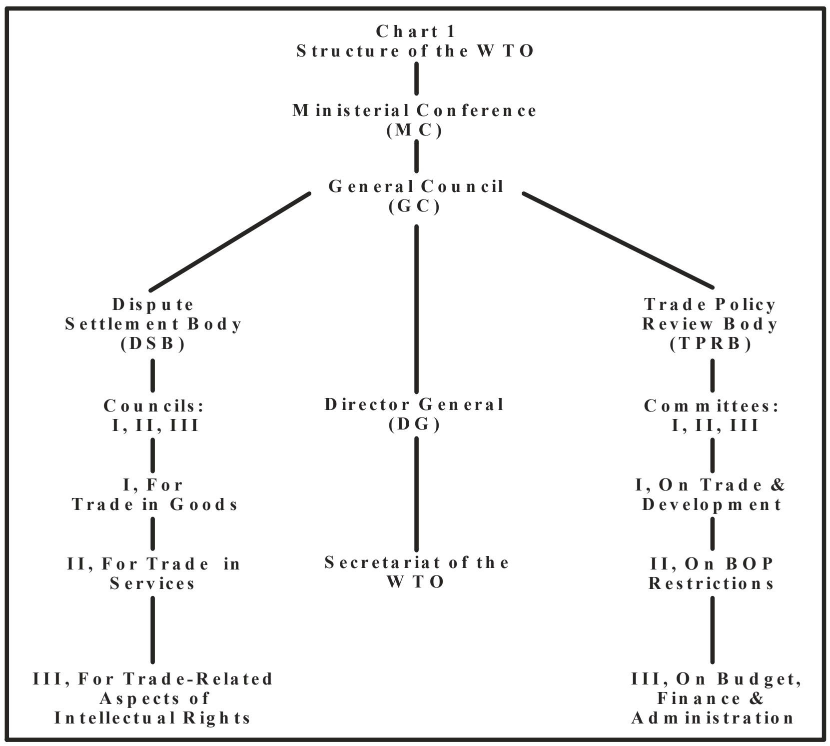
d. **Predictability:** Economic development of a country requires foreign capital, technologies and expertise. However, foreign investments are drawn if there is a promise of stability and the policy environment is predictable. Uncertainly does not exactly help confidence of foreign investors and collaborators, whether individual or institutional. The multilateral trading system under the WTO strives to create stability and predictability in the business environment through negotiations, that create binding commitments on the part of members. Examples of binding commitments are: open access to markets and ceilings on customs tariffs. Transparency in trade rules and government policy goes a long way to inspire confidence in trading partners. The WTO has a Trade Policy Review Mechanism which keeps national trade policies under regular surveillance.

e. **Fair competition:** The WTO encourages fair competition in free trade, though the degree of freedom is circumscribed by reality. In some circumstances where trading practices of a country are proven to be unfair, as in the case of dumping and subsidies, the WTO rules permit raising of customs duty, and even other forms of protection. The MFN and the National Treatment principles ensure, in substantial measure, that the trading environment is fair. It strongly disapproves of subsidies and dumping (exporting a product at below production cost to capture large market share). Several WTO agreements provide for conditions of fair competition to prevail e.g. in agriculture, services, intellectual property, government procurement.

f. Development and Reforms: Alive to the realities of the situation in developing countries, the WTO agreements provide for special assistance and trade concessions to them. Some three fourths of the members of the WTO fall under two categories: developing countries and countries in transition to market economies from the Centrally Planned Economies. They have been given additional time to comply with the requirements of the WTO agreements and join the mainstream. Developed countries have opened their markets to exports from least developed countries allowing duty free, quota free imports.

4.3.2 STRUCTURE OF WTO

The organisational structure of the WTO is outlined in the figure below:



The Ministerial Conference (MC) is at the top of the structural organisation of the WTO. It is the supreme governing body which takes ultimate decisions on all matters. It is constituted by representatives of (usually, Ministers of Trade) all the member countries.

The General Council (GC) is composed of the representatives of all the members. It is the real engine of the WTO which acts on behalf of the MC. It also acts as the Dispute Settlement Body as well as the Trade Policy Review Body.

There are three councils, viz.: the Council for Trade in Services and the Council for Trade-Related Aspects of Intellectual Property Rights (TRIPS) operating under the GC. These councils with their subsidiary bodies carry out their specific responsibilities

Further, there are three committees, viz., the Committee on Trade and Development (CTD), the Committee on Balance of Payments Restrictions (CBOPR), and the Committee on Budget, Finance and Administration (CF A) which execute the functions assigned to them by e WTO Agreement and the GC.

The administration of the WTO is conducted by the Secretariat which is headed by the Director General (DG) appointed by the MC for the tenure of four years. He is assisted by the four Deputy Directors from different member countries. The annual budget estimates and financial statement of the WTO are presented by the DG to the CBFA for review and recommendations for the final approval by the GC.

WTO Bodies:

Two key units are the Dispute Settlement Body (DSB) and the Trade Policy Review Body (TPRB). The DSB, on which all member countries can sit, usually meets twice a month to hear complaints of violations of WTO rules and agreements. It sets up expert panels to study disputes and decide if the rules are being broken. The DSB's final decisions, unlike those of a similar but less powerful body in the old GATT, cannot be blocked.

The TPRB is a forum for the entire membership to review the trade policies of all WTO states. Major trading powers are reviewed every two years, others every four years.

Other major bodies are the Council for Trade in Goods, the Council for Trade in Services and the Council for Trade-Related Aspects of Intellectual Property Rights

4.3.3 OBJECTIVES OF THE WTO

The purposes and objectives of the WTO are spelled out in the preamble to the Marrakesh Agreement. In a nutshell, these are:

a. To ensure the reduction of tariffs and other barriers to trade.

b. To eliminate discriminatory treatment in international trade relations.

c. To facilitate higher standards of living, full employment, a growing volume of real income and effective demand, and an increase in production and trade in goods and services of the member nations.

d. To make positive effect, which ensures developing countries, especially the least developed secure a level of share in the growth of international trade that reflects the needs of their economic development.

e. To facilitate the optimal use of the world's resources for sustainable development.

f. To promote an integrated, more viable and durable trading system incorporating all the resolutions of the Uruguay Round's multilateral trade negotiations.

Above all, to ensure that linkages trade policies, environmental policies with sustainable growth and development are taken care of by the member countries in evolving a new economic order.

4.3.4 FUNCTIONS OF THE WTO

The WTO consisting a multi-faced normative framework: comprising institutional substantive and implementation aspects. **The major functions of the WTO are as follows:**

a. To lay-down a substantive code of conduct aiming at reducing trade barriers including tariffs and eliminating discrimination in international trade relations.

b. To provide the institutional framework for the administration of the substantive code which encompasses a spectrum of norms governing the conduct of member countries in the arena of global trade.

c. To provide an integrated structure of the administration, thus, to facilitate the implementation, administration and fulfillment of the objectives of the WTO Agreement and other Multilateral Trade Agreements.

d. To ensure the implementation of the substantive code.

e. To act as a forum for the negotiation of further trade liberalisation.

f. To cooperate with the IMF and WB and its associates for establishing a coherence in trade policy-making.

g. To settle the trade-related disputes.

4.3.5 FEATURES OF THE WTO

The distinctive features of the WTO are:

a. Unlike the GATT, it is a legal entity.

b. Unlike the International Monetary Fund (IMF) and the World Bank (WB) it is not an agent of the United Nations.

c. Unlike the IMF and the World Bank, there is no weighted voting, but all the WTO members have equal rights.

d. Unlike the GATT, the agreements under the WTO are permanent and binding to the member countries.

e. Unlike the GATT, the WTO dispute settlement system is based not on dilatory but automatic mechanism. It is also quicker and binding on the members. As such, the WTO is a powerful body.

f. Unlike the GATT, the WTOs approach is rule- based and time-bound.

g. Unlike the GATT, the WTOs have a wider coverage. It covers trade in goods as well as services.

h. Unlike the GATT, the WTOs have a focus on trade-related aspects of intellectual property rights and several other issues of agreements.

i. Above all, the WTO is a huge organisational body with a large secretariat.

4.3.6 ROLE OF WTO IN PROTECTING INTERNATIONAL TRADE

The protectionism which rose in worldwide exchange after the Second World War offered approach to steady advancement, containing both one-sided progression and standards based multilateral advancement. Globalisation is the after effect of free or less limited exchanging merchandise, administrations, innovation, and capital among different nations. However there are different standing up to issues that limit the development of universal exchange, they are exchange obstructions, monetary help, robbery and all the more particularly infringement of protected innovation rights. This happens due to various exchanging rules, nonappearance of correspondence, and so on. It is here where WTO gives a worldwide stage to the signatory nations to meet and examine their issues and to catch by and large acknowledged answers for smoother change to more prominent unhindered commerce administrations. In this manner WTO effectively contributes for the improvement of respective concessions to facilitated commerce in products, administrations and innovation.

WTO is the main universal association managing the worldwide tenets of exchange between countries. The World Trade Organization appeared with impact from 1-1-1995. The WTO supplanted General Agreement on Tariffs and Trade (GATT). Its primary capacities are:

a. To take care of the organization of assertions marked at the Uruguay Round.

b. To keep minds the execution of levy cuts and decrease of non-duty measures.

c. To analyse remote exchange approaches of the part countries, and to see that such strategies are tuned in to WTO's rules.

d. To set down techniques for touching base at a concordant arrangement if there should arise an occurrence of exchange clashes.

e. To give vital consultancy to the part countries on the improvement in the World economy.

f. To give a worldwide stage where part countries persistently arrange the trading of exchange concessions.

The resultant result is the confirmation to the buyers and makers who realise that they can appreciate more noteworthy selection of items and administrations. At the core of the framework are the WTO's understandings, which are standard procedures for universal business and are marked by the exchanging countries.

Following are the primary standards of the WTO:

a. **Non-separation:** It infers both remote and national organisations are dealt with the same. Consequently all countries ought to be dealt with similarly regarding exchange.

b. **Correspondence:** Nations should endeavor to give comparable concessions to each other.

c. **Transparency:** Negotiations must be reasonable and open with rules meet for all.

d. **Special and differential treatment:** It gives that creating nations may require 'positive separation' on account of noteworthy unequal exchange.

4.4 INTERNATIONAL MONETARY REFORMS

In respect of exchange rate, it was agreed that the floating exchange system should be legalized. But members are still under an obligation to collaborate with the fund to ensure orderly exchange arrangements and promote a system of stable exchange rate. It was also provided that countries may return to a stable but adjustable par value system at a future date. Meanwhile, floating rate with a wider band of fluctuations of 2.25 percent on either side which was prevailing since the Smithsonian agreement would continue.

A new concept of "international surveillance of the exchange rate system" was developed and accepted as a new approach to the exchange rate system. Out of 149 members in the fund, as at December 1986, there were about 14 member countries independently floating, 8 countries in a joint float and 32 countries linked to the US Dollar, 14 to the French Franc, 12 to SDR, 31 to a currency basket and the rest linked to other currencies. the fixed parity system had disappeared completely.

As regards gold, it would no longer function as an international unit of value or medium of exchange for the purpose of the Fund. The official price of gold is abolished and obligatory payments and receipts in gold between the Fund and members were withdrawn. Members are free however to deal in gold among themselves, SDR will be the unit and medium of exchange in future. The existing gold stocks of the fund are to be disposed of by returning to members half of their original contributions and by selling the other half in the market through auction and to use the proceeds for the Trust Fund. Provisions are made for greater use and resort to SDRs, referred to later.

Two amendments were made to the Articles of Agreement, in connection with the reforms.

Firstly, in 1969 and amendment was made to create a system of SDRs which will be referred to later. Secondly, Articles were amended in 1978 to introduce reforms in the international monetary system referred to earlier.

The principle of surveillance of the Fund over the members exchange rate systems was embodied in the Second Amendment. So also was the abandonment of gold as an international unit of account or a medium of exchange for which SDR is redesigned.

Surveillance involves the following principles:

1. A member shall avoid manipulating exchange rates to its advantage or prevent effective balance of payments adjustments.
2. A member shall intervene in the exchange market if necessary to counter disorderly conditions.
3. Members should take into account the interests of other members of the Fund in their intervention policy.

Members are free to choose their exchange rate arrangements except to maintain values in terms of SDR and to co-operate with the Fund in the orderly exchange arrangements.

The Need for Reform

1. The global crisis. The crisis that engulfed the global economy in 2008 caught most experts and policy makers by surprise, bringing to light a number of hitherto unnoticed vulnerabilities. While these were chiefly found in the financial sectors of major advanced countries, troubles there quickly spread to the entire international monetary and financial system, in the form of a sudden stop or reversal of capital flows and in liquidity shortages, as investors scrambled to reduce risk exposures and deleveraged. The crisis made even more obvious how tightly the economies and financial markets of the world are tied together with a shock in one major country rapidly propagating to the entire system.

2. The response. The crisis response highlighted the benefits of policy coordination as global fiscal and monetary stimulus, and the injection of massive amounts of liquidity averted an even more dramatic worldwide collapse in economic activity. For the first time since the end of world war-II., the emerging market countries played a critical role in these efforts not least through their ambitious fiscal stimulus policies. These developments also resulted in some narrowing of global imbalances. In the financial sphere a series of reforms have been adopted and are now in the process of being implemented, and others are under consideration1. These developments justify a measure of optimism.

3. Persistent dangers. However, significant vulnerabilities remain in the financial sector, related inter alia to the role of the shadow banking system. It should also be cause for concern if, in parts of the finance industry, the lessons of the crisis were to be forgotten. In addition, the long-standing structural weakness of our international monetary arrangements have yet to be addressed. These weakness put in doubt the ability of the international monetary system to durably fulfill its fundamental purpose, namely "….to provide a framework that facilitates the exchange of goods, services and capital among countries, and that sustains sound economic growth (Article IV of the International Monetary Fund). These weakness include the following:

Ø **Ineffective global adjustment process**

· The system lacks effective discipline and countries can accumulate large current account imbalances – whether surpluses or deficits – for extended periods without facing effective pressures for adjustment.

· The peer review over the policies of member countries to be exercised by the IMF ("surveillance") has often been ineffective in bringing about policy adjustment on the port of countries with internal and external imbalances especially when they have no need to borrow from the Fund. This reflects among other issues, the lack of teeth of IMF procedures.

· This situation is fraught with three major risks: (i) the resurgence of prolonged and ultimately unsustainable current account imbalances, susceptible in unwinding in a very disorderly way; (ii) global inflationary pressure if too many countries run excessively expansionary fiscal and monetary policies; (iii) or, conversely, undue restraint on the global economy if too many countries try simultaneously to run current account surpluses.

Ø **Financial excesses and destabilizing capital flows**

· In the run up to the crisis, an unsustainable global expansion was facilitated by rapid growth in global credit. Exceptionally low interest rates (accompanied by massive official reserve accumulation over the same period) triggered an intense search for yield. Combined with inadequate supervision over the financial system, including a blossoming shadow banking system, unrealistically compressed risk spreads and asset bubbles developed. These mounting vulnerabilities went unchecked in part because there are no commonly agreed definitions and measures of global liquidity.

· Large wings in capital flows has have occurred recently, in part as a symptom of an unchecked expansion of global liquidity, can overwhelm countries ability to preserve macroeconomic and financial stability. This is all too evident in the recent tensions over potential currency or trade "wars" and in the increasing resort to capital controls.

· The capacity of individual countries or international institutions to cope with a future systemic liquidity crisis is not assured. In dealing with sudden shifts in international liquidity, unlike at the national level, there is no global lends of last report. In the recent crisis, effective cooperative measures were taken at the peak of the crisis. These included swaps and liquidity lines extended a number of central banks to counterparts, including in some emerging tripling of the IMF's resources and revamping its lending facilities for large scale precautionary and liquidity support; and a $ 250 billion allocation. But these measures were adhoc.

Ø **Excessive exchange rate fluctuations and deviations from fundamentals**

· Since the advent of generalized floating in 1973, exchange rates around major currencies in the system have fluctuated widely, reflecting, in part, strong and capricious speculative forces often disconnected from fundamentals. Exchange rates have failed to move consistently in a direction promoting the adjustment of imbalances. Such deviations from fundamentals can be the result of either inadequate fiscal, monetary and exchange policies or market behavior. This has posed particular problems for small open economies.

· Large, lasting swings in currency values can cause serious distortions in the system and in the allocation of resources.

Ø **Excessive expansion of international services**

· Neither the supply of nor the demand for reserves are subject to collective decision-making. Several consequences of this can be identified.

· A number of emerging market countries and, to a lesser extent, advanced economies have accumulated an unprecedented volume of international reserves, either as a goal in itself (e.g. as a cushion against future uncertainties) or as a result of other policies domestic or external (e.g. to limit exchange rate appreciation). Partly as a result, emerging markets have become net exporters of capital to advanced economies, which appears contrary to longer term priorities for economic development.

· Easy availability of financing has contributed to financial imbalances by postponing needed adjustment, including domestic policies to deal with mounting fiscal imbalances.

· Reserve balances have remained concentrated in a small number of currencies, predominantly the US dollar. Some diversification of reserves is taking place, but the question is being raised of the need for a multilateral way of facilitating such diversification to avoid the risk that expectations of moves by official reserve holders may trigger destabilizing shifts in private portfolios. It is important that such issues be properly dealt with.

4. Lack of effective global governance. There is no unified global governance structure to help ensure that major economic and financial policy decisions made nationally, including exchange rate policies, are mutually consistent and contribute to global stability. In a world so deeply inter-connected, economic outcomes in each country depend significantly on developments and policy decisions made in others. In such a world, there is a strong case for rules and processes to be developed to help ensure global stability. The IMF was intended to provide this structure, but has been insufficiently effective, for three reasons:

· For too long, it was presumed by many that if each country kept its own house in order, and did not manipulate its exchange rate, that would be enough to guarantee global stability. This view has proven too optimistic with respect to the self-equilibrating function of markets and economies.

· There is no shared analytic framework for assessing the spillover effects of policies in large countries on other economies and the system at large.

· The IMF, as the central institution of the system, has suffered from a "legitimacy deficit", reflecting both the underrepresentation of some emerging marked and developing countries, and the failure of the Fund's peer review process to have much influence over the policies of its largest members.

The failure to adjust its governance structure in a timely manner has hindered the Fund's ability to act as the intended institutional "machinery" to promote international monetary cooperation (Article I). The emergence of the G20 as the de facto primary forum for economic and financial cooperation contributed to filling that void. Notwithstanding the success of the G20 in reacting to the onset of the recent crisis, its effectiveness and legitimacy could be improved if somehow it could speak for all countries in the global economy.

5. **Urgency.** Most of the problems described above are not new, but the consequences of not addressing them are increasing and inhibiting the realization of the full benefits of globalization. Much effort has been made in the last year or so to make the international financial system sounder and more robust. But as long as problems in the international monetary system are not addressed, an increasingly integrated world economy becomes more and more vulnerable. A muddling through approach therefore is an increasingly inadequate response. Any meaningful comprehensive reform will require taking near term steps within a longer term vision constantly compatible with an underlying concern about the maintenance of prices stability.

4.5 SUMMARY

WTO happens to be an organization responsible for liberalizing trade. It's a forum to negotiate trade agreements for various governments. It's a place where trade disputes are settled. It is a place where governments who are members go, in order to sort out the trade problems they face with each other. The first step is to talk. The WTO was born out of negotiations, and everything the WTO does is the result of negotiations. The bulk of the WTO's current work comes from the 1986-94 negotiations called the Uruguay Round. The negotiations have helped to liberalize trade where countries have faced trade barriers and wanted them to be lowered. But the WTO is not just about liberalizing trade, and in some cases, its rules are such that trade barriers get support— for example, to protect consumers.

In respect of exchange rate, it was agreed that the floating exchange system should be legalized. But members are still under an obligation to collaborate with the fund to ensure orderly exchange arrangements and promote a system of stable exchange rate. It was also provided that countries may return to a stable but adjustable par value system at a future date. Meanwhile, floating rate with a wider band of fluctuations of 2.25 percent on either side which was prevailing since the Smithsonian agreement would continue.

A new concept of "international surveillance of the exchange rate system" was developed and accepted as a new approach to the exchange rate system. As regards gold, it would no longer function as an international unit of value or medium of exchange for the purpose of the Fund. The official price of gold is abolished and obligatory payments and receipts in gold between the Fund and members were withdrawn. Two amendments were made to the Articles of Agreement, in connection with the reforms. Firstly, in 1969 and amendment was made to create a system of SDRs which will be referred to later. Secondly, Articles were amended in 1978 to introduce reforms in the international monetary system referred to earlier. The principle of surveillance of the Fund over the members exchange rate systems was embodied in the Second Amendment. So also was the abandonment of gold as an international unit of account or a medium of exchange for which SDR is redesigned.

4.6 GLOSSARY

- **WTO-** The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.
- **Monetary reform-** Monetary reform is any movement or theory that proposes a system of supplying money and financing the economy that is different from the current system.

4.7 SELF ASSESSMENT QUESTIONS

1. **Explain the objectives of WTO.**

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2. **Briefly explain the reforms in international monetary system.**

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3. Elucidate the difference between GATT and WTO.

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4.8 SUGGESTED READING

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INTERNATIONAL LIQUIDITY; SPECIAL DRAWING RIGHTS (SDRS): USES, LIMITATIONS; PRE REQUISITES FOR MAKING INDIA AS AN INTERNATIONAL FINANCIAL CENTER

Unit - I **Lesson No. 5**
C.No. M.COM-FC 412 **SEM : Fourth**

STRUCTURE

5.1 INTRODUCTION

International liquidity is generally used as a synonym for international reserves. Such reserves include a country's official gold stock holdings, its convertible foreign currencies, SDRs, and its net reserve position in the IMF. It implies international availability of liquidity and the possibility of obtaining credit from financial institutions operating in international financial markets. Thus, in the broader sense, international liquidity includes private as well as official holdings of international liquidity assets. 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 balance 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. The introduction of SDR as a new international reserve asset by the IMF is a welcome step in the right direction. 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.

5.2 OBJECTIVES

After studying this lesson, you will be able to:

- explain the importance of international liquidity;
- describe the uses of SDRs;
- understand the international liquidity and IMF relationship

5.3 MEANING OF INTERNATIONAL LIQUIDITY

International liquidity is defined as the aggregate stock of internally acceptable assets held by the central bank to settle a deficit in a country's balance of payments. In other words, international liquidity provides a measure of a country's ability to finance its deficit in balance of payments without resorting to adjustment measures. Shortage of liquidity hampers the expansion of global trade and its surplus leads to global inflationary pressures.

In international liquidity there is difference between owned and borrowed reserves, and between conditional and unconditional reserves. Foreign exchange surplus, after meeting all current and capital account obligations of the country with the rest of the world, are "owned" reserves. Similarly, the official gold stock of a country constitutes its owned reserves. Capital imports in the form of borrowings from abroad and direct investments by foreign countries constitute borrowed reserves. Both owned and borrowed reserves are the source of international liquidity. Unconditional international liquidity consists of a country's official gold stock, holdings of its foreign currencies and SDRs, its net position in the IMF, and private holding of international assets. In all such cases, liquidity assets are available to the country without any conditions or restrictions on their use. But in the case of borrowed reserves, the lender country may impose conditions or restrictions on the use of liquid assets by the borrowing country. Many international financial institutions provide funds on conditional basis for specific projects and on specified repayment provisions. All these are cases of conditional liquidity. This is done to avoid the misuse of liquidity by the borrowing country.

5.4 IMPORTANCE OF INTERNATIONAL LIQUIDITY

The importance of international liquidity lies in providing means by which disequilibrium in the BOP of different countries participating in international trade is settled, As such, it helps in the smooth flow of international trade by facilitating the availability of international means of payment. It make be understood that these means or reserves are used to finance deficits in the BOPs. These reserves are not used to finance the inflows or outflows of trade. Changes in the balance of payments— temporary deficits and surplus—must be met by transfers of gold, convertible currencies or international borrowing facilities. All these go to constitute international liquidity. The greater the stock of these items of international liquidity held by any country and by countries in the aggregate, the less will the need for changes in exchange rates.

In a world, in which there are considerable fluctuations in economic activities, accompanied by a growing demand for stability, the importance of international liquidity reserves lies in serving as a buffer, giving each country some leeway for the regulation of its national income and employment and providing it with a means to soften the impact of economic fluctuations arising on account of international trade and transactions. A greater world holding of international liquidity reserves becomes necessary to maintain stable exchange rates over the whole business cycle than to meet any seasonal or short-run fluctuations. It is in this sense that adequacy or otherwise of foreign liquid reserves is an important determinant of the levels of world trade and economic activity. If there are enough or sufficient international liquid reserves, specially with those countries which are likely to incur deficits—there will be less worry or panic for adjustment. On the other hand, if there is too little international liquidity in the world, deficit countries will have no or little time to adjust and they will be forced to impose restrictions on trade and capital movements. As a result, the world growth in international trade will be hampered and the prices of primary products will fall, turning the terms of trade in an unfavorable manner for developing economies. Easy access to international liquidity reserves makes it possible for the swings in the balance of payments to be financed, otherwise, the world trade may be strangled for want of international liquidity.

It implies not only sufficient quantity but the right composition and distribution of international liquid reserves. In other words, stability of reserves (in monetary system) has to be provided in terms of scale, composition and distribution, scale refers to the supply of liquid funds to the system as a whole ; while distribution applies to the distribution of liquid reserves amongst countries. Composition implies the currency composition of reserve holdings. Regarding scale the major limitation is its inability to adjust the supply of reserves in a manner which exerts a stabilizing influence on the world economy. Again, the compositional problem inherent in multi-currency reserve system with floating exchange rates has to be looked into. The distributional problems have to be sorted out to the extent to which some countries have easier, less costly, access to international credits or reserves than do other countries in similar circumstances.

5.5 NEED AND PROBLEM OF INTERNATIONAL LIQUIDITY

The (need or) problem of international liquidity arises because the demand for international liquidity is rising more than its supply, thereby implying shortage of international liquidity. The principal causes for the shortage of international liquidity are the following:

1. BOP Deficits: There have been increasing BOP deficits of the majority of countries in the world. In particular, after the opening of LDCs to world markets, these countries have been facing persistent BOP deficits. Too much dependence on exports has exposed these economies to international fluctuations in the demand for and prices of their products. They have become unstable due to international cyclical instability. On the other hand, their import requirements have been on the increase in order to develop. As a result, they are faced with foreign exchange constraints. This has necessitated larger inflow of aid and foreign investment.

Consequently, debt serving and interest on debt have risen and payments of dividends, profits and royalties on private direct foreign investment have grown, thereby leading to decline in the net inflow of foreign capital. All these have led to further shortage of foreign exchange reserves.

2. High Tariff Barriers: The exports of LDCs to developed countries have not been increasing, thereby adversely affecting their export earnings. One of the reasons for the non-expansion of their exports has been high tariff barriers imposed by the developed countries on their exports, especially by their regional groups like the EEC.

At the same time, the LDCs are trying to cut down their essential imports from the developed countries by means of exchange controls, high tariffs, import quotas and similar protectionist devices in order to conserve foreign exchange. This has adversely affected their development process.

3. Attitude of Developed Countries: The majority of developed countries have surplus in their balance of payments. They are creditors of LDCs and do not take any interest in getting rid of their surplus so as to increase international liquidity.

4. Unequal Distribution of International Reserves: The distribution of international reserves is biased and favours the developed countries. It is primarily based on their quotas in the IMF. Whenever the IMF quotas are revised, the larger share goes to the developed countries. It is the developing countries whose need for international liquidity is far greater which suffer from its shortage.

5.6 FEATURES OF INTERNATIONAL LIQUIDITY

The main features of international reserves or international liquidity have been:

a. Gold reserves of the countries of the world increased from $ 33.9 billion in 1951 to SDR 224.1 billion in 1997.

b. Marked increase in the share of foreign exchange reserves from $13.7 billion in 1951 to SDR 1078.2 billion in 1997.

c. Increase in reserve position in the IMF from $ 1.7 billion in 1951 to SDR 36.2 billion in 1997.

d. Emergence of SDRs since 1972 which increased from SDR 8.7 billion to SDR 18.7 billion in 1997.

Thus the total international reserves comprising the above four items increased from $ 49.3 billion to SDR 1357.2 billion in 1997. No doubt, international reserves have been on the increase but they have not been rising as much as the increase in the volume and value of world trade. More so in the case of LDCs whose needs are greater and more urgent than that of developed countries.

5.7 MEASURES TO SOLVE THE PROBLEM OF INTERNATIONAL LIQUIDITY

The following measures have been suggested to solve the problem of international liquidity:

1) Promoting Export Expansion: Developing countries should reduce BOP deficit by promoting export expansion. The choice lies in concentrating the expansion of primary or secondary products or both. The expansion of secondary products requires import substitution for export expansion. These policies will earn them foreign exchange.

2) Limiting Exports: They should ban non-essential consumer goods, and limit imports of specific goods by selective tariffs, physical quotas, etc. This policy will enable them to conserve foreign exchange.

3) Changing Official Exchange Rate: A developing country can change its official exchange rate by devaluing its currency so that its export prices are lowered and import prices are increased. This will help in earning foreign exchange.

4) Restrictive Monetary-Fiscal Policies: By following restrictive monetary and fiscal policies, a developing country can reduce domestic demand for products which will lower import prices, reduce inflationary pressures and BOP deficit.

5) Reduction in BOP Surplus: The majority of developed countries have BOP surplus which they should reduce by:

a. Accepting the national currencies of developing countries for payments;

b. Removal of trade barriers to the products of developing countries; and

c. Accepting products of developing countries in exchange for their products, as was done by the erstwhile USSR.

6) **Expanding International Reserves:** The IMF should expand international reserves by fresh allocation of larger quotas to member countries. In particular, all new issues of SDRs should be distributed to developing countries so that they may pay then to developed countries to solve their foreign exchange problem.

Besides, the following plans are suggested to solve the problem of international liquidity.

1) **Robert Triffen's Plan:** Prof. Robert Triffen organised this plan in 1958 to remove the problem of international liquidity. Under this plan, the member countries are either required to deposit their currencies in the Central Bank or to transfer their foreign exchange reserves from the Bank.This plan suffers from a drawback that none of the countries was ready to surrender its foreign exchange reserves to the proposed World Bank.

2) **Bernstein's Plan:** The Executive Director of IMF, Prof. Bernstein presented this scheme in 1961 under which the IMF should subscribe the debentures from richest countries like USA, UK, France, West Germany, Canada and Japan and it should be utilised to solve the problem of balance of payment. This theory was known as IMF Borrowing Scheme. But as a whole, this plan was not able to solve the problem of world liquidity.

3) **Gold Tranche Policy:** This policy came in force in, 1952 with the help of IMF under which the people can draw the funds at their own account to the extent of the gold tranche position with the Fund. This is called Unconditional Liquidity. At the same, there is another Credit-Tranche which is called as Conditional Liquidity. For the type of loan, the member will have to fulfill certain conditions imposed by the Fund.

4) **Raising the Official Price of Gold:** This proposal was presented by Charles De Gaulle. He suggested that raising official price of gold is necessary to solve the problem of international liquidity. The volume of liquidity would increase with the raising official price of gold. The official price of gold was increased from 35 US Dollar to 42.2 US Dollar in 1973. This would increase the value of gold stock of member countries to some extent. But this policy benefited to only three countries like France, South Africa and USSR which were largest stock holders of gold. This method could not solve the problem of world liquidity.

5) **Standby Credit Scheme:** The Fund has organised a standby agreement in order to promote drawing facilities in 1952. Under this scheme, the members are permitted to draw the limit, they need foreign exchange from the Fund within a specified period without further application of the Fund.

6) **GAB Scheme:** In 1964, IMF has started a new scheme named as the 'General Arrangements to Borrow' (GAB) to provide liquidity to its member countries. The Fund has borrowed upto SDR 6 billion the currencies from major countries under this scheme. This would increase the GAB of the Fund from 6 billion dollars to 19 billion dollars.

7) **Special Oil Facility:** There was another scheme, named 'Special Oil Facility' presented by IMF in 1974 to finance loans to the non-oil developing countries to meet their deficit of oil imports from the OPEC countries from 3 years to 7 years. This facility proved to be helpful for the improvement of non-oil developing countries but unfortunately it came to an end in 1976 against the protest from developing countries.

8) **Subsidy Account:** The IMF established a subsidy account to assist the most seriously affected members to meet the cost of using resources made available through the oil facility. The subsidy account provides SDR facilities to the member countries of 101 million dollars in 1978.

9) **Compensatory Financing of Export Fluctuations Scheme:** This scheme was devised by IMF in 1963. Under this scheme, IMF offers borrowing facilities to its member countries to meet their deficits in the balance of payment arising from the fluctuations in export earnings beyond their control. Such borrowing facilities are useful to meet with the problem of world liquidity.

10) **Supplementary Financing Facility**: The Interim Committee (1977) provided facilities to promote the international liquidity and financial resources of member countries. – However, Supplementary Facility is like a standby arrangement for the period of one year to meet the imbalance of payment of the member countries.

11) **Trust Fund:** In 1976, a Trust Fund was organised to provide special assistance on concessional terms to solve the problem of balance of payment to developing countries. It has provided total loans disbursement to developing countries of 2991 million SDRs. India received 524 million SDRs with a loan disbursement from the Trust Fund. This fund was, later on, closed in 1981.

12) **IMF Aid Plan for Poor Nations:** In 1980, IMF proposed a plan for poor countries to give them financial aid at half per cent interest rates. This plan has provided 1.25 million Dollar subsidy plan to poor countries to cut interest cost or loans.

5.8 IMF AND INTERNATIONAL LIQUIDITY

There was no problem of international liquidity prior to 1970. This was because under the Bretton Woods Agreement the exchange rates of countries were fixed in terms of gold or the US dollar at $ 35 per ounce of gold. Member countries were forbidden to impose restrictions on payments and trade, except for a transitional period. They were allowed to hold their monetary reserves partly gold and partly in dollars and sterling.

These reserves were meant to incur temporary deficits by member countries while keeping their exchange rates stable. The IMF insisted on expenditure reducing policies and devaluation to correct deficit in balance of payments.

"Therefore, apart from ad hoc loans made by the IMF, the growth in liquidity needed to finance the expansion of world trade had to be found in liquidity needed to finance the expansion of world trade had to be found in the expansion of gold and the supply of dollar and sterling. But the physical supply of gold is virtually limited to the output of the mines in South Africa and the Soviet Union."

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 payments continued to deteriorate. Robert Triffin warned in 1959 that the demand for world liquidity was growing faster than the supply because the incremental supply of gold was increasing little. Since the dollar was convertible into gold, the supply of US dollars would be inadequate in relation to the liquidity needs of countries.

This might introduce trade barriers by countries in order to have balance of payments surpluses and build up reserves. Thus, according to Triffin, a growing liquidity shortage would generate strong contractionary forces that would threaten the expansion of the world economy and lead to a world recession of the 1931 type.

A crisis of confidence had already erupted. The pound had been devalued in November 1967. There was no control over the world gold market with the appearance of a separate price in the open market. On 15 August, 1970, the United States suspended the conversion of dollars into gold and refused to intervene in the foreign exchange markets to maintain exchange rate stability.

The 'Group of Ten' industrial countries met at the Smithsonian Institute in Washington in December 1971 and agreed to the realignment of major currencies by devaluing the dollar by 10 per cent and revaluing their currencies. The Smithsonian Agreement broke down following the US dollar devaluation of February 1973 again and in March 1973 a number of countries had floating exchange rates and the EEC countries had a "joint float" of their currencies.

The Jamaica Agreement of January 1976 formalized the regime of floating exchange rates. By the Second Amendment of the IMF Charter in 1978, the member countries are not expected to maintain and establish par values with gold or dollar. The Fund has no control over the exchange rate adjustment policies of the member countries. The system of flexible exchange rates has tended to reduce the need for more reserves.

5.9 ROLE OF THE IMF IN INCREASING WORLD LIQUIDITY

The IMF is an international monetary institution which is the principal source of supply of world liquidity to its 182 members. Over the years, it has adopted the following measures to increase international liquidity.

SDRs. In early 1970, it introduced a scheme for the creation and issue of Special Drawing Rights (SDRs) as unconditional reserve assets to influence the level of world reserves and to solve the problem of international liquidity. There are SDR 146 billion in the Fund's General Account.

The Fund also creates SDRs and allocates them to members in proportion of their quotas. For this purpose, the Fund has established the Special Drawing Account. As the international monetary asset, SDRs are held in the international reserves of central banks and governments to finance improve international liquidity so as to correct fundamental disequilibria in the balance of payments of Fund members. The participants in the SDR scheme receive SDRs under "transactions with designation" and "transactions by agreement" unconditionally. The IMF acts as a clearing house in these transactions. Since 1981 there are 21.4 billion SDRs in the Fund.

Quotas:

The bulk of Fund's financial resources comes from quota subscriptions of member countries. To meet the global demand for liquidity, it has been increasing quotas of members every four years under the General Review of Quotas. As a result, it increased the member quotas from 7.6 billion in 1947 to SDR 212 billion in 1998.

Selling Gold:

It increases its funds by selling gold to members.

Borrowings:

It borrows from governments, central banks or private institutions of industrialised countries, the Bank for International Settlements, and even from OPEC countries, like Saudi Arabia.

Reserve Tranche:

The Fund has a variety of facilities for lending its resources to member countries. Lending by the Fund is linked to temporary assistance to member in financing disequilibrium in their balance of payments on current account. If a member has less currency with the Fund than its quota, the difference is called gold or reserve tranche.

It can draw up to 25 per cent on its reserve tranche automatically upon representation to the Fund for its balance of payments needs. It is not charged any interest on such drawings, but is required to repay within a period of three to five years.

Credit Tranche:

A member can draw further from balance quota in 4 instalments upon 100 per cent of its quota from credit tranche annually. Drawings from credit tranche are conditional because the members have to satisfy the Fund of adopting a viable programme to ensure financial stability.

To meet the severe balance of payments problems, the Fund has been gradually raising the limit of borrowings by its members over the years under the credit tranche. Now members can draw up to the equivalent of 300 per cent of their new quotas on the total net use of the Fund's resources. The limits exclude drawings from CCFF, BSAF,

SAF, STF and ESAF. The purchases are made under stand-by arrangements rather than directly.

New Credit Facilities:

Since the 1960s, the Fund has created several new credit facilities for its members. Loans from these facilities are separate from tranches and are available for a longer period. These are : BSFF (Buffer Stock Financing Facility), EFF (Extended Fund Facility), SFF (Supplementary Financing Facility), SAF (Structural Adjustment Facility), ESAF (Enhanced Structural Adjustment Facility), CCFF (Compensatory and Contingency Financing Facility), STF (Systematic Transformation Facility), ESAL (Emergency Structural Adjustment Loans) and CCL (Contingency Credit Line).[1] These facilities provide for members annual access to Fund resources up to 150% of their quotas or up to 450% over a three year period.

IDA Replenishments:

Another important source for increasing world liquidity is the IDA Replenishments to the poor developing countries for three years by the developing countries. In recent years, IDA-9 Replenishment gave $ 15.55 billion in 1990, IDA-10 gave $ 18 billion in 1993, and IDA-11 gave 22 billion in 1996 for three years.

Criticisms of IMF:

The various Fund schemes for increasing global liquidity have been criticised for favouring the developed countries. They are inequitable which have tended to mark unfair distribution of international liquidity. For instance, the allocation of SDRs to participating countries is proportional to their quotas. In this sense, the allocation of SDRs to developing countries is too low as compared to their needs. Low allocation of SDRs reduces the borrowing capacity of such countries.

Moreover, the SDR scheme does not link the creation of international reserves in the form of SDRs with the need for development finance on the part of developing countries. The need for liquidity on the part of developing country is great. Therefore, there is need to create more SDRs with fair distribution so that more unconditional liquidity is made available for the greater needs of developing countries.

Unfortunately, due to the rigid attitude of the United States and some other developed countries, the Fund has not been able to resume allocation of SDRs from January 1982, despite the repeated pleas of the developing countries over these years.

So the Fund has failed in its objective of increasing international liquidity through SDRs. Consequently, faced with a recession, an inadequate flow of concessional aid and falling prices of commodities and raw materials, developing countries have been facing severe balance of payments and debt problems. To solve this problem, there is urgent need for fresh allocation of SDRs which should be distributed only to developing countries.

5.10. MEANING OF SPECIAL DRAWING RIGHTS (SDRS)

Special Drawing Rights (SDRs), also known as the paper gold, are a form of international reserves created by the IMF in 1969 to solve the problem of international liquidity. They are not paper notes or currency. They are international units of account in which the official accounts of the IMF are kept. They are allocated to the IMF members in proportion to their Fund quotas and are used to settle balance of payments deficits between them.

5.10.1 ORIGIN OF SDRS

SDRs were created through the First Amendment to the Fund Articles of Agreement in 1969 following persistent US deficits in balance of payments to solve the problem of international liquidity. Until December 1971, an SDR was linked to 0.88867 gram of gold and was equivalent to US $1. With the breakdown of the fixed parity system after 1973 when the US dollar and other major currencies were allowed to float, it was decided to stabilise the exchange value of the SDR. Accordingly, the value of the SDR was calculated each day on the basis of a basket of 16 most widely used currencies of the member countries of the Fund. Each country was given a weight in the basket in accordance with its importance in international trade and financial markets.

After the Second Amendment to the Fund Articles of Agreement in 1978, the SDR became an international unit of account. To facilitate its valuation, the numbers of currencies in the "basket" were reduced to five in January 1981. They include the US dollars, the German Deutsche Mark, the British Pound, the French Franc and the Japanese Yen. The present currency composition and weighting pattern of the SDR is revised every five years beginning January 1, 1986. The revision of weights is based on both the values of the exports of goods and services and the balances of their currencies held by other members. In 1977, they were US dollar (39%), German DM (21%), UK pound and French franc (11% each) and Japanese yen (18%). The value of one SDR was equal to US $ 0.6947010000 on February 18,2021.

5.10.2 USES OF SDRS

SDR is an international unit of account which is held in the Fund's Special Drawing Account. The quotas of all currencies in the Fund General Account are also valued in terms of the SDR. As the international monetary asset, the SDR is held in the international reserves of central banks and governments to finance their deficits or surpluses of balance of payments. All transactions by the Fund in the form of loans and their repayments, its liquid reserves, its capital, etc., are expressed in the SDR.

SDRs are used as a means of payment by Fund members to meet balance of payments deficits and their total reserve position with the Fund. They cannot be used for any other purpose. Thus SDKs act both as an international unit of account and a means of payment.

There are three principal uses of SDRs:

1. Transactions with Designation: Under it, Fund designates a participant in the SDR scheme who has a strong balance of payments and reserve position to provide currency in exchange for SDRs to another participant needing its currency. The currency to be exchanged for SDRs may belong to the designated participated or/ and to other participants. Participants are allowed to accept SDRs in this way as long as their holdings are less than three times their total allocations.

2. Transactions with General Account: SDRs are used in all transactions with the General Account of the Fund. Participants pay charges in SDRs to the General Account for the use of the Fund resources and also to repurchase their own currency from it.

3. Transactions by Agreement: The Fund allows sales of SDRs for currency by agreement with another participant. In order to further widen the uses of SDRs, the Second Amendment empowered the Fund to lay down uses of SDRs not otherwise specified.
Accordingly, the following additional uses of SDRs are:

a. In swap arrangements,
b. In forward operations,
c. In loans,
d. In the settlement of financial objections,
e. As security for the performance of financial obligations, and
f. In donations or grants.

The Fund also empowers certain institutions as "other holder" of SDRs. Besides the World Bank and its associates, some of the other holders of SDRs are the Bank for International Settlements, the African Development Bank. These 'other holders' acquire and use SDRs in transactions and operations by agreement under the same terms and conditions as applicable to the participants. Efforts are being made by the Fund to have a greater use of the SDR as a unit of account in private transactions and in financial markets of the world. The Fund pays interest on all holdings of SDRs kept in the Special Drawing Account and charges interest at the same rate on allocations to participants.

5.10.3 FEATURES OF SDRS

The following are the salient features of SDRs:

a. 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.

b. 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.

c. Transferable Asset: SDRs are transferable assets. The member countries are required to provide their currencies 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.

d. 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 drawl and other countries are obliged to accept them as unit of adjustment.

e. 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.

f. 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.

g. Special Drawing Account: Under the changed rules, the IMF maintains two separate accounts:

i. General Account: It deals with the general tansactions of the IMF relating to quotas, subscriptions, ordinary drawings, etc.

ii. Special Drawing Account: It deals with SDR transactions. The SDRs are created as a percentage of existing resources (quotas).

h. 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.

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

j. Interest-Bearing Asset: SDRs are an interest-bearing asset The IMF pays interest to the countries holding SDRs and charge interest from the countries using SDRs.

k. Use of SDRs: Under the SDR scheme, the participating countries will use SDRs to meet their balance of payments requirements or to improve their adverse reserve position. SDRs are not to be used for exchange with other currencies to reinforce foreign exchange reserves.

l. **Limited Use of SDRs:** Ordinarily, a country can use SDRs up to 70% of the allotted authorisation 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.

m. **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.

5.10.4 MERITS OF SDRS

Despite these weaknesses, the SDRs scheme possesses the following merits:

i. SDRs are a new form of international monetary reserves which have been created to free the international monetary system from its exclusive dependence on the US dollar.

ii. They have rid the world of its dependence on the supply of gold and fluctuations in gold prices.

iii. They cannot be demonetized like gold or become scarce when the demand for dollar increases in the world.

iv. Unlike gold, SDRs are costless to produce because production of gold requires resources to mine, refine, transport and guard it.

v. SDRs have been created to improve international liquidity so as to correct fundamental disequilibria in balance of payments of Fund members. Under this scheme, the participants receive SDRs under transactions with designation and transaction by agreement unconditionally.

vi. Fund members are not required to change their domestic economic policies as they are expected under the Fund aid programmes.

vii. The payment and repayment of SDRs out of the Special Drawing Account is easier and more flexible than under the Fund schemes.

viii. Last but not the least, SDRs act both as a unit of account and a means of payment of international monetary system.

5.10.5 VALUATION OF SDRS

The original SDR scheme envisaged that SDRs would be a sort of paper gold. The value of SDR was fixed in terms of gold. Initially, the unit value of SDR was determined equal to 0.88867 grams of fine gold or equal to one U.S. dollar.

Later on, in 1974, due to general floating of exchange rates, the standard basket technique was adopted and the value of SDR was fixed in terms of a basket of 16 major currencies. Since 1981, the standard basket is composed of the currencies of world's five largest exporting countries. The list of currencies in the basket and their weights are revised at the end of every five years.

The currencies and their share in the total weight for 1986-90 are- U.S. dollar

(42%); Deutsche Mark (19%); Japanese Yen (15%); French Franc (12%); and Pound sterling (12%). The value of SDR is calculated daily on the basis of market exchange rates. For 1989- 90, the average annual value of SDR was: SDR 1 = Rs. 19.262 or $ 0.75. In 1997-98, it moved to: SDRI = Rs. 50.076 or $ 1.364.

5.10.6 WORKING OF SDRS

Whenever the IMF finds that there is a need to increase international liquidity, the SDRs are created and allocated to the members in proportion to their quotas. The first creation and allocation of SDRs was in-1970- 72, totaling SDRs 9.3 billion. Again, the IMF created and allocated SDRs to the tune of 4 billion each in the years 1979, 1980 and 1981. Thus, there are now in existence a total of SDRs 21.3 billion.

Originally there have been three major ways in which the members could use SDRs:

a. **Transactions with Designation:** A member country may use its SDRs to obtain foreign exchange from other member country designated by the Fund. The Fund designates a member country, with a strong balance of payments and reserve position, to provide currency in exchange for SDRs to the country wishing to convert its SDRs.

b. **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 utilise their SDRs to meet adverse balance of payments, and not to change the composition of exchange reserves.

c. **Transactions with General Account:** SDRs can be used by member countries in operations and transactions conducted through the IMF's General Account (i.e., in settling transactions with the IMF). Since 1978, however, the IMF has allowed its members to use SDRs in a variety of other voluntary transactions and operations by agreement among themselves.

5.10.7 LIMITATIONS OF SDRS

Despite these merits, the SDR scheme has been criticised on the following grounds:

a. **Inequitable Distribution:** It is an inequitable scheme which has tended to make unfair distribution of international liquidity. The allocation of SDRs to participating countries is proportional to their quotas. In this sense, the allocation of SDRs to developing countries is too low as compared to their needs. Low allocation of SDRs reduces the borrowing capacity of such countries.

b. **Not Linked with Development Finance:** SDR scheme does not link the creation of international reserves in the form of SDRs with the need for development finance on the part of developing countries. The need for liquidity on the part of developing countries is great "because of their higher costs of adjustment, limited access to private banking and higher capital markets, greater variability of exchange earnings, and opportunity cost of holding foreign exchange reserves". Under these circumstances, there is need to create more SDRs with fair distribution so that more unconditional liquidity is made available for the greater needs of developing countries.

c. **High Interest Rate:** The interest rate originally payable on net use of SDRs is 1.5 per cent. This has been gradually raised through time in order to make a more acceptable asset to hold. Now both users of SDRs pay and holders of SDRs receive, a market rate of interest based on interest rates prevailing in US, Britain, France, Germany and Japan which are quite high for developing countries.

d. **Failure to Distribute Social Saving:** Williamson and others have criticised the SDR scheme for its failure to distribute social saving of SDRs to the developing countries. The present rules for allocation distribute the social saving to a participant country in proportion to his contribution or its demand for SDRs. If the supply of SDRs equals the demand for it, there will no redistribution of resources between countries. But this is not so in the case of developing countries whose holdings of SDRs are very low as compared to the 26 developed countries. Thus the present scheme of SDRs fails to transfer social savings to the developing countries.

e. **Failure to meet International Liquidity Requirements:** Unfortunately, due to the rigid attitude of the United States and some other developed countries, the Fund has not been able to resume allocation of SDRs from January 1982, despite the repeated pleas of the developing countries over these years.

So the Fund has failed in its objective of increasing international liquidity through SDRs. Consequently, faced with a recession, an inadequate flow of concessional aid and falling prices of commodities and raw materials, developing countries have been facing severe balance of payments and debt problems. Thus SDRs have failed to solve the problem of international liquidity.

5.11 PRE-REQUISITES FOR MAKING INDIA AS AN INTERNATIONAL FINANCIAL CENTER

The Indian economy is at an interesting juncture. According to the latest World Bank forecasts, India's economy is the bright spot among all emerging and developing economies with an expected 7.3% GDP growth in 2016 compared to 7% in 2015. These are early positive signs that the economy is picking up and in the coming years is likely to hold an upward trajectory. Notwithstanding the probability of setbacks, India's growth story presents a resilient outlook. However, the pace needs to be sustained and thus, more than ever, the time is right for India to embark on a liberalization of its financial sector.

Various countries at various points in time of their economical development have taken the initiative to develop International Financial Services Centres (IFSCs) to provide International Financial Services (IFS). Over a period of time, some of the important centres like New York, London, Frankfurt, Tokyo, Hong Kong and Singapore have become leading centres for IFS.

These centres have contributed to economic growth and job creation. There are around 196 countries in the world; out of which about 80 countries have developed centres to cater to the demand of IFS. India is one of the largest countries in the world and large user of the IFS, however only recently - in April 2015 - did India announce the development of an IFSC. Despite an open economy since 1991, India's capital account convertibility is still underdeveloped and thereby its contribution to the global financial market is considered negligible. With global markets being connected through technology, it is inevitable that India steps into the map of Global Financial Centre's and mark its presence by setting up a successful IFSC in India. In the absence of an IFSC in India, it is estimated that India is losing around $50 billion per year (data as of 2015), which is likely to grow to $120 billion by 2025, according to India's Ministry of Finance. The development of an IFSC in India therefore will be a major game changer for the country.

The need to develop an IFSC in India

As India seeks to expand its global economic and strategic influence, promoting International Financial Services from India merits urgent consideration of policy makers, and of financial and capital market stakeholders. The primary rationale for promoting IFS in India is that the potential net benefit to the stakeholders and to the country are considerable, and therefore worth the economic, regulatory, administrative and political effort. As M Asher writes in Pragati magazine, there are "three broad imperatives for promoting IFS in India. The first arises from India's deepening linkages and interdependencies with the rest of the world. The second concerns the need for more efficient financial intermediation, while the third concerns the human capital."

India's reliance on foreign funds to finance its current account deficit, and large purchases of IFS from abroad, weakens its position globally, with significantly adverse implications on its economic and strategic space.

India has already become a large purchaser of IFS from the rest of the world, and loses significant revenue from the trading of the rupee and index derivatives on foreign platforms located in IFCs like Singapore, Dubai and London. In trading in rupee derivatives alone, an IFSC is expected to increase the revenue of the country by capturing approximately Rs. 1,334 crore per day or Rs. 2 lakh crore per year worth of trading that presently takes place outside of India.

Moreover, as equity and interest rate derivative markets increasingly move offshore, including to centres that are lightly regulated, India's imports of IFS will grow and its critical talent pool will decline. This trend can only be reversed by enabling, through regulatory, tax, provident and pension fund investment policies and onshore activities to compete more effectively with offshore activities.

The operating rules for setting up banks, insurance and capital market activities in Indian IFSCs were issued in April 2015 and with that, it can be said that India took a small step in the big world of financial centres. India's first IFSC has now been approved by the governments at GIFT City, Gandhingar and in October 2015, India's first IFSC Banking Unit became operational at GIFT IFSC. In the short time of just 50 days the first two IFSC Banking Units at GIFT reported transactions of more than $100 million.

India's comparative advantage

India is conveniently located to serve all time zones and has long-standing trading and cultural ties with markets around the world. To deliver benefits for the country, an IFSC needs talent, capital, excellent infrastructure and regulatory best practices.

India also enjoys lower real estate and wage costs as compared to centers like Singapore, Dubai, London and New York. It has a large pool of individuals with professional and technical skills owing to its demographic dividend. Moreover, it produces the finest brains in finance. IFSCs at London, Dubai, New York, and Singapore incidentally have a large number of Indians managing complex transactions and leading financial innovations.

India has a vast hinterland economy, which small city-based financial centres like Singapore or Dubai lack. In this respect, India is like New York (with the US as its hinterland), London (with Europe) and Hong Kong (with China).

The national ambition of India as set out by the Ministry of Finance is to make the Indian IFSC as competitive as Dubai, Singapore and Hong Kong. It is to provide benefits to both residents and non-residents in a way that will allow businesses that are currently carried outside of India to have an Indian presence. Moreover, such an influx in financial services related businesses will not only bring qualified professionals working abroad to India, but will also provide an opportunity to Indian professionals to pursue global careers while still residing and working in India.

The IFSC will allow businesses to carry out transactions that are currently not being done in India. In addition, it will also result in the re-importing of the Indian securities market and will create employment for people residing in India.

For sustainable growth and development, India can no longer afford to rely only on its manufacturing sector. It has to strengthen its services sector as well, particularly financial services and IT/ITeS. An IFSC will be an important catalyst in this process.

Making India a financial center

For too long, India has exported its financial markets due to its uncertain, unstable, confusing and convoluted tax policies that eventually result in creation of India-focused offshore funds. Today, the rupee is impacted by trades in the non-deliverable forward (NDF) markets of Singapore and Dubai, the Nifty indices by trade in Singapore and gold prices by Dubai and London. Almost all fund managers of overseas capital invested in India are located outside due to perverse tax rules. It is time we get the financial markets back and develop the skills associated with the global financial markets in India.

The last decade has seen unprecedented growth in India's financial services sector. It employs over 6 million people, constitutes about 8% of India's GVA at current prices and our stock market has an estimated market capitalisation of over $2 trillion. As India experiences continued economic growth, the financial sector could generate about 10-11 million jobs and a GDP contribution of $350-400 billion by 2025.

Several developed countries have successfully established high-tech financial hubs. These centres provide suitable regulatory regimes and create a business environment that promotes talent and increases capital flows. As they develop, they create significant value for their respective economies—London and New York account for 10% of their countries' GDP and about 5% of jobs. Emerging financial services centres like Singapore, Dubai and Hong Kong have achieved similar levels of concentration of economic activity over short periods of time.

India is trying to adopt a similar model. The Gujarat International Finance Tec-City (GIFT) is being developed as a global financial and IT services hub at Gandhinagar, a first of its kind in India. GIFT SEZ Limited has been formed for development of a multi-services special economic zone (SEZ) with the prime focus on development of IFSC and allied financial services. GIFT SEZ is the only IFSC in India. Hopefully, Mumbai will get its own IFSC SEZ that will make the city a global financial centre.

GIFT-IFSC seeks to bring to India those financial services that are currently carried out overseas by financial institutions and branches/subsidiaries of Indian financial institutions. The IFSC offers them a physical location in India with the same ecosystem as their present offshore locations. The strategic objective of setting up the IFSC are:

i. To create high value jobs in financial services in India, and

ii. To create an avenue for financial globalisation that benefits the Indian economy and gives policymakers an enhanced set of instruments.

Various capital market intermediaries operating within the GIFT-IFSC can provide financial services, investment advisory or portfolio management services to a person not resident in India, a person resident in India, eligible under FEMA to invest funds offshore, to the extent allowed under RBI's Liberalised Remittance Scheme, or to a financial institution resident in India who is eligible to invest funds offshore to the extent of outward investment permitted under FEMA. A portfolio manager or an alternative investment fund or a mutual fund operating in GIFT-IFSC can invest in securities listed in the IFSC, securities issued by companies incorporated in the IFSC or belonging to a foreign jurisdiction.

Units in GIFT-IFSC enjoy a tax-holiday for 10 years and exemption from long-term capital gains tax, dividend distribution tax, security transaction tax and commodity transaction tax. The minimum alternative tax is reduced from 18.5% to 9% for IFSC units.

One part of getting our financial markets back has now come into force with this, what remains is getting back the fund managers! One of the biggest challenges faced by foreign portfolio investors (FPIs) and India-focused offshore funds is the indirect transfer tax impact on sale of its investments in India. The finance minister—through the Finance

Bill, 2017—has exempted Category I & II FPIs from indirect transfer tax provisions retrospectively from FY12, providing a finality to this challenge.

Another long pending tax challenge for the FPIs and offshore funds is the presence of its fund managers in India, leading to a business connection and creation of a permanent establishment (PE) for the FPIs and offshore funds in India. These funds have a strong desire to place their fund managers in India to manage their India-focused investments. To mitigate this PE risk, the Finance Act, 2015, provided safe harbour rules to encourage offshore fund managers to relocate to India without creating a PE status for the funds. These safe harbour rules are to be fulfilled by the funds and the fund managers to qualify as an 'eligible investment fund' and an 'eligible fund manager'. Some of these conditions are so onerous and vague that the funds and fund managers are unable to fulfill them and mitigate the PE risk. Consequently, fund managers continue to operate outside India.

India is losing a large amount in potential tax on the fund management fees paid to asset management companies located abroad. At present, about $400 billion of stocks and more than $100 billion of private equity and venture capital invested in India are managed outside. Even considering an annual fees of 1.5% for managing these funds, about $7.5 billion of fees is earned outside on such investments in India. We need to create rules that enable the fund managers to relocate to India to create jobs and pay taxes here. This will also enable GIFT and other cities to attract overseas financial market professionals. Similar to resolving the indirect transfer tax challenge for FPIs, the government should categorically and unambiguously provide the following:

a. Presence of fund managers of FPIs and India-focused offshore funds in India shall not result in a business connection or create a permanent establishment in India for the FPIs and the offshore funds, and these funds shall not be taxable in India. The existing classification of fund structure and registration by Sebi shall be accepted for tax purposes with no modifications.

b. Asset management companies located in India shall be liable to taxation here on the net income earned from management fees and the individual fund managers shall also be taxable here based on their residential status.

Such clarification will put to rest all the uncertainty surrounding this issue. India will then be able to attract foreign capital and talent having global expertise in fund management and enable Ahmedabad /Mumbai to become to become one of the global financial centers.

5.12 SUMMARY

International liquidity consists of all the resources that are available to the monetary authorities of countries for the purpose of meeting balance of payments deficits. Such liquidity ranges from assets readily available to resources that become available only after extensive negotiation. The establishment of the scheme of Special Drawing Rights (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. 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 entities 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. Special drawing rights (SDRs) are supplementary foreign exchange reserve assets defined and maintained by the International Monetary Fund (IMF). SDRs are units of account for the IMF, and not a currency per se. They represent a claim to currency held by IMF member countries for which they may be exchanged. International financial centres have become increasingly more important in the world financial system because they have contributed to the explosive growth in the volume of international financial transactions witnessed in the 1980s and 1990s. They can be classified and distinguished in terms of historical growth, regional influence, number of international banks located and volume of international transactions generated.

5.13 GLOSSARY

- **International liquidity-** the aggregate stock of internally acceptable assets held by the central bank to settle a deficit in a country's balance of payments.
- **Special drawing rights-** an international reserve asset, created by the IMF in 1969 to supplement its member countries'
- **International financial centre-** full–service financial centres with direct access to large capital pools from banks, insurance companies, investment funds, and listed capital markets, and are major global cities.

5.14 SELF ASSESSMENT QUESTIONS

1. What do you mean by international liquidity?

2. Briefly explain the uses of SDRs.

3. Elucidate how to make India an international financial center.

5.15 SUGGESTED READINGS

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Unit - II	Concept of Foreign Currency, Foreign	Lesson No. 6
C.No. M.COM-FC 412	Transactions And Forex Market	SEM : Fourth

STRUCTURE

6.1 INTRODUCTION

A defining trait of a globalized economy in the recent years is the increased flows of international investment and trade. Both these activities require the utilisation of foreign exchange, such as dollars, Euros and pounds. This is because sellers in various countries want to be paid in their domestic currency or in a currency considered strong and universally acceptable. For example an exporter based in India who exports to the USA will earn dollars for his goods but will have to transfer them into rupees for use in the domestic economy, and an Indian importer purchasing goods from Germany may have to change Indian rupees into Euros to pay his buyer. This requires a foreign exchange market where foreign currencies are traded

6.2 OBJECTIVES

After studying this lesson, you will be able to:

- Concept of Foreign Currency,

- Concept of Foreign Transactions;
- Concept of Foreign Sector
- Types of foreign exchange transaction
- Forex market
- Functions of Foreign market

6.3 OVERVIEW OF FOREIGN EXCHANGE

Foreign exchange is defined in terms of Section 2 of FEMA, 1999 A Foreign currency includes :

1. All deposits, credits, balance payable in any foreign currency
2. Any drafts . traveler's cheques letters of credit and bills of exchange expressed or drawn in Indian currency and Payable in Foreign Currency.
3. Any instrument giving anyone the option of making it payable either Partly or fully in a foreign currency.

In other words, foreign exchange includes all kind of claims of the resident of the country to foreign currency payable Abroad

The Foreign Exchange Market in any country is a cardinal constituent of the IMS – the institutional framework within which international payments are made, national currencies are exchanged and cross currency exchange rates are determined.

A foreign exchange transaction is an arrangement between a buyer and a seller for the delivery of a certain amount of one currency at a specified rate in exchange for some other currency. This transaction takes place in the **Foreign Exchange Market.**

The foreign exchange market provides a platform for the settlement of international transactions between different players in the market. The Foreign Exchange Market is an **"Over-the-Counter"** market i.e. there is no physical market place where the currencies are traded. Instead it is a network of large commercial/investment banks, brokers and dealers spread across the globe connected through telephones, faxes and computers.

6.4 CONCEPT OF FOREIGN CURRENCY

Foreign Exchange (forex or FX) is the trading of one currency for another. For example, one can swap the U.S. dollar for the euro. Foreign exchange transactions can take place on the foreign exchange market, also known as the Forex Market. the forex market is the largest, most liquid market in the world. The foreign exchange market or forex market is the market where one currency is exchanged or traded for another currency. Forex markets are also called foreign currency or just currency markets. There are domestic and international foreign currency markets. Domestic foreign currency markets serve the foreign currency buying, selling, borrowing and lending needs of residents whereas international markets serve non-residents also It is the conversion of one currency into another at a specific rate known as the foreign exchange rate. The conversion rates for almost all currencies are constantly floating as they are driven by the market forces of supply and demand .This conversion rate of exchanging the currency of one country with other is known as Exchange rate. An exchange rate is the value of one nation's currency versus the currency of another nation or economic zone. For example, how many U.S. dollars does it take to buy one euro?

6.5 FOREIGN TRANSACTIONS: TYPES OF FOREIGN EXCHANGE TRNSACTIONS

A foreign exchange transaction is a contract to buy or sell a quantity of one currency in exchange for another at a specified time for delivery and settlement and at a specified price (exchange rate). These transactions take place in foreign exchange markets It is important because the exchange rate, the price of one currency in terms of another, helps to determine a nation's economic health and hence the well-being of all the people residing in it.The exchange rate is also important because it can help or hurt specific interests within a country: exporters tend to be helped (hurt) by a weak (strong) domestic currency because they will sell more (less) abroad, while consumers are hurt (helped) by a strong currency because imported goods will be more (less) expensive for them

. In terms of counter parties and settlement dates, the forex transactions may be classified as follows:

1.Trade Transaction:

Trade transaction is a transaction between a bank and a non-bank customer, where the customer wishes to buy or sell a quantity of currency to complete a business transaction or (occasionally) speculates for profit by anticipating future changes in the exchange rate.

2. Interbank Transactions :

Interbank transactions are where two banks trade currencies bétween themselves. Banks buy and sell huge quantities of foreign currencies. They also accept currency deposits and lend in foreign currency.

3. Spot Transactions :

A spot transaction is a contract to buy or sell a quantity of a foreign currency for immediate settlement. Immediate settlement as per convention of forex market means two working days from the date of contract. The settlement date is also known as 'value date.

6.6 FOREIGN SECTOR

It is a that part of economy that deals with all the transactions related with the foreign countries. This sector includes all imports and exports of goods and services as well as foreign investment and banking transactions In the context of economic development experience, considerable emphasis has been placed on the foreign sector. This emphasis partly reflects the view that the foreign sector can play a key role in the development process through the exploitation of dynamic comparative advantage, the transfer of technology and of command over resources, and inducements for efficiency,' and partly the fact that, in developing economies, the foreign sector is particularly subject to government influence. Analyses of the foreign sector in actual economic development experience, however, usually have had definite limitations. In many cases the importance of quantitative restrictions in the foreign sector regime has been disregarded or understated. Historical perspective often has been lacking. Too frequently the supporting evidence is impressionistic, and available quantitative information has been ignored or not subjected to rigorous analysis.

Factors Influencing the growth of Foreign Sector

1 **Differences in factor endowments:** Countries have different amounts of land, labor, and capital. Saudi Arabia may have a lot of oil, but perhaps not enough lumber. It will thus have to trade for lumber. Japan may be able to produce technological goods of superior quality, but it may lack many natural resources. It may trade with Indonesia for inputs.

2 **Gains from specialization:** Countries may gain economies of scale from specialization, experiencing long run average cost declines as output increases.

3 **Political benefits:** Countries can leverage trade to forge closer cultural and political bonds. International connections also help promote diplomatic (rather than military) solutions to international problems.

4 **Efficiency gains:** Domestic firms will be forced to become more efficient in order to be competitive in the global market.

5 **Benefits of increased competition:** A greater degree of competition leads to lower prices for consumers, greater responsiveness to consumer wants and needs, and a wider variety of products.

6.7 FOREIGN EXCHANGE MARKET (FOREX)

The need for foreign capital in a developing country like India has an signifivant role to play market is still in the developmental stage. In Indian forex market not all the currencies are bought or sold. The banks use London, New York or Singapore market. for the currencies which are not frequently traded in Indian forex market. From these rates, the cross rates are calculated The foreign exchange market isn't exactly a one-stop shop. There are a whole variety of different avenues that an investor can go through in order to execute forex trades. In forex market, there is basically buying or selling the currency of a particular country. But there's no physical exchange of money from one hand to another. That's contrary to what happens at a foreign exchange

Size of the Foreign Exchange Market

The foreign exchange market is unique for several reasons, mainly because of its size. Trading Volume in the forex market is generally very large. As an example, trading in foreign exchange markets averaged $6.6 trillion per day in April 2019, according to the Bank for International Settlements, which is owned by 62 central banks and is used to work in monetary and financial responsibility

6.8 FUNCTIONS OF FOREIGN EXCHANGE MARKET:

The followings are the various function performed by the foreign exchange market:

1.Transfer Function: The basic function of the foreign exchange market is to facilitate the conversion of one currency in to another ,that is to accomplish transfers of purchasing power between two countries and this transfer of purchasing power is effected through a variety of credit instruments such as telegraphic transfer, bank drafts and foreign bills etc. The primary function of the foreign exchange market is the transfer of funds from one country to the other. It facilitates the conversion of one currency into another. This accomplishes the transfer of purchasing power between two different countries. This is the primary function of the foreign exchange market. The funds can be transferred through telegraphic transfers, bills of exchange, foreign bills and bank drafts. The foreign exchange market determines the price of one country's currency relative to another country's currency. Capital flows, receipts and payments for imports and exports determine the exchange rate. Under the gold standard before 1972, currencies were fixed against the United States dollar. This means that the exchange rate was not determined by supply and demand on the foreign exchange market. When governments of the large economies in the world decided to let their currencies fluctuate freely the role of the foreign exchange market became much more important. Thus the major function of the foreign exchange market is the transfer function.

2. Credit Function: Another function of the foreign exchange market is to provide credit for both national and international market to promote foreign trade. Obviously when foreign bills of exchange are used in international payments a credit for about 3 months is required till the date of maturity . The foreign exchange market provided the provision for short term credit. It provides short term credit to importers so that goods and services from one country to another country can flow with ease. An importer can finance his/her imports on credit by issuing a bill of exchange in the foreign exchange market. This is an essential function of the foreign exchange market.

3. Hedging Function : According to this function of the foreign exchange market is to hedge foreign exchange risk.Hedging means the avoidance of foreign exchange risk. In a free exchange market when the exchange rate of one currency in terms of other currency changes there is a equal chance of gain or loss to the concerned parties, so there is huge exchange risk. and these risks are minimized through forward contracts in exchange. A forward contract which is normally for three months is a contract to buy or sell foreign exchange against another currency at some fixed date in the future. Due to the fluctuating exchange rates in the foreign exchange market there is need for hedging. The parties in the market hedge foreign exchange risk, by participating in the forward market. In the forward market one buys a forward currency contract with a currency pair for a pre-determined amount, rate and date. This is agreed upon on the time of dealing. The rate quoted on the forward market is called a forward exchange rate. If a British company imports goods from the USA and agrees to settle the payment in 3 months' time from the day of purchase the company can buy US dollars now on the forward market and agree on an exchange rate (the forward rate).

6.9 SUMMARY

The market where one currency is traded for another is called forex market. Its primary function is to facilitate international trade and investment. The market consists of the interbank market in which major banks deal with each other and the retail market, in which banks deal with their commercial customers. Foreign exchange market has two segments; (a) spot mazket; end (b) forward market. The participants in the foreign 'exchange markets arc commercial banks, brokers, customers, MNCS and central banks.

6.10 GLOSSARY

Foreign exchange: Foreign Exchange (forex or FX) is the trading of one currency for another. For example, one can swap the U.S. dollar for the euro. Foreign exchange transactions can take place on the foreign exchange market, also known as the Forex Market

Foreign exchange market.: The Foreign Exchange Market in any country is a cardinal constituent of the IMS – the institutional framework within which international payments are made, national currencies are exchanged and cross currency exchange rates are determined.

Foreign Transaction : A foreign exchange transaction is a contract to buy or sell a quantity of one currency in exchange for another at a specified time for delivery and settlement and at a specified price (exchange rate)

Hedge : A hedge is an investment that is made with the intention of reducing the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting or opposite position in a related security.

6.11 SELF ASSESSMENT QUESTIONS

1. What do you mean by Foreign Exchange?

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2. Briefly explain foreign transactions? What are its various types?

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3. What are the various function of Foreign exchange market?

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6.12 LESSON END EXERCISE

Q1 Discuss the concept of Foreign Currency.

Q2 Define Foreign Sector. What are the various factors inflencing Foreign Sector?

Q3 Briefly Explain concept of Foreign Transactions?

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BANK'S PURCHASE AND SALE, INSTRUUMENTS TRADED AND COMPONENTS OF FOREIGN EXCHANGE MARKET

Unit - II	**Lesson No. 7**
C.No. M.COM-FC 412	**SEM : Fourth**

STRUCTURE

7.1 INTRODUCTION

The role of the banks in the development of the currency market represents the first element on influencing the major players and their strategies on a global scale. The currency market is considered the system of the relations between financial and currency exchanges explained by the relation of buying and selling currency or buying-selling deposits throughout foreign coins. This market is also called FOREX (Foreign exchange market), being the biggest financial market in the world. The overcome of borders and the globalization of markets and countries conducted to the internationalization of monetary markets that have great implications in the currency risk of the banks. This paper aims to highlight the main features of the Forex currency market in the light of the extraordinary needs and ability of the banks and the financial system to assure the stability, which not only support the economy but also develop a complex sistem of instruments, transactions - both in the capital market and especially on the currency market - but also by products and derivatives in order to complete the proper satisfaction of clients and other banks. Next to these we add an imminent importance is established by the currency risk, which tend to ensure stability in the current crisis and understanding the tools and policies in global banking, the main goal being the control of national and international financial standards in banks and economy by conducting a stable bank management.

7.2 OBJECTIVES

After studying this lesson, you will be able to understand:

- Role of Bank in Purchase and Sale in Foreign exchange
- Instrument of credit traded in foreign exchange
- Various components of Foreign Exchange Market

7.3 OVERVIEW OF INTERNATIONAL MARKET

We live in a globalized world. Every country is dependent on another country in some other means. Developed countries look for the cheap workforce from developing countries and developing countries look for services and products from developing countries. When a trade happened between two countries as in this case, there are many factors that come into the picture and have to be considered while the execution of the trade so that no violation of regulation happens. For any economy international finance is a significant critical factor, the local government should accordingly execute the policies so that the local players are not facing severe competition from the non-local players.

International trade is one of the most important factors of growth and prosperity of participating economies. Its importance has got magnified many times due to globalization. Moreover, the resurgence of the US from being the biggest international creditor to become the largest international debtor is an important issue. These issues are a part of international macroeconomics, which is popularly known as international finance.

7.4 ROLE OF BANK IN PURCHASE AND SALE OF FOREIGN EXCHANGE

Foreign currency may be exchanged for personal use, as part of your company's business operations or for speculation by traders. The difference in price between two currencies is called the exchange rate. Foreign exchanges are not centralized like a stock market is. Major banks operate electronic interbank exchanges. Smaller banks and individual investors buy and sell their currencies from one of these localized exchanges.

Governments and central banks may manipulate the foreign currency exchange market to implement their national monetary policy. If a country needs to increase its exports, it can sell its home currency on an exchange to weaken it. A large sell-off of a particular currency lowers its price relative to currencies from other countries. When a government needs to strengthen a currency, it can purchase its currency back from the exchange market to reduce the available supply. A country is vulnerable to other countries selling large amounts of its currency on the exchange markets.

7.5 ROLE OF CENTRAL BANK IN PURCHASE AND SALE OF FOREIGN EXCHAGE

Central **Banks** are government agencies that regulate their national **currencies** in order to maintain a healthy economic environment, balance exports and imports, prevent inflation, and stimulate growth within their economies. Central banks have a direct impact on the financial markets, and in particular the foreign exchange markets. The Central Bank is responsible for keeping their domestic economic affairs in order, while remaining competitive in the global environment

1 Setting Lending Rates: One of the primary functions of a Central Bank is to facilitate lending within its state or region. As such Central Banks provide the necessary capital to various commercial banks. This lending arrangement between the central bank the commercial banks allows for an efficient access of capital for individuals and businesses. The rate at which this type of lending arrangement occurs is often referred to as the discount rate. The discount rate is the base rate set by the central bank from which other types of lending rates are calculated. This has a direct effect on the cost of funds to the end borrower.

2 Setting Monetary Policy : The role of central banks extends to setting monetary policy for their particular country. Monetary Policy is defined as the actions taken by a central bank to regulate the supply of its currency.

3 Lender of Last Resort : During times of financial crisis, the central bank can act as a lender of last resort. When the commercial banks are unable or unwilling to provide loans, the central bank may step up to provide liquidity in order to avoid a potential shutdown of the economy. Essentially, the Central Bank will act to prevent a collapse of the banking system in their country

7.6 VARIOUS INSTRUMENTS OF CREDIT TRADED IN FOREIGN EXCHANGE

The Major Instruments used for making International payments are:
1. Foreign Bills of Exchange
2 Bank Drafts and Telegraphic Transfers
3. Telegraphic Transfer
4. Letter of Credit.

1 Foreign Bills of Exchange : It is a written request or an order from the drawer to the drawee to pay a certain sum of money either to himself or to the payee as ordered by the drawer on demand hence. A foreign bill of exchange is generally used with the added formality of a letter of credit. Its working is very simple. The creditors (exporters) of one country draw bills on their debtors (importers) in other countries and have them duly accepted by them. These bills they then sell to the debtors of their own country who desire to send money.

2 Bank Drafts and Telegraphic Transfers: A bank draft is an order of a bank to its branch or another bank to pay the bearer on demand a specified amount out of its deposit account. The debtor in an international transaction can get such a bank draft from his bank and send it to his creditor who will collect the sum from the branch or bank of his own country.

3 Telegraphic Transfer : It is a telegraphic order by a bank to its correspondent bank abroad to pay a certain sum to a certain person on account out of its deposit account. It is a quicker mode of payment.

4 Letter of Credit : A letter of credit is an instrument authorizing a person to draw a bill or a cheque for a specified sum on the issuing bank at a stipulated time. The letter of credit makes the exporter willing to ship the goods to the importer, for the liability for payment is assumed by the bank issuing the letter of credit. such letters of credit are also issued to travelers going abroad. Likewise, travelers' cheques are also issued by the bank, which can be cashed at a branch or correspondent of the bank in a foreign country. In addition to these means, international payments may also be effected by the use of gold, home currency, personal cheques or international money orders.

7.7 SEGMENTS OF FOREIGN EXCHANGE MARKET

There are two segments of foreign exchange market, viz., Spot Market and Forward Market.

1. Spot Market: In spot market currencies are exchanged immediately on the spot. This market is used when a firm wants to change one currency for another on the spot. The procedure is very simple. A banker can either handle the transaction for the firm or may have it handled by another bank. In the Spot market risks are always involved in any particular currency. Regardless of what currency a firm holds or expects to hold, the exchange rate may change and the firm may end up with a currency that declines in values if it is unlucky or not careful.

There are also risks that what the firm owes or will owe may be stated in a currency that becomes more valuable and, as such possibly harder to obtain and use to pay the obligation.

2. Forward Market: Forward market has come into existence to avoid uncertainties. In Forward market, a forward contract about which currencies are to be traded, when the exchange is to occur, how much of each currency is involved, and which side of the contract each party is entered into between the firms.With this contract, a firm eliminates one uncertainty, the exchange rate risk of not knowing what it will receive or pay in future. However, it may be noted that any possible gains in exchange rate changes are also estimated and the contract may cost more than it turns out to be worth

7.8 COMPONENTS OF FOREIGN EXCHANGE MARKET

The foreign exchange market is the place where money denominated in one currency is bought and sold with money denominated in another currency. It provides the physical and institutional structure through which the currency of one country is exchanged for that of another country, the rate of exchange between currencies is determined, and foreign exchange transactions are physically completed.The primary purpose of this market is to permit transfer of purchasing power denominated in one currency to another.The various components of Foreign Exchange Market are as Follows:

(A) Commercial Banks : The major participants in the foreign exchange market are the large Commercial banks who provide the core of market. As many as 100 to 200 banks across the globe actively "make the market" in the foreign exchange. These banks serve their retail clients, the bank customers, in conducting foreign commerce or making international investment in financial assets that require foreign exchange Commercial banks are normally taking over the position to support the economy of the country by carrying over the foreign currency from one period to another, for meeting the future need of the country. They are also sometime making short sale (agree to sell or actually sell the foreign currency without any real capacity to sell through or borrow the required currency from others) of foreign currency to satisfy the need of firms to make payments.Later on to bring the position in equilibrium, they quote the rates for buying and selling of foreign currency accordingly. As they are buying the foreign currency from the customer, the rate they quote for buying the foreign currency is technically named as Bid rate. When they sell the foreign currency to customer, the rate they quote is technically known as Ask rate.

(B) Foreign Exchange Broker : Foreign exchange brokers also operate in the international currency market. They act as agents who facilitate trading between dealers. Unlike the banks, brokers serve merely as matchmakers and do not put their own money at risk. They actively and constantly monitor exchange rates offered by the major international banks through computerized systems

(C) Central banks: Another important player in the foreign market is Central bank of the various countries. Central banks frequently intervene in the market to maintain the exchange rates of their currencies within a desired range and to smooth fluctuations within that range. The level of the bank's intervention will depend upon the exchange rate regime flowed by the given country's Central bank.

(D) MNCs : MNCs are the major non-bank participants in the forward market as they exchange cash flows associated with their multinational operations. MNCs often contract to either pay or receive fixed amounts in foreign currencies at future dates, so they are exposed to foreign currency risk. This is why they often hedge these future cash flows through the inter-bank forward exchange market

(E) Individuals and Small Businesses: Individuals and small businesses also use foreign exchange market to facilitate execution of commercial or investment transactions. The foreign needs of these players are usually small and account for only a fraction of all foreign exchange transactions. Even then they are very important participants in the market. Some of these participants use the market to hedge foreign exchange risk.

7.9 ROLE OF PARTICIPANTS IN FOREIGN EXCHANGE MARKET

1. Commercial Banks : Banks are the principal facilitators or players in foreign exchange transactions and they deal in foreign currencies in the form of buying and selling. Typically, a commercial bank offering foreign exchange services buys foreign exchange from an exporter of goods and sells the foreign exchange to the importer of goods.

Similarly, banks sell foreign exchange to a customer who intends to remit funds to an overseas beneficiary for some purpose, and buys foreign currency when a remittance is received from a foreign country favouring a beneficiary in the country of the bank. The large commercial banks open their branches or agency offices in the important foreign centres for transacting foreign exchange business along with other normal banking function.Banks without any branches in the foreign centres, can also undertake foreign exchange transactions through the other banks in those centres, with whom they have correspondent arrangements

2. Central Banks The central banks in most of the countries are given the responsibility of maintaining the external value of the currency of the country. The value of the currency of the country vis-a-vis the currencies of the other countries largely depends on the demand and supply situation of the relative currencies. If the total value of the imports in a country is more than the value of exports to a particular country, the demand for the currency of the country from where the imports are made will be more than the demand for the currency of the importing country.Under this circumstance, the price of the currency of the importing country will depreciate vis-a-vis the currency of the exporting country. This is represented by a balance of payment position of the two countries involved. For example, the amount of import by the Indian traders from the USA is more than the exports by the Indians to the USA.Consequently, the demand for US$ by the Indian importers to settle their import bills will be more than the receipt or supply of US$ from the Americans' settlement of the export bills of the Indian exporters. Therefore, the price of US$ will go up against that of Indian Rupees, as there will be more demand for US$ towards payment for imports.Too much fluctuation or volatility in the foreign exchange prices is likely to adversely affect the economy of the countries, and under this situation, the central bank of each country has to ensure stability, as far as possible in the movement of exchange rates. This is achieved by the central bank's intervention, in the form of buying and selling in the forex market.

The central banks in each country are required to buy and sell foreign currencies with a view to maintaining an order in the foreign exchange market in the country so that the external value of the domestic currency does not get eroded beyond a certain limit. In India, this function is done by way of intervention by the Reserve Bank of India.

3. Foreign Exchange Broker : Speculators play a very active role in the foreign exchange markets. The speculators undertake foreign exchange transactions with a view to making profit on account of favourable movement in exchange rates. They take positions(i.e). if they feel that the rate of a particular currency is likely to go up in the short term, they buy the currency and sell it as soon as they are able to make some quick profits. Speculative transactions are often made by the banks, multinational corporations, individuals, etc. Like short-term dealings in shares and securities, someone can buy a particular currency of foreign exchange at a particular rate and sell the same when the rates become favourable and can make profit in the short term.

However, in many countries including India, the banks are not allowed to take speculative position in foreign currencies beyond a certain limit and the dealers in foreign exchange are advised to keep square position (neither overbought nor oversold) in foreign currencies as far as possible.

4. MNCs Multinational corporations are those large firms which are incorporated in one country but which own, control or manage production and distribution facilities in several countries. Therefore, these multinational corporations are also known as transnational corporations. They transact business in a large number of countries and often operate in diversified business activities. The movements of private foreign capital take place through the medium of these multinational corporations. Thus multinational corporations are important source of foreign direct investment (FDI). Besides, it is through multinational corporations that modern high technology is transferred to the developing countries. The important question about multinational corporations is why they exist. The multinational corporations exist because they are highly efficient. Their efficiencies in production and distribution of goods and services arise from internalizing certain activities rather than contracting them out to other forms. Managing a firm involves which production and distribution activities it will perform itself and which activities it will contract out to other firms and individuals. In addition to this basic issue, a big firm may decide to set up and operate business units in other countries to benefit from advantages of location.

For examples, it has been found that giant American and European firms set up production units to explore and refine oil in Middle East Countries because oil is found there. Similarly, to take advantages of lower labour costs, and not strict environmental standards, multinational corporate firms set up production units in developing countries.

7.10 SUMMARY

International trade is one of the most important factors of growth and prosperity of participating economies. Its importance has got magnified many times due to globalization. Moreover, the resurgence of the US from being the biggest international creditor to become the largest international debtor is an important issue. These issues are a part of international macroeconomics, which is popularly known as international finance. Governments and central banks may manipulate the foreign currency exchange market to implement their national monetary policy. If a country needs to increase its exports, it can sell its home currency on an exchange to weaken it. A large sell-off of a particular currency lowers its price relative to currencies from other countries. When a government needs to strengthen a currency, it can purchase its currency back from the exchange market to reduce the available supply. A country is vulnerable to other countries selling large amounts of its currency on the exchange markets.We also discuss the role of various credit instruments and various participants of financial market which plays a important role in foreign Exchange

7.11 GLOSSARY

- **Foreign Bills of Exchange :** It is a written request or an order from the drawer to the drawee to pay a certain sum of money either to himself or to the payee as ordered by the drawer on demand .

- **Letter of Credit:** A letter of credit is an instrument authorizing a person to draw a bill or a cheque for a specified sum on the issuing bank at a stipulated time. The letter of credit makes the exporter willing to ship the goods to the importer, for the liability for payment is assumed by the bank issuing the letter of credit.
- **Telegraphic Transfer :** It is a telegraphic order by a bank to its correspondent bank abroad to pay a certain sum to a certain person on account out of its deposit account. It is a quicker mode of payment.
- **Foreign Exchange Broker:** Foreign exchange brokers also operate in the international currency market. They act as agents who facilitate trading between dealers. Unlike the banks, brokers serve merely as matchmakers and do not put their own money at risk

7.12 SELF ASSESSMENT QUESTIONS

1. Role of Central Bank in Purchase and sale of Foreign Exchange?

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2 What are the various Instrument of Credit in Foreign Exchange ?.

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3 What are the various components of Foreign Exchange?

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7.13 LESSON END EXERCISE

Q1 Discuss the Role of Bank in sale and Purchase of Foreign Exchange.

Q2 What is the role of Participants in Foreign Exchange Market?

Q3 What are the various segments of Foreign Exchange Market?

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Unit - II **Lesson No. 8**
C.No. M.COM-FC 412 **SEM : Fourth**

STRUCTURE

8.1 INTRODUCTION

People invest money in the financial market with the hope of making good returns. But the investment may turn risky due to volatility in the prices of securities like commodities, currency, equity, etc. During such fluctuations, all the predictions could go either way. This increases the chances of wiping out your entire investments. Thus, the primary concern of the trader is the risk that is associated with the financial market and flow of returns while trading in the market. There are various instruments available that can protect a trader from the risks and volatility of the financial markets. These instruments not only protect the traders but even guarantees returns to them. Derivatives are such instruments. In fact, you will be surprised to know about just the types of derivatives market that exist. In this chapter, we will understand the concept and different types of financial derivatives in detail.

8.2 OBJECRTIVES

After studying this lesson, you will be able to:

- Meaning and Importance of Derivatives in Foreign Exchange
- Types of Derivatives traded in Foreign Market
- Emerging Importance of Indian rupee

8.3 MEANING OF DERIVATIVES :

Derivatives are financial contracts that derive their value from an underlying asset. The value of the underlying asset keeps on changing depending on the market conditions. The derivatives can be traded by predicting the future price movement of the underlying asset. The derivatives contracts are widely used to speculate and make good returns. These are used for various purposes like hedging, access to additional assets, etc. Derivatives are not new financial instruments. For example, the emergence of the first futures contracts can be traced back to the second millennium BC in Mesopotamia. However, the financial instrument was not widely used until the 1970s. The introduction of new valuation techniques sparked the rapid development of the derivatives market. NowaDays, we cannot imagine modern finance without derivatives.

8.4 IMPORTANCE OF DERIVATIVES

Importance of Derivatives

Unsurprisingly, derivatives exert a significant impact on modern finance because they provide numerous advantages to the financial markets:

1. Hedging risk exposure : Since the value of the derivatives is linked to the value of the underlying asset, the contracts are primarily used for hedging risks. For example, an investor may purchase a derivative contract whose value moves in the opposite direction to the value of an asset the investor owns. In this way, profits in the derivative contract may offset losses in the underlying asset.

2. Underlying asset price determination : Derivates are frequently used to determine the price of the underlying asset. For example, the spot prices of the futures can serve as an approximation of a commodity price.

3. Market efficiency : It is considered that derivatives increase the efficiency of financial markets. By using derivative contracts, one can replicate the payoff of the assets. Therefore, the prices of the underlying asset and the associated derivative tend to be in equilibrium to avoid arbitrage opportunities.

4. Access to unavailable assets or markets : Derivatives can help organizations get access to otherwise unavailable assets or markets. By employing interest rate swaps, a company may obtain a more favorable interest rate relative to interest rates available from direct borrowing.

8.5 TYPES OF DERIVATIVES

The four major types of derivative contracts are **options, forwards, futures and swaps.**

1. Options : Options are derivative contracts which gives the buyer a right to buy/sell the underlying asset at the specified price during a certain period of time. The buyer is not under any obligation to exercise the option. The option seller is known as the option writer. The specified price is known as strike price. You can exercise American options at any time before the expiry of the option period. European options, however, can be exercised only on the date of expiration date. There are two types of options i.e. call option and put option. Call option allows you the right but not the obligation to buy something at a later date at a given price whereas put option gives you the right but not the obligation to sell something at a later date at a given pre decided price. Any individual therefore has 4 options when they buy an options contract. They can be on the long side or the short side of either the put or call option. Like futures, options are also traded on the exchange

2. Futures: Futures are standardized contracts which allow the holder to buy/sell the asset at an agreed price at the specified date. The parties to the future contract are under an obligation to perform the contract. These contracts are traded on the stock exchange. The value of future contracts are marked-to-market everyday. It means that the contract value is adjusted according to market movements till the expiration date. However, futures contracts are listed on the exchange. This means that the exchange is an intermediary. Hence, these contracts are of standard nature and the agreement cannot be modified in any way. Exchange contracts come in a pre-decided format, pre-decided sizes and have pre-decided expirations. Also, since these contracts are traded on the exchange they have to follow a daily settlement procedure meaning that any gains or losses realized on this contract on a given day have to be settled on that very day. This is done to negate the counterparty credit risk.An important point that needs to be mentioned is that in case of a futures contract, they buyer and seller do not enter into an agreement with one another. Rather both of them enter into an agreement with the exchange.

3. Forwards : Forwards are like futures contracts wherein the holder is under an obligation to perform the contract. But forwards are unstandardised and not traded on stock exchanges. These are available over-the-counter and are not marked-to-market. These can be customised to suit the requirements of the parties to the contract. However, a forward contract takes place between two counterparties. This means that the exchange is not an intermediary to these transactions. Hence, there is an increase chance of counterparty credit risk. Also, before the internet age, finding an interested counterparty was a difficult proposition. Another point that needs to be noticed is that if these contracts have to be reversed before their expiration, the terms may not be favorable since each party has one and only option i.e. to deal with the other party. The details of the forward contracts are privileged information for both the parties involved and they do not have any compulsion to release this information in the public domain.

4. Swaps : Swaps are derivative contracts wherein two parties exchange their financial obligations. The cash flows are based on a notional principal amount agreed between both the parties without exchange of principal. The amount of cash flows is based on a rate of interest. One cash flow is generally fixed and the other changes on the basis of a benchmark interest rate. Interest rate swaps are the most commonly used category. Swaps are not traded on stock exchanges and are over-the-counter contracts between businesses or financial institutions. Swaps enable companies to avoid foreign exchange risks amongst other risks. Swap contracts are usually not traded on the exchange. These are private contracts which are negotiated between two parties. Usually investment bankers act as middlemen to these contracts. Hence, they too carry a large amount of exchange rate risks

8.6 EMERGING IMPORTANCE OF INDIAN RUPEE:

The Indian rupee refers to India's national currency and is represented by ISO code INR. It is regulated by the Reserve Bank of India (RBI), the country's central bank. The Indian rupee is named after the "rupiya," a silver coin issued for the first time in the 16th century. At the beginning of 1830, the English exerted a significant influence in India. The Coinage Act of 1835 made a standardized coinage possible in the country. The new version of the coins featured the effigy of William IV on the original side and the denomination on the reverse, written in Persian and English.

On the other hand, coins issued after 1840 bore a portrait of Queen Victoria. In 1862, the first coin issued under the crown was authorized. The Coinage Act of India, which regulates the establishment of mints and the issuance of coins, was passed in 1906 and is still in force today.Historically, the rupiya was a silver coin. It resulted in significant implications in the 19th century when the world's largest countries were under the gold standard. The discovery of huge volumes of silver in the European colonies and the U.S. sparked the panic of 1878. It led to the devaluation of silver compared to gold, resulting in a fall in India's standard currency value.

The condition during the Second World War led to Quaternary Silver Alloy replacing the regular rupee. The coins produced in 1940 were substituted in 1947 by pure nickel coins. India gained its independence on August 15, 1947. However, the prevailing currency remained frozen until January 26, 1950, when the country adopted its own constitution. In 1957, India introduced a decimal currency scheme where 100 paise formed a rupee.In 2016, the government decided to demonetize 500 and 100 INR notes, arguing that it would curb the underground economy, rendering it even more difficult to use illicit and counterfeit cash to finance crime and terrorism. Following the move, the RBI declared the issuance of new notes of denominations 500 and 2000 INR in a new Mahatma Gandhi series.

As of April 2019, the latest circulated notes included denominations of 5 INR,10 INR, 20 INR, 50 INR, and 100 INR notes of the Mahatma Gandhi Old Series and the 10 INR, 20 INR, 50 INR, 100 INR, 200 INR, 500 INR and 2000 INR notes of the Mahatma Gandhi New Series. The new series of INR notes contains various micro-printed texts, such as "Bharata" and "RBI," in different locations.

Officially, INR's exchange rates are determined by the market. However, the RBI aggressively deals in the USD/INR currency market to influence the exchange rate. As a result, the currency system in place for INR compared to the USD is a regulated exchange rate. It is often called a "managed float."Other exchange rates, such as INR/JPY and EUR/INR, are subject to fluctuations characteristic of floating exchange rates. As a result, it generates arbitrage opportunities against the exchange rates. Successive governments through RBI prefer not to pursue a strategy of pegging the INR to a particular foreign currency at a specific exchange rate. RBI's interference in currency markets is primarily intended to make sure that the exchange rate volatility is low.

The following points further highlights the importance of Indian rupee:

1 The Indian rupee has grown rapidly to become the sixteenth most traded currency in the world approximately $70 billion in turnover a day.

1 The rupee ranks among the most actively traded of the emerging market currencies, in the same class with the Korean Won, Russian Ruble, Chinese Renminbi and Mexican Peso

2 ICE Futures U.S announced that it will launch a new cash settled currency future contract based upon the Indian rupee

3 The listing of the Indian rupee contract recognizes the increasing Importance and Integration of India in to the world Economy and respond to mounting interest in exchange traded products from market participant.

8.7 SUMMARY

Derivatives are not new financial instruments. For example, the emergence of the first futures contracts can be traced back to the second millennium BC in Mesopotamia.

However, the financial instrument was not widely used until the 1970s. The introduction of new valuation techniques sparked the rapid development of the derivatives market.. There are various instruments available that can protect a trader from the risks and volatility of the financial markets. These instruments not only protect the traders but even guarantees returns to them. There are basically four types of derivatives traded in Financial market .Like Forward , futures ,Swaps and Spots

The Indian rupee refers to India's national currency and is represented by ISO code INR. It is regulated by the Reserve Bank of India (RBI), the country's central bank. The Indian rupee is named after the "rupiya, The rupee ranks among the most actively traded of the emerging market currencies, in the same class with the Korean Won, Russian Ruble.

8.8 GLOSSARY

- **Hedging :** A hedge is an investment that protects your finances from a risky situation. Hedging is done to minimize or offset the chance that your assets will lose value. It also limits your loss to a known amount if the asset does lose value.
- **Swaps :** Swaps are derivative contracts wherein two parties exchange their financial obligations. The cash flows are based on a notional principal amount agreed between both the parties without exchange of principal.
- **Forwards :** Forwards are like futures contracts wherein the holder is under an obligation to perform the contract. But forwards are unstandardised and not traded on stock exchanges. These are available over-the-counter and are not marked-to-market
- **Pegging :** A currency peg is a policy in which a national government sets a specific fixed exchange rate for its currency with a foreign currency or a basket of currencies. Pegging a currency stabilizes the exchange rate between countries
- **Derivatives :** Derivatives are financial contracts that derive their value from an underlying asset. The value of the underlying asset keeps on changing depending on the market conditions

8.9 SELF ASSESSMENT QUESTIONS

1. What do you mean by derivatives? Explain its importance in Foreign Exchange.

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2 What are the various types of Derivatives Traded in Foreign Exchange.

3 Briefly explain the emergence and importance of Indian rupee.

8.10 LESSON END EXERCISE

Q1 What is the significance of derivatives in Foreign Exchange ?

Q2 Discuss Role of Indian rupee In Foreign Exchange.

Q3 Briefly explain concept and types of Derivatives.

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EXCHANGE RATE MECHANISM;FORCES OF DEMAND & SUPPLY, GUSTAV'S THEORY

Unit - II	Lesson No. 9
C.No. M.COM-FC 412	SEM : Fourth

STRUCTURE

9.1 INTRODUCTION

Exchange rates are determined by demand and supply. But governments can influence those exchange rates in various ways. The extent and nature of government involvement in currency markets define alternative systems of exchange rates. In this section we will examine some common systems and explore some of their macroeconomic implications. There are three broad categories of exchange rate systems. In one system, exchange rates are set purely by private market forces with no government involvement. Values change constantly as the demand for and supply of currencies fluctuate. In another system, currency values are allowed to change, but governments participate in currency markets in an effort to influence those values. Finally, governments may seek to fix the values of their currencies, either through participation in the market or through regulatory policy.

9.2 OBJECTIVES

After studying this lesson, you will be able to:

- Overview of Exchange Rate
- Exchange Rate Mechanism
- Factors of Demand and supply of Foreign Exchange;
- Gustav's theory

9.3 OVERVIEW OF EXCHANGE RATE

We live in a globalized world. Every country is dependent on another country in some other means. Developed countries look for the cheap workforce from developing countries and developing countries look for services and products from developing countries. When a trade happened between two countries as in this case, there are many factors that come into the picture and have to be considered while the execution of the trade so that no violation of regulation happens. For any economy international finance is a significant critical factor, the local government should accordingly execute the policies so that the local players are not facing severe competition from the non-local players.

International trade is one of the most important factors of growth and prosperity of participating economies. Its importance has got magnified many times due to globalization. Moreover, the resurgence of the US from being the biggest international creditor to become the largest international debtor is an important issue. These issues are a part of international macroeconomics, which is popularly known as international finance.

9.4 EXCHANGE RATE MECHANISM

An exchange rate mechanism (ERM) is a device used by countries to manage the strength of their currency. The ERM is a critical pillar in any economy's monetary policy and is frequently utilized by the central banks. It is important to place strong controls over domestic currency to stimulate international trade through the management of domestic currency with respect to international currencies, which are traded on the foreign exchange market.

9.5 WORKING OF EXCHANGE RATE MACHANISM

Originally, currencies began as a fixed exchange rate mechanism that tracked gold or other commodities. The exchange rate mechanism allows central banks to influence domestic currency prices of currency in foreign exchange markets.Moreover, ERM enables the central bank to adjust the currency peg to exert a material impact on imports and exports, as well as attract foreign direct investment and foreign portfolio investment.

The exchange rate mechanism is critical to keeping exchange rates stable and controlling currency rate volatility in the market. Reducing foreign currency fluctuation is important, as it allows the market to become more predictable to outside investors.

Exchange rates that are actively managed through mechanisms set out to establish a reasonable trading range for a currency's exchange rate. The range includes a lower bound and an upper bound. The country must enforce the range through interventions, usually through the purchase or sale of currency.

9.6 FORCES OF DEMAND AND SUPPLY IN EXCHANGE RATE

Determination of foreign exchange rate:

(a) Exchange rate in a free exchange market is determined at a point, where demand for foreign exchange is equal to the supply of foreign exchange.

(b) Let us assume that there are two countries – India and U.S.A – and the exchange rate of their currencies i.e., rupee and dollar is to be determined. Presently, there is floating or flexible exchange regime in both India and U.S.A. Therefore, the value of currency of each country in terms of the other currency depends upon the demand for and supply of their currencies.

(c) In the above diagram, the price on the vertical axis is stated in terms of domestic currency (that is, how many rupees for one US dollar). The horizontal axis measures the quantity demanded or supplied.

(d) In the above diagram, the demand curve [D$] is downward sloping. This means that less foreign exchange is demanded as the exchange rate increases. This is due to the fact that the rise in price of foreign exchange increases the rupee cost of foreign goods, which make them more expensive. As a result, imports decline. Thus, the demand for foreign exchange also decreases.

(e) The supply curve [S$] is upward sloping which means that supply of foreign exchange increases as the exchange rate increases.

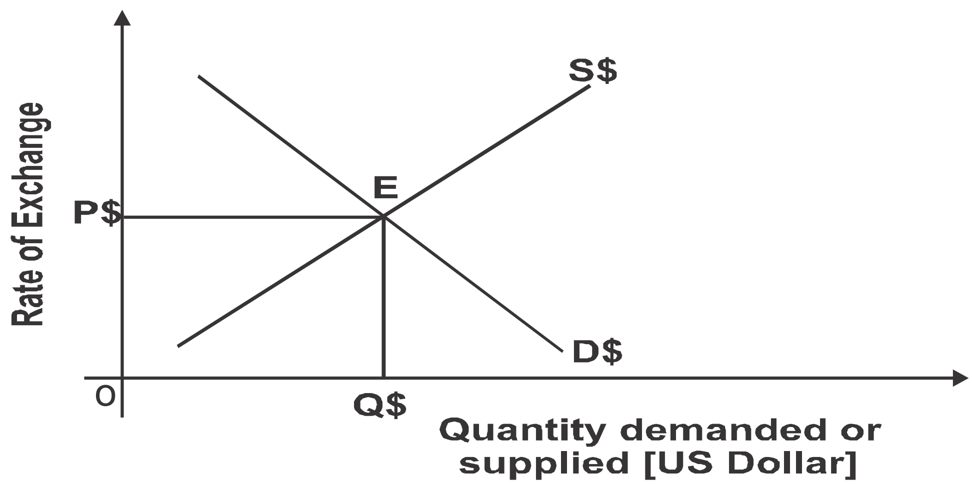


Fig. 9.1

This makes home country's goods become cheaper to foreigners since rupee is depreciating in value. The demand for our exports should therefore increase as the exchange rate increases.

The increased demand for our exports translates into greater supply of foreign exchange. Thus, the supply of foreign exchange increases as the exchange rate increases.

Disequilibrium conditions under equilibrium Exchange rate

A Change in demand:

Increase in demand for dollar: An increase in the demand for US dollar in India will cause the demand curve to shift to D1$ and the exchange rate rises to P1$. Note that increase in the exchange rate means that more rupees are required to buy one US dollar. When this occurs, Indian rupee is said to be depreciating.

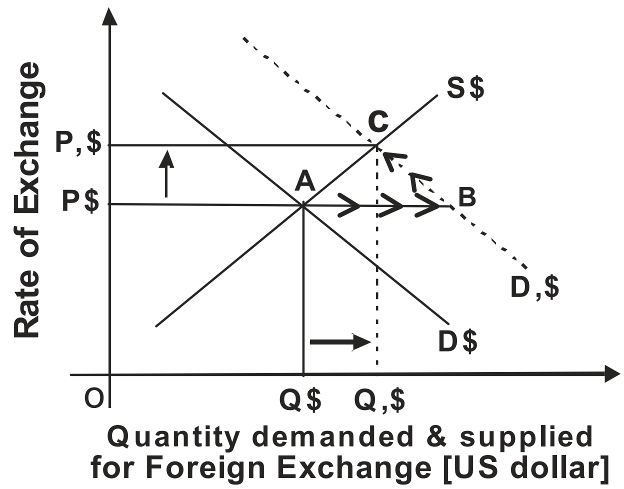


Fig. 9.2

B Change in supply : (i)Increase in supply for dollar: An increase in the supply of US dollar causes the supply curve to shift to S1$ and exchange rate falls to P1$. In this case, rupee cost of US dollar is decreasing and the Indian rupee is said to be appreciating

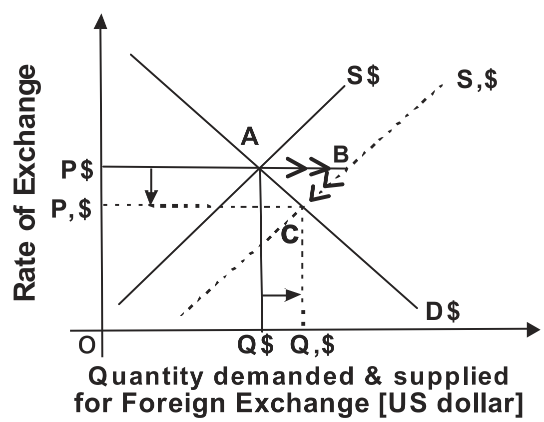


Fig. 9.3

(ii) Decrease in demand for dollar: A decrease in the demand for US dollar in India will cause the demand curve to shift to D1$ and the exchange rate falls to P1$. Note that decrease in the exchange rate means that less rupees are required to buy one US dollar. When this occurs, Indian rupee is said to be appreciating

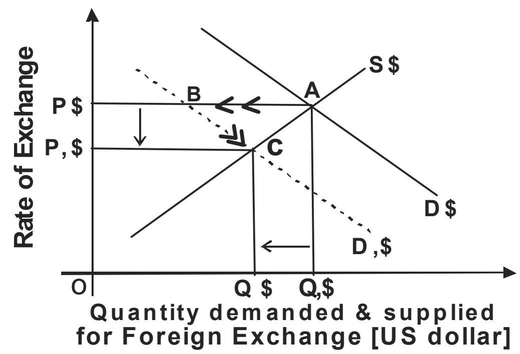
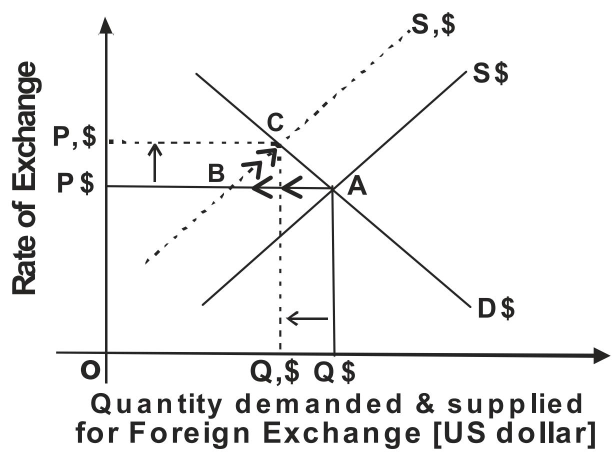


Fig. 9.4

(iii) Decrease in supply of dollar: A decrease in the supply of US dollar causes the supply curve to shift to S1$ and exchange rate rises to P1$. In this case, rupee cost of US dollar is increasing and the Indian rupee is said to be depreciating



9.7 GUSTAV'S THEORY:

THE PURCHASING POWER PARITY : The purchasing power parity theory was propounded by Professor Gustav Cassel of Sweden. According to this theory, rate of exchange between two countries depends upon the relative purchasing power of their respective currencies. Such will be the rate which equates the two purchasing powers. For example, if a certain assortment of goods can be had for £1 in Britain and a similar assortment with Rs. 80 in India, then it is clear that the purchasing power of £ 1 in Britain is equal to the purchasing power of Rs. 80 in India. Thus, the rate of exchange, according to purchasing power parity theory, will be £1 = Rs. 80. Let us take another example. Suppose in the USA one $ purchases a given collection of commodities. In India, same collection of goods cost 60 rupees. Then rate of exchange will tend to be $ 1 = 60 rupees. Now, suppose the price levels in the two countries remain the same but somehow exchange rate moves to $1=61 rupees. This means that one US$ can purchase commodities worth more than 46 rupees. It will pay people to convert dollars into rupees at this rate, ($1 = Rs. 61), purchase the given collection of commodities in India for 60 rupees and sell them in U.S.A. for one dollar again, making a profit of 1 rupee per dollar worth of transactions. This will create a large demand for rupees in the USA while supply thereof will be less because very few people would export commodities from USA to India. The value of the rupee in terms of the dollar will move up until it will reach $1 = 60 rupees. At that point, imports from India will not give abnormal profits. $ 1 = 60 rupees and is called the purchasing power parity between the two countries. Thus, while the value of the unit of one currency in terms of another currency is determined at any particular time by the market conditions of demand and supply, in the long run the exchange rate is determined by the relative values of the two currencies as indicated by their respective purchasing powers over goods and services. In other words, the rate of exchange tends to rest at the point which expresses equality between the respective purchasing powers of the two currencies. This point is called the purchasing power parity. Thus, under a system of autonomous paper standards the external value of a currency is said to depend ultimately on the domestic purchasing power of that currency relative to that of another currency. In other words, exchange rates, under such a system, tend to be determined by the relative purchasing power parities of different currencies in different countries. In the above example, if prices in India get doubled, prices in the USA remaining the same, the value of the rupee will be exactly halved. The new parity will be $ 1 = 120 rupees. This is because now 120 rupees will buy the same collection of commodities in India which 60 rupees did before. We suppose that prices in the USA remain as before. But if prices in both countries get doubled, there will be no change in the parity. In actual practice, however, the parity will be modified by the cost of transporting goods (including duties etc.) from one country to another. A Critique of Purchasing Power Parity Theory: The purchasing power parity theory has been subject to the following criticisms: The actual rates of exchange between the two countries very seldom reflect the relative purchasing powers of the two currencies. This may be due to the fact that governments have either controlled prices or controlled exchange rates or imposed restrictions on import and export of goods. Moreover, the theory is true if we consider the purchasing power of the respective currencies in terms of goods which enter into international trade and not the purchasing power of goods in general. But we know that all articles produced in a country do not figure in international trade. Therefore, the rate of exchange cannot reflect the purchasing power of goods in general. For example, in India we may be able to get a dozen shirts washed with Rs. 40, but only 2 shirts with one dollar in the USA. Obviously, the purchasing power of one dollar in the USA is much less than the purchasing power of Rs. 40 in India. This is due to the fact that dhobis do not form an article of international trade. If dhobis entered into international trade and freely moved into the U.S.A., then in terms of clothes washed, the purchasing power of Rs. 40 may be equalized with the purchasing power of a dollar. Further, it is very difficult to measure purchasing power of a currency. It is usually done with the help of index numbers. But we know that the index numbers are not infallible. Among the difficulties connected with index numbers are the following important ones (i)Different types of goods that enter into the calculation of index numbers; (ii) Many goods which may enter into domestic trade may not figure in international trade; (iii) Internationally traded goods also may not have the same prices in all the markets because of differences in transport costs. Besides, the theory of purchasing power applies to a stationary world. Actually the world is not static but dynamic. Conditions relating to money and prices, tariffs, etc., constantly go on changing and prevent us from arriving at any stable conclusion about the rates of exchange. The internal prices and the cost of production are constantly changing. Therefore, a new equilibrium between the two currencies is almost daily called for. As Cassel observes, "differences in two countries' economic situation, particularly in regard to transport and customs, may cause the normal exchange rate to deviate to a certain extent from the quotient of the currencies intrinsic purchasing powers." If a country raises its tariffs, the exchange value of its currency will rise but its price level will remain the same. Besides, many items of balance of payments like insurance and banking transactions and capital movements are very little affected by changes in general price levels. But these items do influence exchange rates by acting upon the supply of and the demand for foreign currencies. The Purchasing Power Parity Theory ignores these influences altogether. Further, the theory, as propounded by Cassel, says that changes in price level bring about changes in exchange rates but changes in exchange rates do not cause any change in prices. This latter part is not true, for exchange movements do exercise some influence on internal prices. The purchasing power parity theory compares the general price levels in two countries without making any provision for distinction being drawn between the price level of domestic goods and that of the internationally traded goods. The prices of internationally-traded goods will tend to be the same in all countries (transport costs are, of course omitted). Domestic prices on the other hand, will be different in the two countries, even between two areas of the same country. The purchasing power parity theory assumes that there is a direct link between the purchasing power of currencies and the rate of exchange. But in fact there is no direct relation between the two. Exchange rate can be influenced by many other considerations such as tariffs, speculation and capital movements

9.8 SUMMARY

To conclude we can say that An exchange rate system, also called a currency system, establishes the way in which the exchange rate is determined, i.e., the value of the domestic currency with respect to other currencies. Choosing the currency system is a pivotal element of the economic policy adopted by a country's government or import supplies from foreign manufacturer initially to establishing subsidiaries in foreign countries. An exchange rate mechanism (ERM) is a device used by countries to manage the strength of their currency. The ERM is a critical pillar in any economy's monetary policy and is frequently utilized by the central banks. In this chapter we also discuss the various factors that determine the demand and supply of foreign exchange .Gradually in the end we discuss the Gustav's theory which is also known as purchasing power parity theory According to this theory, rate of exchange between two countries depends upon the relative purchasing power of their respective currencies. Such will be the rate which equates the two purchasing powers.

9.9 GLOSSARY

- **Exchange rate.:** When a trade happened between two countries as in this case, there are many factors that come into the picture and have to be considered while the execution of the trade so that no violation of regulation happens.
- **Exchange rate mechanism:** The exchange rate mechanism is critical to keeping exchange rates stable and controlling currency rate volatility in the market. Reducing foreign currency fluctuation is important, as it allows the market to become more predictable to outside investors..
- **Gustav's Theory :** According to this theory, rate of exchange between two countries depends upon the relative purchasing power of their respective currencies. Such will be the rate which equates the two purchasing powers

9.10 SELF ASSESSMENT QUESTIONS

1. Elaborate exchange rate Mechanism in Detail?

2 What are the various forces determining Demand and supply of Exchange rates?

3. Discuss Gustav's Theory in detail.

9.11 LESSON END EXERCISE

Q1 What do you mean by Exchange rate. Discuss the working of Exchange Rate Mechanism ?

Q2 What are the various Disequilibrium conditions under equilibrium Exchange rate ?

Q3 Critically Discuss the Gustav's Theory ?

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INDIAN FOREIGN EXCHANGE MARKET, FIXED V/S FLUCTUATING EXCHANGE RATES.

Unit - II | **Lesson No. 10**
C.No. M.COM-FC 412 | **SEM : Fourth**

STRUCTURE

10.1 INTRODUCTION

Foreign Exchange, Forex (FX) as it is called is trading of a single currency for another at a certain price and bank deposits on the over-the-counter (OTC) market place. It simply means buying one currency and selling the other. The values appreciate and depreciate as a result of various economic and geopolitical factors. The objective of FX trader is to make profits from these fluctuation in prices, speculating on which way the foreign exchange rates are likely to move in the future. Currency trading markets are available 24-hrs a day, five days a week, Sunday being a holiday. Forex transactions are generally quoted in pairs because when one currency is bought, the other is sold. The first currency is called the **'base currency'** and the second Currency called as the **"quote Currency"**

10.2 OBJECTIVES:

After studying this lesson, you will be able to:

- Over view of Indian Foreign Exchange market;
- Characteristics of Indian Foreign Exchange market;
- Exchange Rate System in India;
- Fixed V/s Fluctuating Exchange rate in India..

10.3 OVERVIEW OF INDIAN FOREIGN EXCHANGE MARKET

We live in a globalized world. Every country is dependent on another country in some other means. Developed countries look for the cheap workforce from developing countries and developing countries look for services and products from developing countries. When a trade happened between two countries as in this case, there are many factors that come into the picture and have to be considered while the execution of the trade so that no violation of regulation happens. For any economy international finance is a significant critical factor, the local government should accordingly execute the policies so that the local players are not facing severe competition from the non-local players.

The government of India allowed banks to trade in the foreign exchange market in the year 1978 for the first time. The Indian foreign exchange market was the resultant establishment at this time and has over the years experienced different periods that have greatly determined the position of the Indian Rupee in the global forex market today.

During the initial period, the Indian Forex market entailed features such as forex trade confined only among banks, but a lot has changed since then, with institutions such as the Foreign Exchange Management Act of 1999 (FEMA) being established to regulate the Indian Forex market. Other fundamental facts about the Indian forex market includes its operation under the Central Government of India which has the mandate to execute foreign exchange transactions.

10.4 CHARACTERSTICS OF INDIAN FOREIGN EXCHANGE MARKET

The following points signifies the various characteristics of Indian Foreign Exchange Market:

- Direct and Two Way quotations
- Commercial Banks involvement
- Spot and forward exchange rates
- Currencies futures
- Inter-bank, Merchant and Card Rates

1. Direct and Two Way Quotation : The foreign exchange price sold with reference to the Indian Rupee (INR) as the domestic currency creates a direct quotation. Price quotation which is the other name for direct quotation expresses that the foreign exchange quote is determined by how given currency associates with the INR. That, therefore, establishes an inverse relationship between the value of the INR as the domestic currency with its exchange rate. A two-way quotation, on the other hand, shows to potential foreign traders the selling and buying process of the INR

2. Forex Brokers and Commercial Banks' Involvement : After the liberalization of the Indian forex market, commercial banks and Indian forex brokers were granted permission by the Central Government of India to trade in the forex market. With over 97 commercial banks in India that partly participate in the forex market for the profits, the ability to declare their own forex rates creates a variance across the market. However, they are guided by a strict trading relationship as entities that provide a channel for forex market traders

3. Spot and Forward Exchange Rates : In the event that the forex market shows less promise in terms of a depreciating value in the INR, then an agreement would be made among the parties involved to sell the Indian currency at a specified later date. This agreement is referred to as a forward contract, which is settled by a forward rate payment price for the agreement. The spot rate and forward correlate in a way that allows the former to be used in the calculation determinant of the latter.

4. Currencies Futures : When two entities within the Indian FX market come to a signed agreement that allows them to exchange the Indian currency for another currency at a convenient future date at a given exchange rate; the agreement is referred to as a currency future. Given the quotation method for the Indian foreign exchange (direct quotation), the NSE price of a currency future contract is determined by the price of the INR per unit of the exchange currency.

5. Inter-bank, Merchant and Card Rates : The inter-bank rate entails the foreign exchange trading price between banks within the Indian forex market. The foreign exchange of currencies between banks is usually centralized by a commercial bank which conducts the trade and determines the inter bank rate to other banks such as central banks and nationalized banks among others. Whereas card rates are currency prices that are designed for basic and minor forex transactions such as tourism and hospitality transactions.

10.5 EXCHANGE RATE SYSTEMS IN INDIA:

The structure of forex market in India is three tier. The first part consists of transactions between the Reserve Bank of India and the authorised dealers. These dealers are usually the commercial banks. The second is the interbank market in which the banks transact among themselves. The third is the retail part in which the authorised dealer deal with their corporate clients and other retail customers. In the retail part money changers also operate. These are licensed dealers in the currency market to cater to the needs of retail customers. In the interbank market the quotes appear in swap points. there are currency brokers also who match the buyers and sellers and they work on commission basis.

10.6 FIXED V/S FLUCTUATING EXCHANGE RATES :

1. The Fixed Exchange Rate :

When the exchange rate between the domestic and foreign currencies is fixed by the monetary authority of a country and is not allowed to fluctuate beyond a limit, it is called fixed exchange rate. Under the IMF system, the monetary authority of a member nation fixes the official value of its currency in terms of a reserve currency (usually the US dollar) or a basket of 'key currencies.' The exchange rate so determined is known as currency's par value. It is also called 'pegged' exchange rate. However, flexibility is allowed within the upper and lower limits prescribed by the IMF, usually 1% up and down, under the normal conditions.

The basic purpose of adopting fixed exchange rate system is to ensure stability in foreign trade and capital movements. Under fixed exchange rate system, the government assumes the responsibility of ensuring stability of exchange rate. To this end, the government undertakes to buy and sell the foreign currency-buy when it becomes weaker and sell when it gets stronger. Private sale and purchase of foreign currency is suspended. Any change in the official exchange rate is made by the monetary authority of the country in-consultation with the IMF. In practice, however, most countries adopt a dual system: a fixed exchange rate for all official transactions and a market rate for private transactions.

2. The Flexible/Fluctuating Exchange Rate :

Interest rate which is volatile and keeps on changing as per market scenario is termed as Floating Interest Rate. This type of interest rate depends on the base rate offered by several lenders, so whenever the base rate changes, the interest rate gets automatically revised. As compared to fixed interest rate, floating rates are comparatively cheaper. Fixed interest rates are 1%-2.5% higher than the floating interest rate. The increase and decrease in the floating interest rate is temporary, as it varies as per the market trends. As home loan is a long-term association with the lender, sometimes it becomes difficult to plan for the financials. Nowadays, floating interest rate is becoming more popular and is considered as the first choice of home buyers. Even banks and NBFCs are offering home loan interest (floating) at a low and attractive rate.

The following Table further highlight the difference between the Fixed Exchange Rate and Floating/Flexible Exchange rate :

Fixed Interest Rate	Fluctuating Interest Rate
Higher Interest Rate	Lower Interest Rate
Not affected by financial market conditions	Affected by changes in the financial market
Fixed EMIs	EMIs change as per interest rate or MCLR
Budget planning possible	Difficult to budget or manage financials
Sense of security	Generates savings
Suitable for short/medium term (3-10 years)	Suitable for long term (20-30 years)
Lesser risk	Higher risk

Arguments in Favour of Fixed Exchange Rate:

1 .It provides stability in the markets, certainty about the future course of actions in the Foreign Exchange Market, and it eliminates the risk caused by the uncertainty.

2 It creates a system for a smooth flow of foreign capital between the nations, as it gives assurance of fixed return on investment.

3 It removes the possibility of speculative transactions in foreign exchange markets.

4 it reduces the possibility of competitive exchange depreciation or devaluation of currencies.

Arguments in favour of Flexible/Fluctuating Exchange Rate:

1. Flexible exchange rate provides a good deal of autonomy in respect of domestic policies as it does not require any obligatory constraints. This advantage is of great significance in the formulation of domestic economic policies.
2. Flexible exchange rate is self-adjusting and therefore it does not devolve on the government to maintain an adequate foreign exchange reserves to stabilize the exchange rate.
3. Since flexible exchange rate is based on a theory, it has a great advantage of predictability and has the merit of automatic adjustment.
4. Flexible exchange rate serves as a barometer of actual purchasing power of a currency in the foreign exchange market.

10.7 SUMMARY

An exchange-rate regime is the way an authority manages its currency in relation to other currencies and the foreign exchange market. Between the two limits of fixed and freely floating exchange regimes, there can be several other types of regimes. In their

operational objective, it is closely related to monetary policy of the country with both depending on common factors of influence and impact.The exchange rate regime has a big impact on world trade and financial flows. The volume of such transactions and the speed at which they are growing makes the exchange rate regime a central piece of any national economic policy framework During the initial period, the Indian. Forex market entailed features such as forex trade confined only among banks, but a lot has changed since then, with institutions such as the Foreign Exchange Management Act of 1999 (FEMA) being established to regulate the Indian Forex market. Other fundamental facts about the Indian forex market includes its operation under the Central Government of India which has the mandate to execute foreign exchange transactions

10.8 GLOSSARY

- **OTC Market:** An over-the-counter **(OTC) market** is a decentralized market in which market participants trade stocks ...

- **Base And Quote Currency :** A currency pair is the quotation of two different currencies, with the value of one currency being quoted against the other. The first listed currency of a currency pair is called the base currency, and the second currency is called the quote currency.

- **Peg Currency :** A currency peg is a policy in which a national government sets a specific fixed exchange rate for its currency with a foreign currency or a basket of currencies..

10.9 SELF ASSESSMENT QUESTIONS

1. Discuss in detail Indian Foreign Exchange market.

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2. What are the various Characteristics of Indian Foreign Exchange Market?

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3. Differntiate between Fixed and Fluctuating Exchange rate system ?

10.10 LESSON END EXERCISE

Q1 What are the various features of Foreign Exchange Market ?
Q2 Enlist the arguments in favour of Fluctuating Exchange rate system.
Q3 Discuss the Exchange Rate Mechanism in India.

10.11 SUGGESTED READINGS

1. Levi, M. D. (2005). International finance. Psychology Press.
2. Levi, M. D. (2009). International finance 5th edition. Routledge.
3. Antonio, J., Jan, O., & Stephany, K. (2007). International finance and development. Zed Books.
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Unit - III **Lesson No. 11**
C.No. M.COM-FC 412 **SEM : Fourth**

STRUCTURE

11.1 INTRODUCTION

Exchange Control is an important area of international trade. The term exchange control applies to the rules and regulations designed to regulate transactions involving foreign exchange. The objective of the exchange control is primarily to regulate the demand for foreign exchange for various purposes within the limits set by available supply. Exchange control becomes necessary when the country's external reserves are not adequate for meeting its current and potential requirements. Foreign exchange controls are various forms of controls imposed by a government on the purchase and sale of foreign currencies by residents or on the purchase and sale of local currency by non-residents. Common foreign exchange controls include:

- Banning the use of foreign currency within the country,
- Banning locals from possessing foreign currency,
- Restricting currency exchange to Government-approved exchangers,
- Fixed exchange rates and
- Restrictions on the amount of currency that may be imported or exported.

Countries possessing foreign exchange controls are also termed as "Article-14 countries", after the provision in the International Monetary Fund Agreement allowing exchange controls for transitional economies. Such controls used to be common in most countries, particularly poorer ones, until the 1990s when free trade and globalization started a trend towards economic liberalization. Today, countries which still impose exchange controls are the exception rather than the rule. Often, foreign exchange controls can result in the creation of black markets to exchange the weaker currency for stronger currencies. This leads to a situation where the exchange rate for the foreign currency is much higher than the rate set by the government, and therefore creates a shadow currency exchange market. As such it is unclear whether governments have the ability to enact effective exchange controls.

11.2 OBJECTIVES

In this unit you will learn:

1. The objectives of exchange control
2. Various exchange control regulations prevalent in India
3. RBI as an Exchange Control Authority
4. Role of Authorised Dealers
5. Concept of Money Changers

11.3 FOREIGN EXCHANGE

Foreign exchange, as defined under Foreign Exchange Regulation Act. 1973 is foreign currency and includes:

i) all deposits, credit and balances payable in foreign currency

ii) any drafts, traveller's cheques, letters of credit and bills of exchange expressed or drawn in Indian currency but payable in any foreign currency and,

iii) any instrument payable at the option of the drawee or holder thereof or any other party thereto, either in Indian currency or foreign currency or partly in one and partly in the - Foreign exchange accrues out of foreign exchange transactions.

The regulation and control of foreign exchange implies, therefore, regulation and control of foreign exchange transactions.

Foreign Exchange Transactions: A foreign exchange transaction is ultimately the purchase or sale of one national currency against another arising out of import or export of goods and services, foreign remittances and foreign travel both inward and outward, etc. The goods refer to raw materials, intermediary or finished products capital goods, etc., appraising the visible items of a country's foreign trade. Services refer to shipping, air travel, insurance, banking, supply of technical know-how, consultancy, transfer of capital by way of lending and or investment, interest on such capital and dividends on such investment, tourists income and expenses, cost of Indian students abroad and of foreign students in India, gifts and donations, remittances, etc., which taken together comprise the invisible items of a country's foreign trade. A **foreign exchange transaction** is thus transfer of purchasing power, i.e. acquisition or parting with the right to wealth in a foreign country. As the foreign exchange is precious for a country, government regulate and control the foreign exchange transactions.

11.4 EXCHANGE CONTROL

Exchange control means official intervention in the foreign exchange of a country. It is a system of rationing foreign exchange among competing demands for it, effected by controlling the receipts and payments thereof. The control of receipts aims at centralizing the country's means of external payments in a common pool in the hands of its monetary authorities. The control of payments aims at restraining the demand for foreign exchange broadly in consonance with the national interests within the limits of available resources. For a long time, foreign exchange in India was treated as a controlled commodity because of its limited availability. The early stages of foreign exchange management in the country focussed on control of foreign exchange by regulating the demand due to its limited supply. Exchange control was introduced in India under the Defense of India Rules on September 3, 1939 on a temporary basis. The statutory power for exchange control was provided by the Foreign Exchange Regulation Act (FERA) of 1947, which was subsequently replaced by a more comprehensive Foreign Exchange Regulation Act, 1973. This Act empowered the Reserve Bank, and in certain cases the Central Government, to control and regulate dealings in foreign exchange payments outside India, export and import of currency notes and bullion, transfer of securities between residents and non-residents, acquisition of foreign securities, and acquisition of immovable property in and outside India, among other transactions. Reserve Bank of India is the monetary authority in India. It facilitates judicious use of foreign exchange.

Exchange Control Regulations

1. Meaning

The term exchange control regulations applies to the rules and regulations designed to regulate transactions involving foreign exchange. A foreign exchange transaction is ultimately the purchase or sale of one national currency against another arising out of import or export of goods and services, foreign remittances and foreign travel both inward and outward, etc. A foreign exchange transaction is thus transfer of purchasing power, i.e. acquisition or parting with the right to wealth in a foreign country. The foreign exchange is precious for a country and the government of the country regulate and control the foreign exchange transactions through exchange control regulations. Exchange control regulations becomes necessary when the country's external reserves are not adequate for meeting its current and potential requirements. The exchange control regulations have been liberalised over the years to facilitate the inflow and outflow of funds from India. The changes have been introduced on a continuous basis in line with the government policy of economic liberalisation.

These regulations in India are governed by the Reserve Bank of India under Foreign Exchange Regulation Act(FERA) 1973, which then replaced by the Foreign Exchange Management Act (FEMA) 1999. The apex exchange control authority in India is the Reserve Bank of India (RBI) which regulates the law and is responsible for all key approvals.

2. Transactions Regulated by Exchange Control

The types of transactions which are affected by the Foreign Exchange Regulation Act are, in general, all those having international financial implications. In particular, the following matters are regulated by Exchange Control:

(a) Purchase and sale of and other dealings in foreign exchange and maintenance of balances at foreign centres.

(b) Procedure for realisation of proceeds of exports

(c) Payments to non-residents or to their accounts in India

(d) Transfer of securities between residents and non-residents and acquisition and holding of foreign securities

(e) Foreign travel with exchange

(f) Export and import of currency, cheques, drafts, travellers cheques and other financial instruments, securities, etc.

(g) Activities in India of branches of foreign firms and companies and foreign nationals

(h) Foreign direct investment and portfolio investment in India including investment by non-resident Indian nationals/persons of Indian origin and corporate bodies predominantly owned by such persons

(i) Appointment of non-residents and foreign nationals and foreign companies as agents in India

(j) Setting up of joint ventures/subsidiaries outside India by Indian companies

(k) Acquisition, holding and disposal of immovable property in India by foreign nationals and foreign companies

(l) Acquisition, holding and disposal of immovable property outside India by Indian nationals resident in India.

3. Provisions under Exchange control regulations

A) Authorised Dealers in Foreign Exchange

Authorisations in the form of licences to deal in foreign exchange are granted to banks which arewell equipped to undertake foreign exchange transactions in India. Authorisations have also been granted to certain financial institutions to undertake specific types of foreign exchange transactions incidental to their main business. A list of such banks and institutions is given in the Annexure to this Chapter.

B) Authorised Co-operative/Commercial Banks

Authorisations have also been issued to certain State Co-operative/Urban Co-operative banks and Scheduled Commercial banks to open and maintain Ordinary Non-Resident Rupee Accounts (NRO Accounts) and Non-Resident (External) Rupee Accounts (NRE Accounts), on behalf of non-resident individuals of Indian nationality/origin.

C) Authorised Money-Changers

In order to provide facilities for encashment of foreign currency to visitors from abroad, especially foreign tourists, Reserve Bank has granted licences to certain established firms, hotels and other organisations permitting them to deal in foreign currency notes, coins and travellers cheques subject to directions issued to them from time to time. These firms and organisations who are generally known as' authorised money-changers' fall into two categories, viz. 'Full-fledged money-changers' who are authorised to undertake both purchase and sale transactions with the public and 'Restricted money-changers' who are authorised only to purchase foreign currency notes, coins and travellers cheques, subject to the condition that all such collections are surrendered by them in turn to an authorised dealer in foreign exchange/full-fledged money-changer.

D) Revocation of Licence/Authorisation granted by Reserve Bank

Reserve Bank may revoke the licence/authorisation granted by it to an authoriseddealer, co-operative/commercial bank or money-changer at any time if the holder of the licence/authorisation is found to have failed to comply with any condition subject to which it was granted or to have contravened any provision of FERA 1973 or of any Rule, Notification, Direction or Order made thereunder.

E) Publicity to Regulations

Authorised dealers should bring the Exchange Control regulations and changes made therein from time to time through A.D. Circulars to the notice of their customers. They may also advise their customers that copies of this Manual are available with Reserve Bank for sale to the public.

F) Authorised Dealers' Responsibility

Reserve Bank trusts that authorised dealers will ensure that the Exchange Control regulations are observed by themselves and their constituents both in letter and in spirit. Their responsibility has considerably increased with the delegation of large powers. It will also welcome any comments likely to facilitate administration of Exchange Control so that it may serve better its purpose of conserving and increasing the foreign exchange resources of India with the least obstruction to trade and its financing.

G) Evasion or Attempts of Evasion

Authorised dealers should report to Reserve Bank cases which may come to their notice,of evasion of, or of attempts, either direct or indirect, to evade the provisions of the Foreign Exchange Regulation Act or any Rule, Notification, Order, Direction or Regulation issued thereunder.

H) Restrictions on Dealings in Foreign Exchange

Except for transactions involving purchase or sale of foreign currency betweenany person and an authorised money changer, no person, firm or company, other than an authorised dealer, is permitted to enter into transactions involving the buying, acquiring or borrowing from, or selling, transferring or lending to, or exchanging with a person not being an authorised dealer, any foreign exchange except with the general or special permission of Reserve Bank. Anyone dealing in foreign exchange in any form, except to the extent indicated above, will be deemed to be contravening the provisions of the Act.

I) Breach of Regulations by Non-resident Branches/ Correspondents of Authorised Dealers

If any non-resident branch or correspondent of an authorised dealer is found to havecontravened or attempted to contravene any of the Exchange Control regulations in force in India, all rupee transfers on its account may be made subject to prior permission of Reserve Bank or totally prohibited.

J) Exchange Rates

Section 8(2) of FERA 1973 lays down that all transactions in foreign exchange shall be done at rates for the time being authorised by Reserve Bank. In pursuance of this provision,Reserve Bank has authorised that the rates of exchange for inter-bank as well as merchant transactions in all currencies (including currency notes and travellers cheques) may be fixed by authorised dealers on the basis of prevailing market conditions subject to the guidelines that may be framed by the Foreign Exchange Dealers' Association of India (FEDAI) from time to time. The terms and conditions laid down by FEDAI for transacting foreign exchange business will govern all business transacted by authorised dealers.

K) Employment of Brokers

There is no objection to employment of brokers, but in all cases their principals as wellas the brokers must comply with the requirements of the Exchange Control. Exchange brokers are, however, not authorised to deal in foreign exchange and hence they should not purchase or sell foreign exchange from/to public.

L) Compliance with Laws

Nothing in this Manual authorises any transaction which is contrary to any ofthe provisions of any statute (including the Foreign Exchange Regulation Act, 1973) or any Rule, Notification, Order, Direction or Regulation issued thereunder. Similarly, any approval granted by the Exchange Control Department of Reserve Bank will be deemed to be its approval only under the Foreign Exchange Regulation Act and/or Rules, Notifications and Orders issued thereunder. Approvals required under any other statute should be obtained separately from the concerned authority.

M) Penalties

Adjudications and prosecutions for infringement of the provisions of FERA 1973 are made by the Enforcement Directorate set up by the Government of India under the Act. In terms of Section 73A of FERA 1973, Reserve Bank can also impose penalty on an authorised dealer without prejudice to the powers of the Enforcement Directorate.

11.5 OBJECTIVES OF EXCHANGE CONTROL

Most of the developing countries including India, found it necessary to continue exchange control introduced during the ~ecodkl World War on a systematic and long-term basis. Exchange control became essential in view of the substantial requirements of foreign exchange for the planned developmental effort undertaken by them. Over the years, the scope of exchange control in India has steadily widened. The regulations have become progressively more elaborate with the increasing foreign exchange outlays under successive Five Year Plans and the relative inadequate earnings of foreign exchange. During the span of more than 40 years that the control has remained in force, appraisals and reviews of policies and procedures have been undertaken periodically and modifications made as and when considered necessary. In specific terms, the broad objective of the exchange control are:

1) To prevent flight of capital,

2) To ensure the availability of sufficient foreign exchange for specific purposes such as meeting the international commitments,

3) To stabilize the external value of the domestic currency, and

4) To insulate the economy from external economic pressures.

11.6 STATUTORY BASIS

Exchange control was introduced in lndia wilh the outbreak of second World War on September 3, 1939. This was done by virtue of the emergency powers derived under the financial provisions of the Defence of India Rules. The main purpose was to conserve the non-sterling area currencies and utilize them for essential purposes. The exchange control policy is determined in India by the Ministry of Finance, Govenunent of India on the basis of The Foreign Exchange Regulation Act, 1973 (amended in'1993 and 1995). The Act is administered by the Reserve Bank in accordance with the general policy laid down by the Central Government in consultation with the Bank. The Central Government is empowered to give to the Reserve Bank such general or special directions as it thinks fit. The Bank is obliged to comply with these directions in the discharge of its'finctions under the act. Exchange control is also related to and supplemented by trade control. Exchange control is more comprehensive and covers not only exports and imports but invisibles and capital transactions as well.

11.7 RBI AS EXCHANGE CONTROL AUTHORITY

One of the important central banking functions of the Reserve Bank of India (RBI) is the maintenance of the external value of the rupee. As such it has been given the custody of foreign exchange reserves and sole agency for the administration of exchange controls in India. All receipts and payments in and out of India require general or special permission of the RBI. The dealings in foreign exchange and foreign securities in India, payments to person resident outside India and export and import of currency notes, bullion or precious stones etc., are subject to general or special permission of RBI or are prohibited. The RBI with the help of authorized dealers, and moneychangers carries on the administration of controls. The types of transactions, which are controlled by the RBI and the government are in general those which have international financial implications and include inter alia the following important items. Many of them are liberalized and some of them withdrawn since the 1991 economic reforms.

1) Purchase and sale of and other dealings in foreign exchange and maintenance of balances at foreign centres.
2) Procedures for realisation of proceeds of exports.
3) Payments to non-residents or to their accounts in India.
4) Transfer of securities between residents and non-residents and acquisitjm and holdings of foreign secuniies.
5) Foreign travel with exchange.
6) Export and Import of currency, cheques, drafts, travellers cheques and other financial instruments, securities, etc.
7) Activities in India of branches of foreign firms and companies and foreign nations.

8) Foreign direct Investment loan India includes investing by non-resident Indian nationals/ persons of Indian origin and corporate bodies predominantly owned by such persons.
9) Appointment of non-residents and foreign nationals and foreign companies as agents in India.
10) Setting up of Joint ventures/subsidies outside India by Indian companies.
11) Acquisition, holding and disposal of immovable property in India by foreign nationals and foreign companies.
12) Acquisition, holding and disposal of immovable property outside India by Indian nationals resident in India.

Functions of RBI in foreign exchange reserves

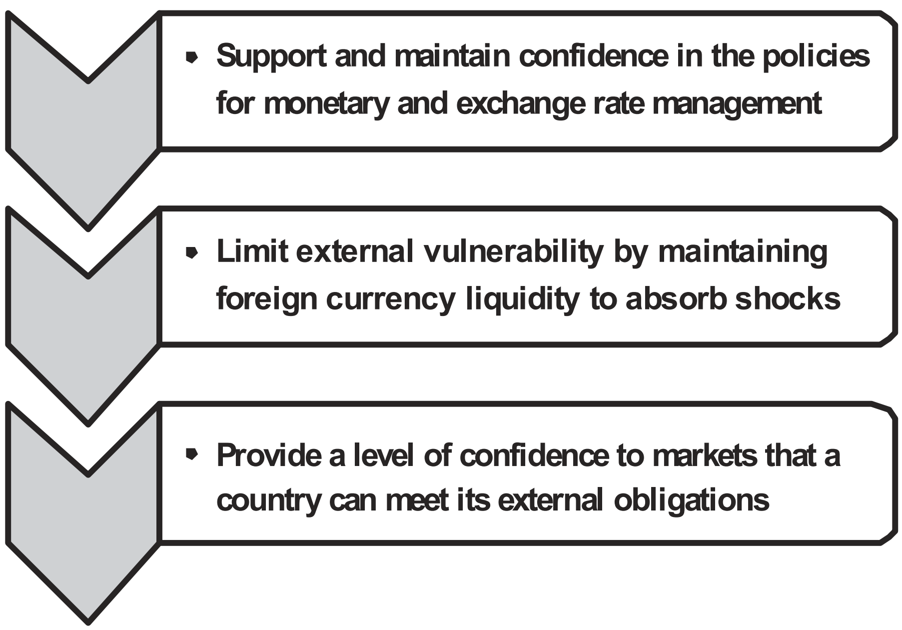

Fig. 11.1 RBI as exchange control authority

11.8 AUTHORISED DEALERS

Authorised dealers are the institutions that have the license from the RBI to sell and buy foreign currencies. Most of the authorised dealers are banks. As per the Foreign Exchange Management Act, 1999, the Reserve Bank, on an application, may authorise any person to be known as an authorised person, to deal in foreign exchange as an Authorised Dealer. An Authorised Dealer is a person authorised by the Financial Surveillance Department to deal in gold or to deal in foreign exchange, for transactions relating to gold and foreign exchange respectively.The term authorized dealer refers to any type of financial institutions who has received authorization from the RBI as a dealer to involve in trading of foreign currencies. The transaction of the authorized dealer should have been conducted in pursuance of a legal mode and under the framework established by law. Authorized dealers are nothing else but the market pronounced name of AMC i.e., Authorized Money Changer. As per master circular no. 10/2013-14 of RBI dated 01st July 2013 it describes that the AMC/ADs are entities, authorized by the Reserve Bank under section 10of the Foreign exchange Management Act 1999. In addition to Authorized Dealers category-I Banks (AD Category –I Banks) and Authorized Dealer Category – II (Ads category- II), Full Fledged Money Changers (FFMCs) are authorized by Reserve Bank to deal in Foreign exchange for specified purposes, to widen the access of foreign exchange facilities to residents and tourists while ensuring efficient customer service through competition.

The ADs have an association called as Foreign Exchange Dealer's Association (FEDA) which fixes the rates for dealing in sterling with rupee on the basis of the rates declared by RBI for buying and selling and the middle rates. They are free to quote their own rates for other currencies on the basis of cross rates quoted in London as between sterling and other currencies.

As the agent of RBI, the ADs have to scrutinize the applications from public and implement the rules and regulations of exchange control under power delegated to them by the RBI. They have to satisfy themselves that all receipts and payments are in accordance with the Exchange Control Manual.They can deal in permitted methods of receipts and payments, keep minimum working balances in foreign centres, operate in the inter-bank market and maintains a square or near square position in each currency which means that their purchases (spot and forward) and sales should be matched as far as possible.

Table 11.1 Categories of Authorized Dealers in India

SI NO.	Category of ADs	Qualifying Entities	Activities/Functions
1.	Authorized Dealers Category – I (ADs- I)	All Commercial Banks And Scheduled banks registered Under RBI Act. Urban Co-operative Banks (To some prescribed extent).	It deals in all type of current ant capital account transaction according to the norms and procedure laid down by RBI.
2.	Authorized Dealers Category – II (ADs- II)	Upgraded Full Fledged Money Changer and another new inclusion like Department Of Post and various type of NBFCs who are operated in open market	It deals in transaction of foreign exchange which is non-trade in characteristics.
3.	Authorized Dealers Category – III (ADs- II)	Financial Institutions, EXIM Bank, SIDBI, IFCI, Clearing corporation of India and Various Factoring Agents.	It deals with the activities which are incidental to financing of international trade related activities undertaken by these institutions.
4.	Full Fledged money Changer (FFMCs)	It can any entities who are related with the finance sector including NBFCs, Department of Postetc.,	FFMCs are authorized to purchase foreign exchange from resident and non-resident visiting India and to sell Foreign Exchange for certain approved purposes.

Brief Explanation Of Different Category of Investor's

1. Authorized Dealers Category – I (ADs – I)

As per the latest circular issued by the RBI, there are around 110 entities who are qualified under the segment of Authorized Dealers category – I. It includes all type of Commercial Banks irrespective of Nationalized Banks, Scheduled Banks, Private Banks and Foreign

Commercial Banks operating in India. These segments of banks allowed to deals in all type of foreign exchange transaction related to current and capital account transaction according to the norms and procedure laid down by RBI.

2. Authorized Dealers Category – II (ADs –II)

The second category of authorized dealer operates under the restrictive environment for the implementation of some specified purposes prescribed by RBI. It includes the Upgraded Full Fledged Money Changer and another new inclusion like Department Of Post and various types of NBFCs who are operated in open markets. As per RBI the detailed of dealers classified under this category are considered as per region basis. At present, there are 11 region in India which under this category.

3. Authorized Dealers Category -III (ADs –II)

The third category of authorized dealer operates with the purpose to boost the international trade by proving them adequate availability foreign currency for promotion of international trade as per the norms lay down in section 10 of the FEMA Act 1999. It includes the major player of financial institutions like IFCI, SIDBI EXIM Bank and various Factor Agencies.

4. Full-Fledged money Change (FFMCs)

It is the new aspect of regulation of Indian Foreign Exchange markets. It may be any financial entity other than Commercial Banks who qualified the norms and criteria laid down by RBI. FFMCs are authorized to purchase foreign exchange from resident and non-resident visiting India and to sell Foreign Exchange for certain approved purposes. The main objective of the enactment of FFMCs is to provide easy access to foreign exchange transaction to common masses.

11.9 MONEY CHANGERS

A money changer is an individual who exchanges the coins or currency of a country for that of another. This transaction is considered the origin of modern banking in Europe. The introduction of paper money in the mid-seventeenth century along with the advancement of modern banking and floating exchange quotes in the twentieth century enabled a currency market to emerge. This presented a means for banks and other specialized financial institutions like bureau de change and foreign exchange brokers to easily exchange one country's money for another. The twentieth century also witnessed the development of devices capable of changing money. A coin changer or coin dispenser is a machine that can change or dispenses coins. It often takes numerous forms like the portable coin dispenser a fixed coin dispenser and the change maker Whenever outsiders particularly traveling merchants traveled to cities for business deals, it became essential to exchange foreign coins to locally accepted coins at local money changers. Money changers evaluates a foreign coin considering its form, wear and tear, and credibility after which he accepts it as deposit, keeping its worth in local currency. The merchant can later withdraw the money in

local currency to carry out business transactions or sometimes make it deposited & the money changer function as a clearing facility As the volume and operations of money changers expanded, they started to offer a lending facility by including a 'lending fee' to the currency exchange rates.
In essence, money changers are authorized by the RBI to deal in foreign currencies and coins. Restricted money changers can only purchase while others can do both purchases and sales in foreign currencies and coins. Some hotels, firms and establishments etc., have been given licenses by the RBI to act as money changers.

11.10 SUMMARY

The need for exchange control does not requirs any emphasis, especially for a developing country like India. Even advanced countries like Britain and France have been forced to resort to exchange control to protect their economy. The preamble to the Foreign Exchange Regulation Act, 1947 (hereinafter referred to as "the Act") states that it is expedient in the economic and financial interests of India to provide for the regulation of certain payments, dealings in foreign exchange and securities and the import and export of currency and bullion. Foreign exchange is largely earned by a country by means of exports of commodities and services from that country. Imports of goods and services by that country are to be paid for in foreign exchange (and not in the national currency of the importing country) except to the extent they are financed by credits. which in any event have to be repaid. Therefore. it is very much important for a country to conserve foreign exchange and ensure that all that hard-earned foreign exchange comes into its control and is wisely utilised in the best interests of the country. Exchange control in India is exercised through the Foreign Exchange Regulation Act, 1947 which came into force on 25th March 1947. The Act empowers the Reserve Bank and the Central government to secure that foreign exchange earned by exports or otherwise is properly accounted for and realised. It is important to note that the regulaions under the Act are based on residence of the parties rather than on nationality.

11.11 GLOSSARY

Exchange controls: Exchange controls are government-imposed limitations on the purchase and/or sale of currencies.
Foreign Exchange: Foreign Exchange (forex or FX) is the trading of one currency for another. For example, one can swap the U.S. dollar for the euro. Foreign exchange transactions can take place on the foreign exchange market, also known as the forex market.
Authorised Dealers: These are the institutions that have the license from the RBI to sell and buy foreign currencies.

Money Changer: A money changer is a person or organization whose business is the exchange of coins or currency of one country for that of another.

11.12 SELF-ASSESSMENT QUESTIONS

1. What do you understand by exchange controls?

2. What are the categories of authorized dealers in India?

3. Describe the role of RBI as an exchange control authority.

11.13 SUGGESTED READINGS

1. 1. Levi, M. D. (2005). International finance. Psychology Press.
2. Levi, M. D. (2009). International finance 5th edition. Routledge.
3. Antonio, J., Jan, O., & Stephany, K. (2007). International finance and development. Zed Books.
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Unit - III | **Lesson No. 12**
C.No. M.COM-FC 412 | **SEM : Fourth**

STRUCTURE

12.1 INTRODUCTION

Adequate and smooth financing is a pre condition for any economic activity to occur in a successful manner. Foreign trade is not an exception to this fact. There is always a need to supply required funds for financing different types of activities which take place in import or export of merchandise from one nation to the others. India has been facing the problem of adverse BOP since the independence and remained under pressure for correcting it by export promotion and import reductions. However import of some crucial items like petroleum products, chemicals etc. was also important for developmental activities. In India, some decades back, the exchange rate was controlled by RBI for conversion of

Indian currency into foreign exchange. By virtue of this control all the foreign exchange earned was to be sold to authorized dealer and if we want to purchase foreign exchange we have to seek permission of central bank. The main purpose behind this was to utilize the foreign exchange earned by the residents as per the priorities fixed by the government. These controls were necessary at that time as India was underdeveloped country and its exports were limited to agricultural product and raw material and it used to import only consumable goods. But now India is a fast developing country and one of the most preferred countries for investment by foreigners. India could not restrict its foreign trade as It needs togrow further. So government has allowed convertibility of rupee in phased manner on current account transactions.

12.2 OBJECTIVES

After reading this unit, you will be able to understand:

1. Foreign currency accounts
2. Non-resident accounts
3. Export Credit Guarantee Corporation
4. EXIM bank
5. Convertibility of currency

12.3 FOREIGN CURRENCY ACCOUNTS

Foreign Currency Account (FCA) is a transactional account denominated in a currency other than the home currency and can be maintained by a bank in the home country (onshore) or a bank in another country (offshore).

Foreign currency accounts are generally not covered by national deposit insurance schemes. However, such accounts are covered in the United States, within the usual limits, as long the financial institution is insured and the deposits are available for withdrawal inside the U.S.

This article throws light upon the three main types of foreign currency accounts. The types are: 1. Nostro Account 2. Vostro Account 3. Loro Account.

Type 1. Nostro Account:

In Latin, 'Nostro' means "our account with you". Nostro account is the account maintained by an Indian bank with an overseas/foreign bank. For example, PNB may maintain an account with Citibank, New York. The account would be in the host country's currency, i.e., in US dollar. All foreign exchange transactions are routed through Nostro accounts by Indian Bank.

Type 2. Vostro Account:

In Latin, 'Vostro' means "your account with us". A foreign bank, say Citibank, New-York, may open Rupee account with State Bank of India. The account would be maintained in home currency where account is opened, i.e., Indian Rupees.

Type 3. Loro Account:

Loro account' word stands for 'Their account with you', in Latin. Say, State Bank of India is maintaining an account with Citibank, New York. When Syndicate Bank of India likes to refer this account during the course of correspondence with Citibank, it would refer to it as 'Loro Account'.

12.3.1 FOREIGN CURRENCY ACCOUNTS IN INDIA

Foreign currency accounts are an option for Indians who are looking to deposit overseas earnings or those who want to protect themselves against exchange rate fluctuations domestically. A foreign currency account is an account offered in many banks across India. It is unique because rather than holding the balance in rupees, you hold the money in a foreign currency here in India. The foreign currencies available are going to be dependent on the bank that you use to open.

The account can be in the form of a savings account, current account or term deposit. And it can be held by any person who is a resident of India.[1]

Resident foreign currency (domestic) account

A Resident foreign currency domestic account can be opened in the form of a non-interest bearing account. The RBI defines a resident as someone who is living in the country for over 182 days. This can include foreigners who are working or running a business in India. You can use foreign currency from the following situations to open a resident foreign currency (domestic) account:

- Foreign currency you've gotten as payment or service while you were abroad or from a non-resident who is visiting India
- Foreign currency received as a gift or honorarium you've received from abroad or a visiting non-resident
- Any extra unspent foreign currencies you've gotten while traveling abroad
- Gifts from a relative
- Earnings through the export of goods/services
- Foreign currency you've received from life insurance claims, maturity or surrendered value.

12.4 NON-RESIDENT ACCOUNTS

A non-resident who is an OCI or NRI can open a foreign currency non-resident account in India. The Foreign Currency Non-Resident account is only allowed to be a term deposit, versus a savings or current account for residents. The term deposit is required to be a minimum of 1 year and have a maximum time of 5 years.

You can credit the account through inward remittance from abroad into the currency of your choice in the foreign currency non-resident account. This can be from the income you've earned outside the country, including rent or pension income.[3]

A foreign currency non-resident account tends to have a few more options in terms of currencies to hold the funds in. Check with your preferred bank to find the one that fits best for you.

Non-Resident bank accounts are those, which are maintained by Indian nationals and Persons of Indian origin resident abroad, foreign nationals and foreign companies in India. Bank branches can open ordinary non-resident accounts in the names of private individuals provided initial deposits for opening the accounts are received from abroad in an approved manner or the initial amount is tendered in foreign currency while on a visit to India or transfer of funds from the existing non-resident account of the same person.

NRIs can open and operate the following five types of Bank accounts.

1). Ordinary Non-Resident Rupee Accounts (NRO Accounts)

These are Rupee denominated non-repatriable accounts and can be in the form of savings, current recurring or fixed deposits. These accounts can be opened jointly with residents in India. When an Indian National / PIO resident in India leaves for taking up employment, etc. outside the country, his bank account in India gets designated as NRO account.

The deposits can be used to make all legitimate payments in rupees. Interest income, from NRO accounts is taxable. Interest income, net of taxes is reportable. NRO account can be funded through any of the following sources:

- By proceeds of foreign exchange remittance from abroad through banking channels in an approved manner
- By proceeds of foreign currency notes and traveler cheques brought into India by the non-resident while on a temporary visit to India
- By transfer from an existing non-resident account in the name of the same person
- By funds from a local source representing bonafide transactions in rupees

Conditions regarding repatriation of balances in NRO accounts:

- Repatriation is allowed up to US dollars 1 million per calendar year for any purpose from the balances in NRO accounts subject to payment of applicable taxes

- Limit of US dollars 1 million includes sale proceeds of immovable properties held by NRIs / PIOs for a period of 10 years

- In case a property is sold after being held for less than 10 years, remittance can be made if the sale proceeds have been held by the NRI/PIO for the balance period

2). Non-Resident (External) Rupee Accounts (NRE Accounts)

NRIs, PIOs, OCBs are eligible to open NRE Accounts. These are rupee denominated accounts and can be in the form of savings, current, recurring or fixed deposit accounts. Accounts can be opened by remittance of funds in free foreign exchange. Foreign exchange brought in legally, repatriable incomes of the account holder, etc. can be credited to the account. Joint operation with other NRIs/PIOs is permitted. Power of attorney can be granted to residents for operation of accounts.

The deposits can be used for all legitimate purposes. The balance in the account is freely repatriable. Interest lying to the credit of NRE accounts is exempt from tax in the hands of the NRI. Funds held in NRE accounts may be freely transferred to FCNR accounts of the same account holder. Likewise, funds held in FCNR accounts may be transferred to NRE accounts of the same account holders.

Immediately upon return of the account holder to India and on his becoming a resident in India, NRE Account will be re-designated as Resident Rupee Account or converted to RFC account as per the option of the account holder. However, if the account holder is only on a short visit to India, the account will continue to be treated as NRE account.

The initial deposit in NRE account can be made in any of the following manners:

- By proceeds of foreign exchange remittances from abroad through banking channels in an approved manner

- By proceeds of foreign currency notes and traveler cheques brought into India by the non-resident while on a temporary visit to India

- By transfer from an existing NRE Account of the same person

3). Foreign Currency (Non –Resident) Accounts (Banks) (FCNR (B) Accounts)

NRIs / PIOs / OCBs are permitted to open such accounts in US Dollars, Sterling Pounds, Australian Dollars, Canadian Dollars, Japanese Yen and Euro. The account may be opened only in the form of term deposit for any of the following maturity periods; (a) one year and above but less than two years, (ii) two years and above but less than three years, (iii) three years and above but less than four years, (iv) four years and above but less than five years, and (v) five years.

Interest income is tax free in the hands of NRI until he maintains a non-resident status or a resident but not ordinarily resident status under the Indian tax laws. Money lying in FCNR (B) accounts can also be utilised for local disbursements including payment for exports from India, repatriation of funds abroad and for making investments in India, as per foreign investment guidelines.

4). Non-Resident (Non-Repatriable) Rupee Deposit Accounts (NRNR Accounts)

NRIs / PIOs / OCBs, other non-resident Individuals/entities are permitted to open these accounts by transfer of freely convertible foreign currency funds from abroad, or from NRE / FCNR accounts. Non-residents can open joint accounts with other Non-Residents (except Pakistan and Bangladeshi nationals) or resident close relatives in India. Deposits can be held jointly with a resident. Deposits can be for a period from 6 months to 3 years, and can be renewed further. Accounts may also be opened by transfer of funds from the existing NRE/FCNR accounts of the non-resident accounts holders.

The principal is non-repatriable; interest can be repatriated. There is no income tax on the interest. Accounts under the Non-Resident (Non-Repatriable) Rupee Deposit Scheme may be opened in Indian rupees out of the funds in freely convertible foreign exchange transferred for the purpose to India in an approved manner from the country of residence of the prospective non-resident account holder or from any other country. Transfer of funds from the existing NRE / FCNR Accounts of the non-resident account holder may also open accounts.

5). Non-Resident (Special) Rupee Accounts with banks in India

NRIs/PIOs presently have the facility of maintaining bank accounts and undertaking financial transactions in India subject to certain exchange control regulations.

In order to simplify the procedures and to provide greater freedom to NRIs/PIOs for putting through financial transactions in India, NRIs and PIOs are now permitted to open bank accounts in India, which will be at par with rupee accounts, maintained by residents. They can now open Non-Resident (Special) Rupee Accounts with banks in India which will have the same facilities and restrictions as are applicable to rupee accounts maintained in India by residents relating to repatriation of funds held in these accounts and/or income/ interest earned on them. The procedure for opening such accounts is the same as that of domestic accounts of resident individuals. The existing facilities for NRIs / PIOs to maintain and operate NRO, NRE and FCNR accounts also continues. The repatriation facilities available under these accounts will continue as before.

12.5 EXPORT CREDIT GUARANTEE CORPORATION

Background of ECGC

• Board headed by Chairman and Managing director with 13 Directors

• Head Office at Mumbai

• Regional Offices at Mumbai, New Delhi, Kolkatta, Chennai and Bangalore

• Authorised capital Rs.1000 crs

• Branch Offices at 50 export centers in India

• Registered with IRDA

Role of ECGC as an Export Credit Insurer Providing credit insurance covers to exporters against loss in export of goods & services Providing export credit guarantees to banks & FI's to enable exporters obtain better facilities from them Providing Overseas Investment Insurance to Exporters - Indian Entrepreneurs in Overseas Ventures (Equity/ Loans) DCI to Banks & Exporters

Types of Export Credit Risks

Fig. 12.1 Types of Export credit risks

Risks Covered by ECGC

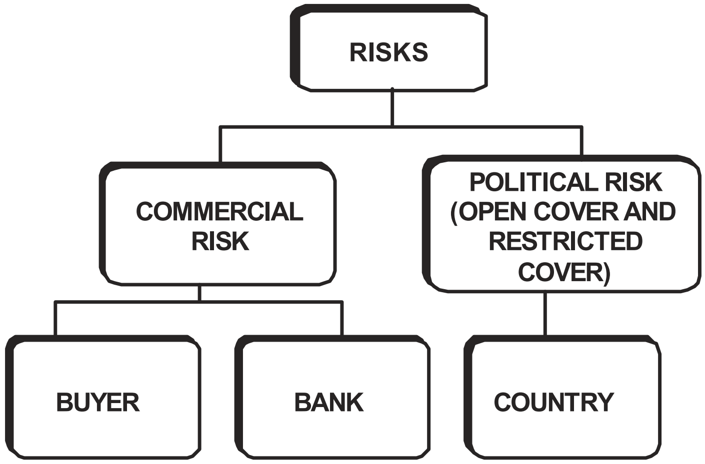

Fig. 12.2 Risks covered by ECGC

Risks Not Covered

×Risks of loss due to commercial or quality disputes

×Insolvency or default of any agent of the exporter or of the collecting bank

×Loss or damage to the goods which can be covered by general insurers

×Exchange Rate Fluctuation ×Failure of the exporter to fulfil the terms of the contract or negligence on his part

Seven Fold Country Classification

Risk Category	ECGC Classification
Insignificant	A1 (1/7)
Low	A2 (2/7)
Moderately Low	B1 (3/7)
Moderate	B2 (4/7)
Moderately High	C1 (5/7)
High	C2 (6/7)
Very High	D (7/7)

Types of Cover

While underwriting the country risk, ECGC places the country either in Open Cover or Restricted Cover.

The basis for deciding on the type of cover and terms of cover is a host of economic and political factors

1). Open cover countries

- Cover with No Restrictions
- Cover is offered usually on normal terms and conditions i.e. 90% cover, 4 months waiting period for ascertainment of loss and settlement of claims, etc.
- Currently ECGC places 195 countries under Open Cover

2). Restricted cover countries

- Usually those countries where the political and/or economic conditions are relatively deteriorating or have deteriorated and likelihood of payment delays or non-payment are imminent or have occurred
- Permits selection of risks ECGC wishes to underwrite.

Category 2: Countries where Specific Approval will be given on case to case basis on merits – Valid for six months – Normal waiting Period of 4 months – Only 8 countries under this category: Afghanistan, Palestine, Cuba, East Timor, Iraq, North Korea, Somalia, Lebanon.

Policy basics

- Ascertain risks covered and risks not covered
- Take the policy required for the purpose
- Ensure limit on the buyer to cover
- Remit premium in time
- Monitor payments and Report overdue in time
- Initiate timely recovery action
- File claim early

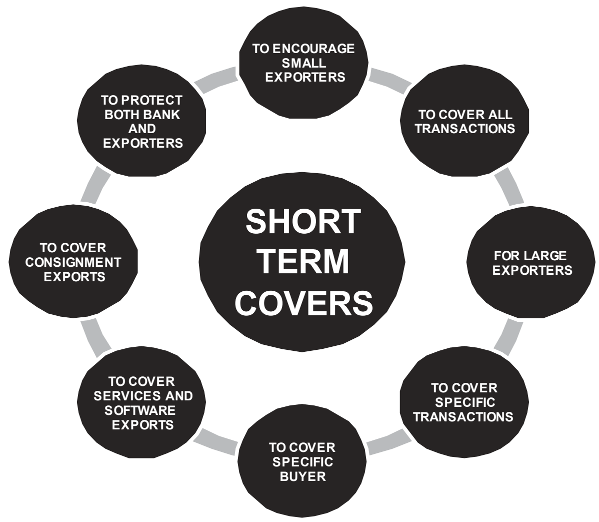

Fig. 12.3 Short term covers of ECGC

12.6 EXIM BANK

Enhancing the trading activities across the globe also needs funds which was a great obstacle for Indian importers and exporters. Looking at the requirement of a sound financial institution for financing trading abroad, Government of India established Export–Import Bank in 1982 under Export-Import Bank of India Act 1981. It was mainly set up for promoting global trade and investment at a larger extent. The main function of this non banking financial institution is to provide financial and other assistance to importers and exporters of the country. It also looks after and facilitates the working of other institutions involved in this sector.

Organization Set up: The organisation structure of this bank is of diversified nature. It is managed by an apex level body called Board of Directors which is headed by Managing Director. There are 17 other Directors on the board who includes representatives from the Government, Reserve Bank of India, Export Credit Guarantee Corporation of India, public sector banks, and the business community. The organizational structure can also be presented on the basis of several operating groups which are performing distinguished functions as under:

• **Small and Medium Enterprises:** The group handles credit proposal from SMEs under various lending programmes of the Bank.

• **Corporate Banking Group,** which handles a variety of financing programs for Export Oriented Units (EOUs), Importers, and overseas investment by Indian companies.

• **Export Services Group** offers variety of advisory and value-added information services aimed at investment promotion.

• **Export Marketing Services Bank** offers assistance to Indian companies, to enable them in establishing their products in overseas markets. The idea behind this service is to promote Indian export. Export Marketing Services covers wide range of export oriented companies and organizations.

• **Project Finance/Trade Finance Group** handles the entire range of export credit services such as supplier's credit, Preshipment Agri Business Group, to spearhead the initiative to promote and support Agri-exports. The Group handles projects and export transactions in the agricultural sector for financing.

• **Besides these, the support services groups,** which include: Research and Planning, Treasury and Accounts, Loan Administration, Internal audit, Management Information Services, Information Technology, Legal, Human Resources Management and Corporate Communications.

Key Points about EXIM Bank

1. EXIM Bank is a public sector financial institution, established by an Act of Parliament for the purpose of financing, facilitating, and promoting foreign trade of India.

2. The EXIM Bank Act empowers the Bank to finance export of consultancy and related services, assist Indian joint ventures in third countries, conduct export market studies, finance export oriented industries and provide international merchant banking services.

3. The Bank's authorised capital is 200 crores which can be increased to 500 crores. The Bank can also raise loan resources from: (i) the Government of India (ii), the Reserve Bank of India, (iii) the Indian capital market, and (iv) the International markets.

4. The paid up capital as on March 31, 2015, stood at Rs. 5,059 crore and the Net Worth stood at Rs. 9,902 crore. Profit after tax of the Bank for the year 2014-15 amounted to Rs. 726 crore.

5. The Bank facilitates two-way technology transfer by financing import of technology into India, and investment abroad by Indian companies for setting up joint ventures, subsidiaries or undertaking overseas acquisitions.

6. During the year ended 31st March, 2015, EXIM Bank sanctioned loans of Rs. 57,684 crore, while disbursements amounted to Rs. 38,508 crore. Loan Assets stood at Rs. 86,953 crore as on March 31, 2015.

7. Other than providing financial assistance, the Export and Import Bank of India bank is always looking for ways to promote the foreign trade sector in India. In the early 1990s, EXIM introduced a program in India known as the Clusters of Excellence.

Functions of the EXIM Bank

EXIM Bank performs the following functions:

a. EXIM Bank provides Finances for the purpose of import and export of goods and services from India.

b. It also facilitates the funding of import and export from countries other than India.

c. It finances the import or export of machines and machinery on lease or hires purchase basis as well.

d. The bank provides refinancing services to banks and other financial institutes for their financing of foreign trade

e. It also undertakes the responsibility of underwrite shares/debentures/stocks/bonds of companies engaged in foreign trade.

f. Apart from financial support, the bank also provides technical and other assistance to traders. This institution provides guidance and assistance in technical as well as administrative matters as there are multiplicity of documentation and foreign trade procedure which becomes sometimes cumbersome for a person.

g. Undertakes functions of a merchant bank for the importer or exporter in transactions of foreign trade.

h. Indian businessmen wishing to collaborate with foreign players in other countries can also avail financial assistance.

i. In order to promote exports EXIM bank also has schemes such as production equipment finance program, export marketing finance, vendor development finance, etc.

j. Short-term loans or lines of credit are also provided to foreign banks and governments.

k. EXIM bank can also provide business advisory services and expert knowledge to Indian exporters in respect of multi-funded projects in foreign countries.

Policies and Program initiated by EXIM Bank

• The EXIM Bank provides Indian project exporters with a comprehensive range of services to enhance the prospect of their securing export contracts, particularly those funded by Multilateral Funding Agencies like the World Development Bank, Asian Development Bank and European Bank for Reconstruction and Development.

• The Bank extends lines of credit to overseas financial institutions, foreign governments and their agencies, enabling them to finance imports of goods and from India on deferred credit terms.

• EXIM Bank's lines of Credit preclude credit risks for Indian exporters and are of particular relevance to SME export.

• The Bank's Overseas Investment Finance programme offers a variety of facilities for Indian investments acquisitions overseas. The facilities include loan to Indian companies for equity participation in overseas ventures, direct equity participation by EXIM Bank in the overseas venture and non-funded facilities such as letters of credit and guarantees to facilitate local borrowings by the overseas venture.

• The Bank provides financial assistance by way of term loans in Indian rupees/foreign currencies for setting up new production facility, expansion/modernization/ upgradation of existing facilities and for acquisition of production equipment/technology. Such facilities particularly help export oriented Small and Medium Enterprises for creation of export capabilities and enhancement of international competitiveness.

• The Bank has launched the Rural Initiatives Programme with the objective of linking Indian rural industry to the global market. The programme is intended to benefit rural mor through creation of export capability in rural enterprises.

• In order to assist the Small and Medium Enterprises, the Bank has put in place the Export Marketing Services (EMS) Programme. Through EMS, the Bank seeks to establish, on best efforts basis, SME sector products in overseas markets, starting from identification prospective business partners to facilitating placement of final orders. The service is provided on success fee basis.

• Under its Export Marketing Finance programme, EXIM Bank supports Small and Medium Enterprises in export marketing efforts including financing the expenditure relating to implementation of strategic and systematic export market development plans

• EXIM Bank supplements its financing programmes with a wide range of value-added information, advisory and support services, which enable exporters to evaluate international risks, exploit export opportunities and improve competitiveness.

Export Financing Programmes Operated by EXIM Bank

(i) Bulk import finance

(ii) Small scale industry Enables Banks to Rediscount

(iii) Pro-shipment credit (period exceeding six months)

(iv) Export Bills Rediscounting

(v) Export oriented units and units in export processing zones

(vi) Export Marketing Fund

(vii) Consultancy and technology services

(viii) Relending facility to international banks overseas

(ix) Overseas Buyer's credit

(x) Export product development

(xi) Overseas Investment Finance

(xii) Computer Software exports

(xiii) Refinance of export credit

12.7 CONVERTIBILITY

India is a fast developing country and one of the most preferred countries for investment by foreigners. India could not restrict its foreign trade as It needs togrow further. So government has allowed convertibility of rupee in phased manner on current account transactions. But full convertibility of currency for capital account transactions is still a distant dream. Meaning Convertibility of currency means when currency of a country can be freely converted into foreign exchange at market determined rate of exchange that is, exchange rate as determined by demand for and supply of a currency. For example, convertibility of rupee means that those who have foreign exchange (e.g. US dollars, Pound Sterlings etc.) can get them converted into rupees and vice-versa at the market determined rate of exchange. Rupee is both convertible on capital account and current account.

By capital account convertibility we mean that in respect of capital flows (that is, flows of portfolio capital, direct investment flows, flows of borrowed funds and dividends and interest payable on them) a currency is freely convertible into foreign exchange and vice-versa at market determined exchange rate. Current Account Convertibility of rupee Current account convertibility means when foreign exchange (e.g. Pound Sterling, U.S.Dollar etc) received for export of merchandise and services can be freely converted into Indian rupees and vice-versa in case of imports. In the seventies and eighties, many countries switched over to the free convertibility of their currencies into foreign exchange. By 1990, 70 countries of the world had introduced currency convertibility on current account and another 10 countries joined them in 1991. As a part of new economic reforms initiated in 1991, India also joined the regime and made rupee partly convertible from March 1992 under the "Liberalized Exchange Rate Management scheme". In this scheme, 60 per cent of all receipts on current account (i.e., merchandise exports and invisible receipts) could be converted freely into rupees at market determined exchange rate quoted by authorised dealers while 40 per cent of them were to be surrendered to Reserve Bank of India at the officially fixed exchange rate. These 40 per cent exchange receipts on current account was meant for meeting Government needs for foreign exchange and for financing imports of essential commodities. Thus, partial convertibility of rupee on current account meant a dual exchange rate system. Further, full convertibility of rupees at that stage was considered to be risky in view of large deficit in balance of payments on current account. As even after partial convertibility of rupee foreign exchange value of rupee remained stable, this laid down a base for the full convertibility on current account.

Hence, from March 1993, rupee was made convertible for all trade in merchandise. In March' 1994, even indivisibles and remittances from abroad were allowed to be freely convertible into rupees at market determined exchange rate. But this does not mean that one can get any amount of foreign exchange for meeting one's needs e.g. one cannot convert his savings in the country for investment in foreign exchange as could be done by citizens of developed countries like U.K. and USA. However, on capital account rupee remained non-convertible.

Advantages of Currency Convertibility:

1. Encouragement to exports: Market rate remains generally higher than the officially determined exchange rate. This implies that from given exports, exporter can get more rupee against foreign exchange. This will help to increase exports.

2. Encourages import substitution: Imports become expensive due to convertibility of rupee. So it discourages imports and boosts import substitution.

3. Incentive to remittances from abroad: Earlier, NRIs used to send money illegally to India such as Hawala money and gold etc. But due to removal of restrictions, NRIs can easily remit money to India. It will help to improve Balance of payment.

4. Reduction in Malpractices: The malpractices like under-invoicing of exports may not arise as rupee is fully convertible and they will get full value for their exports

5. A self – balancing mechanism: Another important merit of currency convertibility lies in its self-balancing mechanism. When balance of payments is in deficit due to over-valued exchange rate, under currency convertibility, the currency of the country depreciates which gives boost to exports by lowering their prices on the one hand and discourages imports by raising their prices on the other.

In this way, deficit in balance of payments get automatically corrected without intervention by the Government or its Central bank. The opposite happens when balance of payments is in surplus due to the under-valued exchange rate.

Capital Account Convertibility of Rupee: Capital Account Convertibility (CAC) is the freedom to convert local financial assets into foreign financial assets at market determined exchange rates. Referred to as 'Capital Asset Liberation' in foreign countries, it implies free exchangeability of currency at lower rates and an unrestricted mobility of capital. India, at present has partial capital account convertibility.

In India there are conflicting views regarding whether to move towards full convertibility of capital account or not. At present, there are limits on investment by foreign financial investors and also caps on FDI ceiling in most sectors, for example, 74% in banking and communication, 49% in insurance, 0% in retail, etc.

Advantages of capital account convertibility:

(1) Unrestricted mobility of Capital: Capital account convertibility allows free mobility of Capital into a country from the foreign investors. It allows converting the foreign exchange brought into as Capital to convert into rupees at market determined rates, which makes the investors encouraging. It allows the foreign investors to easily move in and move out from an economy. This enables the domestic companies to raise funds from abroad.

(2) Ability to invest in abroad easily: Capital account convertibility allows the individuals of a nation to invest in abroad by easily converting their rupees into foreign exchange at the rates determined by the Market. This enables those potential domestic investors to acquire & own the assets in abroad.

(3) Improved access to global financial markets: One can easily invest in the equity and debt markets of another economies alongside a reduction in the cost of capital

Disadvantages:

(1) Easier access to Hawala money: As it allows converting any foreign receipt into Indian rupees at market determined rates there may be chance that domestic economy will be flooded with foreign exchange which in long run may damage the financial health of an economy.

(2) High volatility of markets: During the times when the financial markets of an economy are doing good, a country may receive huge foreign investment. But during the adverse times the reverse scenario may happen. For example when the federal reserve Bank of America gave a sign that they are going increase the interest rates the foreign Institutional investors who invested their dollars in Indian stock market had withdrawn their investment from India which adversely impacted the rupee value.

12.8 SUMMARY

ISo in India, there is free regime for current account transactions but still partial convertibility for capital account transactions. Many economics experts are of view that we need full capital account convertibility of currency. Recently RBIs governor Raguram Rajan, in an interview has suggested moving towards full capital account convertibility in short numbers of years. Mr. G Padmanabhan, Executive Director of the Reserve Bank of India (RBI), has suggested that India should move towards making the rupee more convertible for capital transactions by foreign investors. According to him keeping any restriction for too long could prove self defying. But he also said that How fast that movement should be would, however, depend on how fast the country could meet the pre-conditions such as fiscal consolidation, inflation control, low level of NPAs (non-performing assets), low and sustainable current account deficit, strengthening of financial markets, prudential supervision of financial institutions etc. otherwise, it may prove very risky.

12.9 GLOSSARY

Foreign Currency Account: Foreign Currency Account (FCA) is a transactional account denominated in a currency other than the home currency and can be maintained by a bank in the home country (onshore) or a bank in another country (offshore).

Ordinary Non-Resident Rupee Accounts (NRO Accounts): These are Rupee denominated non-repatriable accounts and can be in the form of savings, current recurring or fixed deposits. These accounts can be opened jointly with residents in India.

Resident Account: A Resident foreign currency domestic account can be opened in the form of a non-interest bearing account.

Nostro Account: In Latin, 'Nostro' means "our account with you". Nostro account is the account maintained by an Indian bank with an overseas/foreign bank. For example, PNB may maintain an account with Citibank, New York. The account would be in the host country's currency, i.e., in US dollar. All foreign exchange transactions are routed through Nostro accounts by Indian Bank.

12.10 SELF-ASSESSMENT QUESTIONS

1. Write a descriptive note on Export Credit Guarantee Corporation.

2. What do you mean by Exim Bank?

3. Illuminate the concept of Convertibility.

12.11 SUGGESTED READINGS

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Unit - III **Lesson No. 13**
C.No. M.COM-FC 412 **SEM : Fourth**

STRUCTURE

13.1 INTRODUCTION

Merchandise trade, i.e., exports and imports of goods is the oldest and least risky form of international business. Of concern to the exporter is the risk of non-payment by the importer of goods. Of concern to the importer is the risk that the exporter may not ship the products that have been paid for. In trade finance banks act as intermediaries to ensure that the exporter gets paid while the importer receives the merchandise.

13.2 OBJECTIVES

After reading this unit, you will be able to understand

1. Export and Import financing mechanism
2. Buyer's credit
3. Supplier's credit
4. Difference between buyer and supplier credit

13.3 EXPORT AND IMPORT FINANCING MECHANISM

13.3.1 EXPORT FINANCE

Export financing is another important area of export business. Export finance refers to the credit facllitles extended to the exporters at pre-shipment and post-shipment stages. It includes any loan to an exporter for financing the purchase, processing, manufacturing or packing of goods meant for overseas markets. Credit is also extended after the shipment of goods to the date of realization of export proceeds.

13.3.1.1 INSTITUTIONAL FRAMEWORK

The institutional framework for providing finance comprises Reserve Bank of India, Commercial Banks, Export Import Bank of India and Export Credit and Guarantee Corporation. Reserve bank of India, being the central bank of the country, lays down the policy framework and Terms of Payment provides guidelines for implementation. Export finance short or medium term, is provided and Export Finance exclusively by the Indian and foreign commercial banks, which are members of the Foreign Exchange Dealer's Association. The Reserve Bank of India function as refinancing institutions for short and medium term loans respectively, provided by commercial banks. Export Import Bank of India, in certain cases, participates with a commercial bank in extending medium term loans to exporters. Commercial banks provide finance at a concessional rate of interest and, in turn, are refinanced by the Reserve Bank/Export Import Bank of India at concessional rate. In case they do not wish to avail refinance, they are entitled for an interest rate subsidy. Export Credit & Guarantee Corporation (ECGC) also play an important role through its various policies and guarantees providing cover for commercial and political risks involved in export trade.

13.3.1.2 PRE-SHIPMENT FINANCE

Pre-shipment finance is provided to the exporters for the purchase of raw materials, processing them and converting them into finished goods for the purpose of export. Let us discuss various prc-shipment advances available to the exporters.

1. Packing Credit

The basic purpose of packing credit is to enable the eligible exporters to procure, process, manufacture or store the goods meant for export. Packing credit refers to any loan to an exporter for financing the purchase, processing, manufacturing or packing of goods as defined by the Reserve Bank of India. It is a short term credit against exportable goods. Packing credit is normally granted on secured basis. Sometimes clear advance may also be granted. Many advances are clean at their initial stage when goods have not yet been acquired. Once the goods are acquired and are in the custody of the exporter banks usually convert the clean advance into hypothecation/pledge.

2. Advance Against Incentives

When the value of the materials to be procured for export is more than FOB value of the contract, the exporters may get packing credit advdnce more than the FOB value of the goods. The excess of cost of production over the FOB value of the contract represents incentives receivables. For example, when the domestic price of goods exceeds the value of export orders, the difference represents Duty drawback entitlement. Banks can grant advances against duty drawback at pre-shipment stage subject to the condition that the loan is covered by Export Production Finance Guarantee of Export Credit Guarantee Corporation (ECGC). This guarantee enables banks to sanction advances at the pre-shipment stage to the full extent of cost of production. The extent of cover and the premium are the same as for packing crddit guarantee.

3. Pre-Shipment Credit In Foreign Currency

This is an additional window to rupee packing credit scheme. This credit is available to cover both the domestic and imported inputs of the goods exported from India. The facility is available in any of the convertible currencies. The credit will be self liquidating in nature and accordingly after the shipment of goods the bills will be eligible for discounting/ rediscounting or for post-shipment credit in foreign currency. me exporters can avail this finance under the following two options.

i) the exporters may avail pre-shipment credit in rupees and, then, the post-shipment credit either in rupees or in foreign currency denominated credit or discounting/rediscounting of rediscounting of export bills.

ii) Exporters may avail pre-shipment credit in foreign currency and discounting or rediscounting of the export bills in foreign currency.

13.3.1.3 POST SHIPMENT FINANCE

It may be defined as "any loan or advance granted or any other credit provided by a bank to an exporter of goods from India from the date of extending the credit after shipment of goods to the date of realisation of export proceeds. It includes any loan or advance granted to an exporter on consideration of or on the security of, any Duty Drawback or any cash receivables by way of incentive from the Marketing Development Fund or any other relevant While granting post-shipment finance, banks are governed by the guidelines issued by the RBI, the rules of the Foreign Exchange Dealers Association of India (FEDAI). the Trade I 'erms of payment Control and Exchange Control Regulations and the International Conventions and Codes of nd Export Finance the International chambers'of Commerce. The exporters are required to obtain credit limits suitable to their needs. The quantum of credit depends on export sales and receivables. Post-shipment finance is granted under various methods. The exporter may choose the type of facility as per his requirement. The Banks scrutinise the documents submitted for compliance of exchange control provisions like:

i) the documents are drawn in permitted currencies and payment receivable as permitted method of payment;

ii) the relevant GRPP form duly certified by the customs is submitted and particulars as stated in the GWPP form are consistent with the documents tendered as well as the sale contractJfirm order etc./letter of credit;

iii) the documents are submitted within the time limit stipulated and in case of delay suitable explanation is made;

iv) the period of usance is in consonance with the time limit prescribed for realisation of export proceeds. Let us now discuss various types of post-shipment finance.

1. Negotiation Of Export Documents Under Letters Of Credit

Where the exports are under letter of credit arrangements, the banks will negotiate the export bills provided it is drawn in conformity with the letter of credit. When documents are presented to the bank for negotiation under L/C, they should be scrutinized carefully taking into account all the terms and conditions of the credit. All the documents tendered should be strictly in accordance with the L/C terms. It is to be noted that the L/C issuing bank undertakes to honour its commitment only if the beneficiary submits the stipulated documents. Even the slightest deviation from those specified in the L/C can give an excuse to the issuing bank of refusing the reimbursement of the payment that might have been already made by the negotiating bank.

2. Purchase/Discount Of Foreign Bills

Purchase or discount facilities in respect of export bills drawn under confirmed export contracts are generally granted to exporters who enjoy Bill Purchase/Discounting limits sanctioned by the bank. As the security offered by the issuing bank under letter of credit arrangement is not avai!able, the financing bank is totally dependent upon the credit worthiness of the foreign buyer. The documents, under the Documents against Payment (DP) arrangements, are released through foreign correspondent only when payment is received. Whereas in the case of Documents against Acceptance (DIA) bills, documents are delivered to the overseas importers against acceptance of the draft to make payment on maturity. Since the financing banks are open to the risk of non-payment, ECGC policies issued in favour of exporters and assigned to banks are insisted upon.

3. Advance Against Bills Sent On Collection

Post-shipment finance is granted against bills sent on collection basis in the following situations: i) when the accommodation available under the foreign bills purchase limit is exhausted ii) when some export bills drawn under L/C have discrepancies iii) where it is customary.practice in the particular line of ?rade and in the case of exports to countries where there are problems of externalization.

4. Advance Against Export Incentives

Advances against the export Incentives are given at the pre~shipment stage as well as the postshipment stage. However, the major part of the advance is given at the post-shipment stage. The advance is granted to an exporter in consideration of or on the security of any duty drawback incentives receivable from the Government. The banks follow their own procedure in granting the advance. The most common practice is to obtain a power of attorney from the exporter executed in their favour by the banks. It is sent to the concerned government department like the Director General of Foreign Trade, Commissioner of Customs, etc. These advances are not granted In isolation, It is granted only if all other types of export finance are extended to the exporter by the same bank.

5. Advance Against Undrawn Balances

In some of the export business, it is the trade practice that the bills are not drawn for the full invoice value of the goods. A small part of the bills is left undrawn for payment after adjustments due to difference in weight quality, etc. Advances are granted against such undrawn balances. In this case the export proceeds must be realised within 90 days.

6. Advance Against Retention Money

Banks grant advances against retention money, which is payable within one year from the date of shipment. The advancesare granted upto 90 days. If such advances extend beyond one year, they are treated as deferred payment advance which are also eligible for concessional rate of interest.

7. Post-Shipment Export Credit Guarantee And Export Finance Guarantee

Past-shipment finance given to exporters by banks through purchase, negotiation or discount of export bills or advances against such bills qualifies for this guarantee. Exporters are expected to hold appropriate shipments or contracts policy of ECGC to cover the overseas credit risks.

8. Post-Shipment Credit In Foreign Currency

The exporters have the option of availing of export credit at the post-shipment stage either in rupee or in foreign currency. The credit is granted under the Rediscounting of Export Bills Abroad Scheme (EBR) at LIBOR linked interest rates. The scheme covers export bills with usance period upto 180 days from the date of shipment, Discounting of bills beyond 180 days requires prior approval from RBI. The exporters have the option to avail of pre-shipment credit and post-shipment credit either in rupee or in foreign currency. If pre-shipment credlt has been avai!ed of in foreign currency, the post-shipment credit necessarily to be under the EBR scheme. This is done because the foreign currency pre-shipment credit has to be liquidated in foreign currency.

13.3.2 IMPORT FINANCE

Imports play an important role in the economy of every country, rich and poor alike. Rich countries need to import capital goods, raw materials and technology to ensure an optimum utilisation of their production capacity. They need to import a wide variety of consumer goods to enable their people to enjoy a high standard of living. Poor countries need to import technology and capital equipment and some time strategic raw materials to develop industries for accelerating pace of their development. In India, for example, the pace of industrialization, level of exports and consequently the rate of economic growth is heavily dependent Llpon imports. A low level of imports usually indicates low purchasing power of its people and also emergence of recessionary trends in economy. At a firm's level efficient management of import operations is a critical factor in determining the overall profitability of its imports. Hence, a thorough understanding of import financing techniques and practices is nscessary: for concerned managers. In this unit, you will learn the regulatory framework and related exchange control mechanism of import financing and various methods of import financing,

India followed a restricted import policy till mid eighties. Export Import policies of 1992-97 and 1997- 2002 were the steps in this direction. It is against the background of nature and significance of India's import trade, one has to understand import financing methods and techniques. Import financing involves making payment to foreign entities for the goods purchased from them. From the management decision making viewpoint, it means making decision regarding terms of payment (i.e. choosing one among several alternatives), arranging funds, involving choice of financial institution and the instrument to be used for making payment and involving choice of intermediary, through whom the payment is to be made.

13.3.2.1 THE REGULATORY FRAME WORK The principal objectives of India's Export Import Policy is to accelerate the country's transaction to an internationally oriented economy with a view to derive maximum benefit from the expanding global market, Various policy objectives are achieved basically through three legislations. These are: 1. Foreign Trade (Development & Regulation) Act, 1993 administered by Director General, Foreign Trade (DGFT) replacing the earlier legislation Impel-t & Export, (Control) Act, 1947, administered by the Chief Controller of Imports & Exports (CCIE). 2. Foreign Exchange Management Act, 1999 administered by the Department of Economic Affairs, Ministry of Finance and the Exchange Control Development of the Reserve bank of India. FEMA has been brought is place of Foreign Exchange, Regulation Act. 3, Indian Customs and Excise Act, 1962 administered by Central Board of Exclse and Customs.

13.3.2.2 EXCHANGE CONTROL REGULATIONS CONCERNING IMPORTS

Exchange control regulations refer to rules and regulations framed and administered by the Rcserve bank of India (RBI) under the provisions of Foreign Exchange Management Act, 1999. These regulations aim at pooling resources for national development in the best interest of the country. Under the provisions of the Act, RBI regulates the sale and purchase of foreign currencies, Commercial banks with a license to deal in foreign currencies, called authorised dealers (ADS) buy and sell foreign currencies in accordance with the guidance provided by the RBI. Let us learn various regulations regarding payment of imports. Mode of Payment: Exchange control regulations govern sales of foreign currencies to non - residents against import of goods from any country except - Nepal and Bhutan. It may be pointed OLI~ that residents of these two countries are residents for the purposes of exchange control regulations, hence, ADS cannot sell any foreign exchange for financing imports from these two countries. Under the existing regulations, ADS provide foreign currencies to importers:

i) for remittance to foreign supplies as advance payments.
ii) Paying the foreign supplies in compliance of their undertaking under the letter of credit.
iii) discounting on purchasing except documents.
iv) advances against shipping documents

13.3.2.3 METHODS OF IMPORT FINANCE

The methods of import financing include: financing under L/C, financing against' bills under collection, financing against deferred payment, financing under foreign credit and finance by EXIM Bank of India. Let us discuss them in detail.

1. Financing Import Under Letter Of Credit

Letter of credit can be defined as a commitment of bank to pay the seller of goods or services a certain amount provided he presents stipulated documents evidencing the shipment of or the performance of services within a prescribed period of time. As credit is an instrument and means of making and securing payment, the letter of credit is an essential instrument for conducting world trade today. It fulfills all the requirements provided the regarding its use are stated in clear and unambiguous terms. Import letters of credit financing involves three principal stages:

i) Requesting bank to open a letter of credit
ii) Retiring documents under letter of credit
iii) Import Trust receipt facility.

2. Financing Against Bills Under Collection

In the case of imports not covered by letters of credit, the documents are forwarded by a bank in the supplier's country, known as the collecting bank, for collection of proceeds from the importer and payment to the supplier through the remitting bank. In such cases, the collecting bank would examine the documents and the instructions stated in the covering schedule to ensure that all the stated documents have been received intact and the bill of lading and the bill of exchange are endorsed in its favour or blank endorsed. To enable the bank to handle the documents. The bank than presents the documents to the importer on payment (in case of sight or DIP Bill) or against written acceptance (in case of usance or D/A bill). Where the importer is eligible to receive the documents only on payment, he can avail an import loan or a trust receipt facility, as discussed before. Obligations of various parties involved are provided in Uniform Rules for Collection (URC) Publication NO. 322 issued by International Chamber of Commerce, Paris

3. Financing Imports Against Deferred Payment

Imports under deferred payment implies that the supplier has agreed to supply goods on credit terms extending beyond six months. In such cases, authorised dealer has to refer each deferred payment case to RBI for prior approval of advance payment, bank guarantee and instalments (principal and interest) with documents viz. exchange control copy of import license, if any, contract copy arid statement of desired facilities.

4. Financing Under Foreign Credit

Government of India gets assistance in the form of loans and developments credits from international financial institutions as also foreign governments. These loans are of two types - tied loans and loans in free foreign currencies. Terms and conditions of each loan along with detailed instructions regarding the procedure to be followed for opening letters of credit. submission of documents etc. are set out in public notices issued by DGFT. RBI also issues circulars for each foreign credit giving important instructions relating to such imports.

5. Import Loans By Export-Import Bank Of India

Bank finances imports from third countries required for executing projects overseas for which contracts have been won by Indian exporters. Regarding imports into India, Exim Bank finances such imports which are export-related, i.e. imports by Export Oriehted Units, import of computer systems for development and export of software, import of plant, machinery, technology for upgradation/expansion of production capability for export markets.

13.4 BUYERS' CREDIT

A financial arrangement in which a bank or financial institution, or an export credit agency in the exporting country, extends a loan directly to a foreign buyer or to a bank in the importing country to pay for the purchase of goods and services from the exporting country. Also known as financial credit. This term does not refer to credit extended directly from the buyer to the seller (for example, through advance payment for goods and services). The Practical example is that foreign Bank makes payment to exporter based on either Letter of Undertaking from the Importer bank or based on their risk on Importer. Letter of Undertaking is simply confirmation by a bank here in importer country to pay to exporter bank thus exporter bank risk get reduced. The Letter of undertaking is issued by Importer bank on the basis of risk on Importer. Simply, Importer Bank takes risk on Importer, This bank sends LOU to exporter bank which in turn takes risk on Imprter bank and makes payment. On final day Importer bank recover money from importer and makes payment to exporter bank. This all exercise is done to exploit existance of interest rate arbitrage.

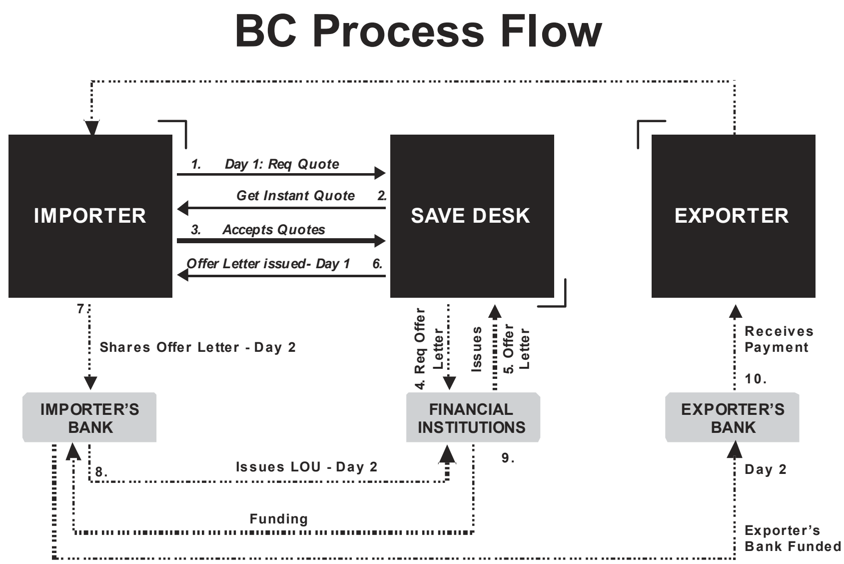
13.4.1 ACCOUNTING TREATMENT FOR BUYERS CREDIT

If Secured then it is under Secured Loan else under Current Liablity Check the terms of this loan and the collateral provided with it and you will have following scenarios:

1. Term for more than 12 months and has collateral attached to it - Secured loan under non-current liability.

2. Term for more than 12 months with no collateral attached to it - Unsecured loan under non-current liability. The answer will be vice versa if the term is less than less than 12 months and it will be classified under current liability.

13.4.2 BUYER'S CREDIT FLOW PROCESS



13.4.3 RBI GUIDELINES FOR BUYER'S CREDIT

Buyer's Credit refers to loans for payment of imports into India arranged on behalf of the importer through an overseas bank. The offshore branch credits the nostro of the bank in India and the Indian bank uses the funds and makes the payment to the exporter' bank as an import bill payment on due date. The importer reflects the buyers credit as a loan on the balance sheet.

13.4.4 BENEFITS OF BUYER'S CREDIT

The benefits of buyer's credit for the importer is as follows:

The exporter gets paid on due date; whereas importer gets extended date for making an import payment as per the cash flows

The importer can deal with exporter on sight basis, negotiate a better discount and use the buyers credit route to avail financing.

The funding currency can be in any FCY (USD, GBP, EURO, JPY etc.) depending on the choice of the customer.

The importer can use this financing for any form of trade viz. open account, collections, or LCs.

The currency of imports can be different from the funding currency, which enables importers to take a favourable view of a particular currency.

13.4.5 BUYERS CREDIT PROCESS FLOW

1.Indian customer imports the goods either under DC / LC, DA / DP or Direct Documents
2.Indian customer requests the Buyer's Credit Consultant before the due date of the bill to avail buyers credit finance.
3.Consultant approaches overseas bank for indicative pricing, which is further quoted to Importer.
4.If pricing is acceptable to importer, overseas bank issue's offer letter in the name of the Importer.
5.Importer approaches his existing bank to get letter of undertaking / comfort (LOU / LOC) issued in favour of overseas bank via swift.
6.On receipt of LOU / LOC, Overseas Bank as per instruction provided in LOU, will either funds existing bank's Nostro account or pays the supplier's bank directly.
7.Existing bank to make import bill payment by utilizing the amount credited (if the borrowing currency is different from the currency of Imports then a cross currency contract is utilized to effect the import payment)
8.On due date existing bank to recover the principal and Interest amount from the importer and remit the same to Overseas Bank on due date.

13.5 SUPPLIERS' CREDIT

Suppliers credit is a trade credit funded to the importer on basis of Letter Of Credit (LC). Under the LC method of payment, the overseas suppliers or financial institutions preferably from the seller's country finances the importers at cheaper rates than the local source of funding, which are close to Libor rates. It is beneficial to the seller as he receives payments immediately after the shipment of goods, which in turn helps the importer to negotiate for better prices.

Since the issuance of LOU(letter of undertaking) has been banned, the importers are switching to avail suppliers credit facility which also aids in availing cheap interest rates like buyers credit.

13.5.1 Benefits of Suppliers Credit

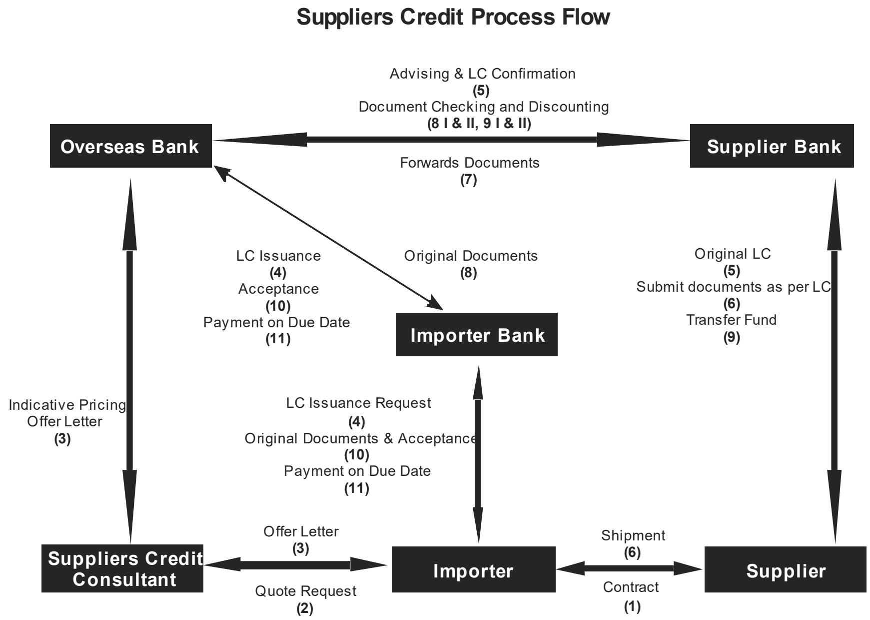
For Importer

- Availability of cheaper funds for import of raw materials and capital goods
- Ease short-term fund pressure as able to get credit
- Ability to negotiate better price with suppliers
- Able to meet the Suppliers requirement of payment at sight

For Supplier

- Realize at-sight payment
- Avoid the risk of importer's credit by making settlement with LC

13.5.2 Suppliers Credit Process Flow



1. Importer enter into contract with supplier for import.
2. With transaction details importer approaches arranger to get suppliers credit for the transaction
3. Arranger get an indicative pricing from overseas bank, which importer confirms.
4. Importer approach his bank and get LC issued, restricted to overseas bank counters with other required clauses
5. Overseas Bank confirms the LC and advise LC to Supplier's Bank. Suppliers Bank provides the copy of the LC to Supplier.
6. Supplier ships the goods and submits documents at his bank counter.
7. Supplier's Bank sends the documents to Overseas Bank.
8. Overseas Bank post checking documents for discrepancies (As per UCP 600) sends the document to importer's bank for acceptance:

- If documents are as per order, the same is discounted and transferred to supplier's bank.
- Incase of discrepant documents, documents are sent on acceptance basis. On receipt of Importer bank acceptance, the same is discounted and transferred to supplier's bank.

9. Supplier receives the payment for the LC. Depending on who is bearing the interest cost:
   - If importer is bearing interest cost, supplier receives full payment.
   - If Suppliers is bearing interest cost, supplier will receive LC amount – Interest.
10. Importer's Bank receives the documents. Importer's bank and Importer accept documents. Importer's Bank provides acceptance to Overaseas Bank, guaranteeing payment on due date.
11. On maturity, Importer makes the payment to his bank and Importer's bank makes payment to Supplier's Credit Bank

13.5.3 COST INVOLVED

- Foreign bank interest cost
- Foreign Bank LC Confirmation Cost (Case to Case basis)
- LC advising and or Amendment cost
- Negotiation cost (normally in range of 0.10%)
- Postage and Swift Charges
- Reimbursement Charges
- Cost for the usance (credit) tenure. (Indian Bank Cost)

13.5.4 REQUIREMENT

- Import transaction under LC
- Incoterms : FOB/CIF/C&F
- Arrangement has to be done before LC gets opened. Incase of LC already opened, relevant amendment has to done.
- LC to be restricted to suppliers credit providing bank under 41D clause of LC
- Under Payment Term: 90 days Usance payable at Sight (mention tenure according to tenure and offer received)

13.5.5 PREPAYMENT OF SUPPLIERS CREDIT

Technically yes, prepayment can be made to Usance LC subject to below condition is satisfied. But as there will be loss of interest for overseas banks it will not accept reduced payment. Even if they accept it will be with penal charges. Thus practically prepayment will not be possible.

13.5.6 DIFFERENCE BETWEEN BUYER'S CREDIT AND SUPPLIER'S CREDIT

1.Supplier's Credit can be arranged against LC transactions only, where as Buyer's Credit can be arranged for any type of payment mode (LC Sight, LC Usane, DA and DP) except advance payment.

2.Clauses in the LC would need amendment or few clauses will have to be incorporated as per the requirement of the supplier's credit providing bank. In buyer's credit, as the arrangement is after documents reaches your banks counter, no such clause are required to be incorporated.

3.Supplier's Credit has to be arranged before shipment of the goods or at the time of LC opening where as Buyers Credit can be arranged only after documents come at your bank counter for payment or on due date.

4.There can a difference in time of your cash flow. Many banks are structuring the transaction where in overall pricing is divided between confirmation cost and discounting cost, where confirmation cost is payable upfront at the time of advising the Lc. Where as in buyers credit, as the payment is in form of interest and it is payable only on maturity

13.6 SUMMARY

Export finance is provided at the pre-shipment and post-shipment stages. In India, the export credit facilities are provided largely by commercial banks. RBI and EXIM banks offer refinance. EXIM bank, in certain cases, participates with corm~iercial banks in extending medium and long-term credit to exporters. In India, pre-shipment finance is offered in the form of (i) packing credit (ii) Advance against incentives and (iii) Pre-shipment Credit in Foreign Currency (PCFC). Packing credit facilities are provided to the exporters for making necessary arrangements for executing export contracts. The basic purpose of packing credit is to enable the eligible exporters to procure, process, manufacture or store the goods meant for export. It is extended on the strength of either the letter of credit or confirmed export contracts. Generally the amount of packing credit does not exceed FOB value of the export goods or their domestic value whichever is less. When the value of the materials to be procured for export is more than FOB value of the contract, the exporters may get the credit against the receivables export incentives. The pre-shipment finance may also be available in foreign currency. Imports play an important role in economy of every country - rich and poor a like'. Their role in India is particularly crucial in view of country's continued dependence of foreign capital and technology. Hence, it is necessary to ensure that import operations at firm's level also are managed efficiently. Significant changes in India's import policy aiming at removing bottlenecks on account of red tape and lengthy documentation have taken place in recent years. Import financing means making decisions regarding term of payment (choosing one among several alternatives) arranging funds, involving choice of financial institution and the instrument through which the payment is to be made. The choice is conditioned by regulatory framework concerning imports and availability of foreign'currencies.

13.7 GLOSSARY

Pre-shipmenPre-shipment finance: Pre-shipment finance is provided to the exporters for the purchase of raw materials, processing them and converting them into finished goods for the purpose of export.

Post-shipment finance: It may be defined as "any loan or advance granted or any other credit provided by a bank to an exporter of goods from India from the date of extending the credit after shipment of goods to the date of realisation of export proceeds.

CCIE: Chief Controller of Imports & Exports.

13.8 SELF-ASSESSMENT QUESTIONS

1. Give buyer and supplier credit flow process in detail.

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2. Throw some light on the concept of import finance.

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3. Write a short note on methods of import financing.

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13.9 SUGGESTED READINGS

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EXPOSURES

Unit - III	Lesson No. 14
C.No. M.COM-FC 412	SEM : Fourth

STRUCTURE

14.1 INTODUCTION

Liberalisation of financial markets has enhanced corporate risk significantly. Corporate treasurers have become increasingly concerned about exchange rate risk. It is primarily due to significant increased in international capital flows and exposure to different currencies. Foreign exchange exposure is a measure of the potential for firm's profitability, net cash flow and market value to change because of a change in exchange rates. An importance task of the financial manager is to measure foreign exchange exposure and to manage it so as to maximize the profitability, net cash flow and market value of the firm.

14.2 OBJECTIVES

After reading this unit, you will be able to understand

1. Transaction Exposure
2. Economic Exposure
3. Translation Exposure

14.3 TRANSACTION EXPOSURE

Transaction exposure measures gains or losses that arise from the settlement of existing financial obligations the term of which are stated in a foreign currency. Transaction exposure arises from:

• Purchasing or selling on credit goods and services when prices are stated in foreign currencies.
• Borrowing or lending funds when repayment is to be made in a foreign currency.
• Acquiring assets or incurring liabilities denominated in foreign currencies.

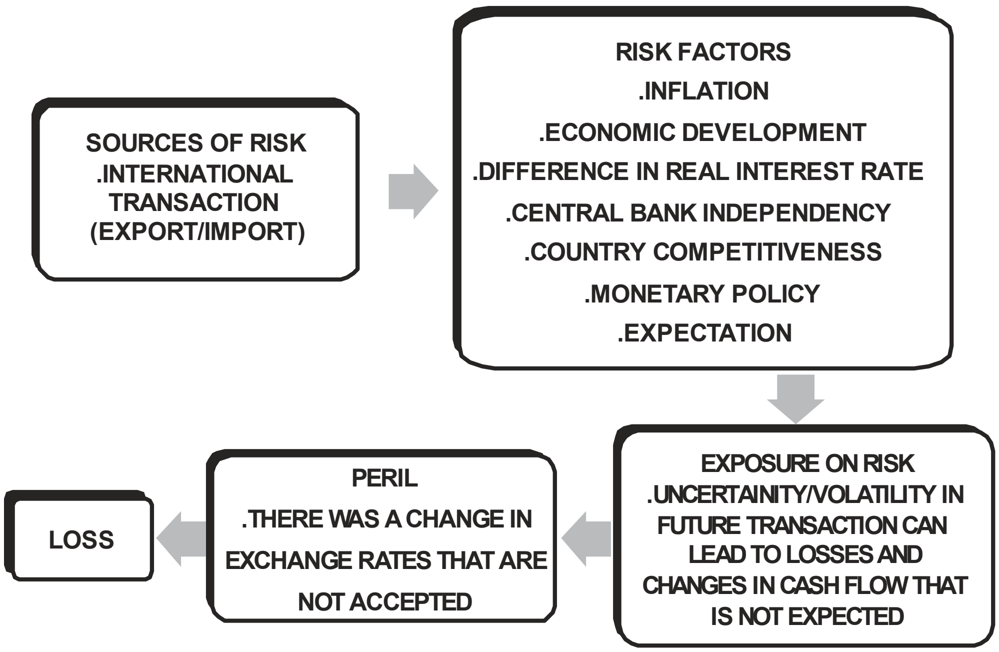

Fig. 14.1 Flowchart of Transaction exposure

Foreign currencies denominated receivables or payables are common types of transaction exposures. A transaction exposure is actually created at the first moment the seller quotes a price in foreign currency term to a potential buyer. With the placing of the order, the potential exposure created at the time of the quotation is converted into actual exposure, called "backlog exposure" because the product has not yet been shipped or billed. Backlog exposure lasts until the goods are shipped and billed, at which time it becomes "billing exposure". Billing exposure remains until actual payment is received by the seller.

Transaction exposure is the risk incurred due to the fluctuations in exchange rates before the contract is settled. The foreign exchange rate that changes in cross-currency transactions can adversely affect the involved parties. Once a cross-currency contract has been framed, and a specific amount of money and quantity of goods is fixed, exchange rate fluctuations can change the value of the contract. However, a company that has agreed to a contract but not yet settled it, faces the transaction exposure risk. The greater the time between agreement and settlement of contracts, the higher is the risk involved with exchange rate fluctuations.

Explanation with Example

To simply state, an Indian company bought a machine from US vendor at USD 10000 in June when the foreign exchange rate was Rs. 60 per USD. The payment terms stated payment in August. The exchange rate changed to Rs. 65 per USD in August.

For the buyer, the value at the time of buying was Rs. 600000 and at the time payment became Rs. 650000. It became costly by Rs. 50000. For the seller, there is no impact because he dealt and USD and the home currency is also USD.

The buyer's risk of losing additional Rs. 50000 can be termed as Transaction Exposure.

14.3.1 TREATMENT OF TRANSACTION EXPOSURE

Four key steps involved in the treatment of transaction exposures.

1. Initial recording of the transaction exposures
2. Recording of outstanding foreign currency balances
3. Treatment of Exchange gain or loss
4. Settlement of foreign currency receivable and payables.

With the recording of foreign currencies denominated assets and liabilities, the transaction exposures are not over. Till the final completion of cash settlement transaction exposures are continued to be there in the balance sheet of the company.

14.3.2 FINANCIAL TECHNIQUES FOR MANAGING TRANSACTION EXPOSURE

After understanding the meaning of transaction exposure, let us look at the techniques for managing transaction exposure. The following are the financial techniques for hedging transaction exposure:

1. Forward Contracts

If a firm is required to pay a specific amount of foreign currency in the future, it can enter into a contract that fixes the price for the foreign currency for a future date. This eliminates the chances of suffering due to currency fluctuations.

2. Futures Contracts

Futures contracts are similar to 'forward contracts'. However, futures contracts have standardized and limited maturity dates, initial collateral and contract sizes.

3. Money Market Hedge

In a money market hedge, the forward price is equal to current spot price multiplied by the ratio of the currency's riskless returns. This also creates the finance for the foreign currency transaction.

4. Options

The options contracts involve an upfront fee and do not oblige the owner to trade currencies at a specified price, time period and quantity.

After gaining an insight into the financial techniques, we will have a look at the operation techniques for managing transaction exposure

14.3.3 OPERATIONAL TECHNIQUES FOR MANAGING TRANSACTION EXPOSURE

The following are the operational techniques for managing transaction exposure:

1. Risk Shifting

The firm can completely avoid transaction exposure by not involving itself in foreign exchange at all. All the transactions can be conducted in the home currency. However, this is not possible for all types of businesses.

2. Currency Risk Sharing

The two parties involved in the deal can have the understanding to share the transaction risk.

3. Leading and Lagging

Leading and lagging involve manipulating currency cash flows in accordance with the fluctuations. Paying off liabilities when the currency is appreciating is known as leading. While collecting receivables when the currency is at a low value in called lagging.

4. Reinvoicing Centers

A reinvoicing center is a single third-party subsidiary used to conduct all intra-company trades. The reinvoicing centers carry out transactions in domestic currency, thereby bearing the losses from the transaction exposures.

14.4 ECONOMIC EXPOSURE

Economic exposure, also known as operating exposure refers to an effect caused on a company's cash flows due to unexpected currency rate fluctuations. Economic exposures are long-term in nature and have a substantial impact on a company's market value.

Economic exposure can prove to be difficult to hedge as it deals with unexpected fluctuations in foreign exchange rates. As the foreign exchange volatility rises, the economic exposure

increases and vice versa. Multinational companies having numerous subsidiaries overseas and transactions in foreign currencies face a greater risk of economic exposure.
After knowing the meaning of economic exposures, let us know how to determine the same.

14.4.1 DETERMINING ECONOMIC EXPOSURE

The following are the two factors that help in determining economic exposure:

- Economic exposure is higher for firms having both, product prices and input costs sensitive to currency fluctuations. It is lower when costs and prices are not sensitive to currency fluctuations.

- Economic exposure is higher for firms which do not adjust its markets, product mix, and source of inputs in accordance with currency fluctuations. Flexibility in adapting to currency rate fluctuations indicates lesser economic exposure.

After gaining an insight on how to determine economic exposure, we will have a look at how to manage the same.

14.4.2 MANAGING ECONOMIC EXPOSURE

The risk of economic exposure can be hedged either by operational strategies or currency risk mitigation strategies.

14.4.2.1 OPERATIONAL STRATEGIES

The following are the operational strategies which can be used to alleviate the risk of economic exposure:

1. Diversifying Production Facilities and Markets for Products

Diversifying the production facilities and sales to a number of markets rather than concentrating on one or two markets would mitigate the risk inherent. However, in such cases, the companies have to forgo the advantage earned by economies of scale.

2. Sourcing Flexibility

Companies may have alternative sources for acquiring key inputs. The substitute sources can be utilized in case the exchange rate fluctuations make the inputs expensive from one region.

3. Diversifying Financing

A company can have access to capital markets in a number of major regions. This enables the company to gain flexibility in raising capital in the market with the cheapest cost of funds.

14.4.2.2 CURRENCY RISK MITIGATION STRATEGIES

The following are the currency risk mitigation strategies which can be used to alleviate the risk of economic exposure:

1. Currency Risk-Sharing Agreements

An agreement is framed between the two parties involved in the purchase and sales contract. The agreement states that the parties must share the risk arising from the exchange rate fluctuations. The agreement consists of a price adjustment clause which states that the base price of the transaction will be adjusted in case of currency rate fluctuations.

2. Back-to-Back Loans

This method, also known as credit swap involves two companies located in different countries entering into an arrangement to borrow each other's currency for a fixed period of time. Once the defined period is over, the currencies are repaid.

3. Currency Swaps

The currency swap method is similar to the back-to-back loans method, however, does not reflect on the balance sheet. This method involves two firms who borrow currencies in the world market where each can benefit from the best rates and then swap the proceeds.

14.5 TRANSLATION EXPOSURE

Translation exposure (also known as translation risk) is the risk that a company's equities, assets, liabilities, or income will change in value as a result of exchange rate changes. This occurs when a firm denominates a portion of its equities, assets, liabilities, or income in a foreign currency. It is also known as "accounting exposure."

Accountants use various methods to insulate firms from these types of risks, such as consolidation techniques for the firm's financial statements and using the most effective cost accounting evaluation procedures. In many cases, translation exposure is recorded in financial statements as an exchange rate gain (or loss).

14.5.1 KEY TAKEAWAYS

- Translation exposure (also known as translation risk) is the risk that a company's equities, assets, liabilities, or income will change in value as a result of exchange rate changes.
- When a firm denominates a portion of its equities, assets, liabilities, or income in a foreign currency, translation risk occurs.
- "Accounting exposure" means the same thing as translation risk.
- Translation risk can lead to what appears to be a financial gain or loss that is not a result of a change in assets, but in the current value of the assets based on exchange rate fluctuations.

14.5.2 UNDERSTANDING TRANSLATION EXPOSURE

Translation exposure is most evident in multinational organizations since a portion of their operations and assets will be based in a foreign currency. It can also affect companies that produce goods or services that are sold in foreign markets even if they have no other business dealings within that country.

In order to properly report the organization's financial situation, the assets and liabilities for the whole company need to be adjusted into the home currency. Since an exchange rate can vary dramatically in a short period of time, this unknown, or risk, creates translation exposure. This risk is present whether the change in the exchange rate results in an increase or decrease of an asset's value. Translation risk can lead to what appears to be a financial gain or loss that is not a result of a change in assets, but in the current value of the assets based on exchange rate fluctuations. For example, should a company be in possession of a facility located in Germany worth €1 million and the current dollar-to-euro exchange rate is 1:1, then the property would be reported as a $1 million asset.

If the exchange rate changes and the dollar-to-euro ratio becomes 1:2, the asset would be reported as having a value of $500,000. This would appear as a $500,000 loss on financial statements, even though the company is in possession of the exact same asset it had before.

Translation risk can occur at any time a business operates in regions that use different currencies.

14.5.3 TRANSACTION VS. TRANSLATION EXPOSURE

There is a distinct difference between transaction and translation exposure. Transaction exposure involves the risk that when a business transaction is arranged in a foreign currency, the value of that currency may change before the transaction is complete. Should the foreign currency appreciate, it will cost more in the business's home currency. Translation risk focuses on the change in a foreign-held asset's value based on a change in exchange rate between the home and foreign currencies.

14.5.4 HEDGING TRANSLATION RISK

A variety of mechanisms are in place that allow a company to use hedging to lower the risk created by translation exposure. Companies can attempt to minimize translation risk by purchasing currency swaps or hedging through futures contracts.

In addition, a company can request that clients pay for goods and services in the currency of the company's country of domicile. This way, the risk associated with local currency fluctuation is not borne by the company but instead by the client who is responsible for making the currency exchange prior to conducting business with the company

14.5.5 MEASUREMENT OF TRANSLATION EXPOSURE

Translation exposure can often depict a distorted representation of a company's international holdings if foreign currencies depreciate considerably compared to the home currency.

Accountants can choose among several options while converting the values of foreign holdings into domestic currency. They can choose to convert at the current exchange rate or at a historical rate prevalent at the time of occurrence of an account.

Whichever rate they choose, however, needs to be used consistently for several years, in accordance with the accounting principle of consistency. The consistency principle requires companies to use the same accounting techniques over time to maintain uniformity in the books of account.

In case a new technique is adopted, it should be mentioned clearly in the footnotes of the financial statements.

Consequently, there are four methods of measuring translation exposure:

1. Current/Non-current Method

The values of current assets and liabilities are converted at the exchange rate that prevails on the date of the balance sheet. On the other hand, non-current assets and liabilities are converted at a historical rate.

Items on a balance sheet that are written off or converted into cash within a year are called current items, such as short-term loans, bills payable/receivable, and sundry creditors/debtors. Any item that remains on the balance sheet for more than a year is a non-current item, such as machinery, building, long-term loans, and investments.

Consider the following balance sheet of a European subsidiary of an American company, which follows the method. Assume that the historical exchange rate is €1 = $1.20, and the current rate is €1 = $1.15.

Table 14.1: Example showing current/non current method of translation exposure measurement

Liabilities	Value (in €)	Value (in $)	Assets	Value (in €)	Value (in $)
Sundry Creditors (Current rate)	1,000	1,150	Cash in Hand (Current rate)	500	575
Long-term Debt (Historical rate)	10,000	12,000	Sundry Debt (Current rate)	1,500	1,725
Capital (Historical rate)	50,000	60,000	Buildings (Historical rate)	59,000	70,800

2. Monetary/Non-monetary Method

All monetary accounts are converted at the current rate of exchange, whereas non-monetary accounts are converted at a historical rate.

Monetary accounts are those items that represent a fixed amount of money, either to be received or paid, such as cash, debtors, creditors, and loans. Machinery, buildings, and capital are examples of non-monetary items because their market values can be different from the values mentioned on the balance sheet.

The balance sheet prepared using the monetary/non-monetary method will be as follows:

Table 14.2: Table showing monetary/non monetary method of translation exposure measurement

Liabilities	Value (in €)	Value (in $)	Assets	Value (in €)	Value (in $)
Sundry Creditors (Current rate)	1,000	1,150	Cash in Hand (Current rate)	500	575
Long-term Debt (Historical rate)	10,000	11,500	Sundry Debt (Current rate)	1,500	1,725
Capital (Historical rate)	50,000	60,000	Buildings (Historical rate)	59,000	70,800

3. Current Rate Method

The current rate method is the easiest method, wherein the value of every item in the balance sheet, except capital, is converted using the current rate of exchange. The stock of capital is evaluated at the prevailing rate when the capital was issued.

The balance sheet prepared using the current rate method will be as follows:

Table 14.3: Table showing current rate method of translation exposure method measurement

Liabilities	Value (in €)	Value (in $)	Assets	Value (in €)	Value (in $)
Sundry Creditors (Current rate)	1,000	1,150	Cash in Hand (Current rate)	500	575
Long-term Debt (Historical rate)	10,000	11,500	Sundry Debt (Current rate)	1,500	1,725
Capital (Historical rate)	50,000	60,000	Buildings (Historical rate)	59,000	67,850

4. Temporal Method

The temporal method is similar to the monetary/non-monetary method, except in its treatment of inventory. The value of inventory is generally converted using the historical rate, but if the balance sheet records inventory at market value, it is converted using the current rate of exchange.

In the example above, if there is an inventory of goods recorded in the balance sheet at its historical value of, say €1,000, its value in dollars after conversion will be $(1,000 x 1.2), or $1,200.

However, if the inventory of goods is recorded at the current market value of, say €1,050, then its value will be $(1,050 x 1.15), or $1,207.50.

In each of the methods used above, there is a mismatch between the total values of assets and liabilities after conversion. While calculating income and net profit, variations in exchange rates can distort the amounts to a great extent, which is why accountants often use hedging to do away with this risk.

14.6 SUMMARY

In today's world of volatile currencies and increasing global integration and international trade, few companies, if any, remain unaffected by movements in foreign exchange rates. Unexpected changes in exchange rates affect firms' ability to sell abroad, increase the cost of foreign-sourced inputs, and reduce domestic and international competitiveness Transaction exposure risks are suffered due to foreign exchange rate fluctuations. However, these risks can be minimised or completely eliminated by numerous financial and operational techniques.. An awareness of the impact of economic exposure can help firms take steps to mitigate this risk. Investors should identify stocks and companies that have major exposures and make better investment choices during times when exchange rate volatility is at its peak. Translation exposure is a kind of accounting risk that arises due to fluctuations in currency exchange rates. Converting the values of holdings of a foreign subsidiary into the domestic currency of the parent company can lead to inconsistencies if exchange rates change continuously.

14.7 GLOSARY

Transaction exposure: Transaction exposure involves the risk that when a business transaction is arranged in a foreign currency, the value of that currency may change before the transaction is complete.

Futures Contracts: Futures contracts are similar to 'forward contracts'. However, futures contracts have standardized and limited maturity dates, initial collateral and contract sizes.

Money Market Hedge: In a money market hedge, the forward price is equal to current spot price multiplied by the ratio of the currency's riskless returns. This also creates the finance for the foreign currency transaction.

14.8 SELF-ASSESSMENT QUESTIONS

1. **Describe the various types of financial exposures.**

2. **What are the various methods of determining translation exposures?**

3. **Give in detail currency risk mitigation strategies.**

14.9 SUGGESTED READINGS

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EXCHANGE RATE AND CURRENCY RISK

Unit - III	Lesson No. 15
C.No. M.COM-FC 412	SEM : Fourth

STRUCTURE

15.1 INTODUCTION

Exchange rate risk, also known as currency risk, is the financial risk arising from fluctuations in the value of a base currency against a foreign currency in which a company or individual has assets or obligations. Exchange rate risk, or foreign exchange (forex) risk, is an unavoidable risk of foreign investment, but it can be mitigated considerably through hedging techniques. To eliminate forex risk, an investor would have to avoid investing in overseas assets altogether. However, exchange rate risk can be mitigated with currency forwards or futures.

The exchange rate risk is caused by fluctuations in the investor's local currency compared to the foreign-investment currency. These risks can be mitigated through the use of a hedged exchange-traded fund or by the individual investor using various investment instruments, such as currency forwards or futures, or options. Exchange rate risk isn't completely avoidable but it can be mitigated.

15.2 OBJECTIVES

After reading this unit, you will be able to understand

1. Exchange Rate and Currency Risk
2. Risk in Foreign Trade and Finance
3. Types of Risks, their Causes, their Mitigation and Risk Analysis

15.3 EXCHANGE RATE AND CURRENCY RISK FOR INTERNATIONAL BUSINESSES

For the U.S. investor, hedging exchange rate risk is particularly important when the U.S. dollar is surging since the risk can erode returns from overseas investments. For overseas investors, the reverse is true, particularly when U.S. investments are performing. This is because the depreciation of the local currency against the USD can provide an additional boost to returns. In such situations, since the exchange rate movement is working in the investor's favor, the appropriate course of action is to go unhedged.

The rule-of-thumb, with regard to foreign investments, is to leave the exchange rate risk unhedged when the local currency is depreciating against the foreign-investment currency but to hedge this risk when the local currency is appreciating against the foreign-investment currency.

15.3.1 HOW EXCHANGE RATE AND CURRENCY RISK WORKS

For the U.S. investor, hedging exchange rate risk is particularly important when the U.S. dollar is surging since the risk can erode returns from overseas investments. For overseas investors, the reverse is true, particularly when U.S. investments are performing. This is because the depreciation of the local currency against the USD can provide an additional boost to returns. In such situations, since the exchange rate movement is working in the investor's favor, the appropriate course of action is to go unhedged.

The rule-of-thumb, with regard to foreign investments, is to leave the exchange rate risk unhedged when the local currency is depreciating against the foreign-investment currency but to hedge this risk when the local currency is appreciating against the foreign-investment currency.

15.3.2 MITIGATION OF EXCHANGE RATE AND CURRENCY RISKS

Here are two ways to mitigate forex risk:

Invest in hedged assets: The easiest solution is to invest in hedged overseas assets, such as hedged exchange-traded funds (ETFs). ETFs are available for a wide range of underlying assets traded in most major markets. Many ETF providers offer hedged and unhedged versions of their funds that track popular investment benchmarks or indexes. Although the hedged fund will generally have a slightly higher expense ratio than its unhedged counterpart due to the cost of hedging, large ETFs can hedge currency risk at a fraction of the hedging cost incurred by an individual investor. For example, for the MSCI EAFE index—the primary benchmark for U.S. investors to measure international equity performance—the expense ratio for the iShares MSCI EAFE ETF (EFA) is 0.31%. The expense ratio for the iShares Currency Hedged MSCI EAFE ETF (HEFA) is 0.69.

Hedge exchange rate risk yourself: Investors most likely have some forex exposure if their portfolio contains foreign-currency stocks or bonds or American depositary receipts (ADRs). A common misconception is that their currency risk is hedged, but that is not the case.

15.3.3 SPECIAL CONSIDERATIONS FOR HEDGING THESE RISKS

You can hedge currency risk using one or more of the following instruments:

Currency forwards: Currency forwards can be effectively used to hedge currency risk. For example, assume a U.S. investor has a euro-denominated bond maturing in a year's time and is concerned about the risk of the euro declining against the U.S. dollar in that time frame. The investor can enter into a forward contract to sell euros (in an amount equal to the maturity value of the bond) and buy U.S. dollars at the one-year forward rate. While the advantage of forward contracts is that they can be customized to specific amounts and maturities, a major drawback is that they are not readily accessible to individual investors. An alternative way to hedge currency risk is to construct a synthetic forward contract using the money market hedge.

Currency futures: Currency futures are used to hedge exchange rate risk because they trade on an exchange and need only a small amount of upfront margin. The disadvantages are that they cannot be customized and are only available for fixed dates.

Currency ETFs: The availability of ETFs that have a specific currency as the underlying asset means that currency ETFs can be used to hedge exchange rate risk. This is probably not the most effective way to hedge exchange risk for larger amounts. However, for individual investors, their ability to be used for small amounts and the fact that they are margin-eligible and can be traded on the long or short side leads them to provide major benefits.

Currency Options: Currency options offer another feasible alternative to hedging exchange rate risk. Currency options give an investor or trader the right to buy or sell a specific currency in a specified amount on or before the expiration date at the strike price. For example, currency options traded on the Nasdaq are available in denominations of EUR 10,000, GBP 10,000, CAD 10,000 or JPY 1,000,000, making them well-suited for the individual investor.

Exchange rate risk cannot be avoided altogether when investing overseas, but it can be mitigated considerably through the use of hedging techniques. The easiest solution is to invest in hedged investments such as hedged ETFs.

The fund manager of a hedged ETF can hedge forex risk at a relatively lower cost. However, an investor who holds foreign-currency stocks or bonds, or even American depository receipts (ADRs) should consider hedging exchange rate risk using one of the many avenues available such as currency forwards, futures, ETFs or options.

15.4 RISK IN FOREIGN TRADE AND FINANCE

Risk happens on account of uncertainty about happening of an event like loss, damage, variations in foreign exchange rates, interest rate variations, etc. Every business manager is always risk averters, i.e., managers usually do not want to take risk. Hence, he likes to work out higher probability for creating wealth and profit. He likes to work as hedger.

The risk taker would like to take risk. He normally works as speculator. Any change in the business environment, would bring the same type of risk. Generally, the areas of business prone to risks are shortage of inventory, shortage of business orders, shortage of manpower, shortage of utilities like power and fuel, changes in government policies, etc.

15.4.1 REASONS OF THESE RISKS

The international business faces the risk due to the following reasons:

i. Operations across and with different political, legal, taxation and culture systems.

ii. Operations across and with a wider range of product and factor markets, each with different levels of competition and efficiency.

iii. Trades in wider range of currencies and frequent resort to foreign exchange markets.

iv. Unregulated international capital markets.

In other words, risk is the main measurement of the probability of incurring a loss or In other words, risk is the main measurement of the probability of incurring a loss or damage. The chance and possibility that the actual outcome from an activity will differ from the expected outcome normally gives rise to risk. This means that, higher the variability the possible outcomes that can occur (i.e. broader the range of possible outcomes), results in to greater risk.

The value of firm's assets, liabilities, operating incomes, operating expenses, and other abnormal incomes, expenses differ from expected one clue to changes in many economic and financial variables like exchange rates, interest rates, inflation rates etc.

The appreciation of a local currency results in decreasing the local currency value with respect to exports receivable denominated in foreign currency. Such appreciation or depreciation of local currency makes effect on the cash flow of domestic currency due to the transactions' exposure of merchandise and non-merchandise exports and imports.

Exposure is a measure of the sensitivity of the value of a financial item (cash flow, assets, liability etc.) to changes in variables like exchange rates, etc., while risk is a measure of the variability of the value of the financial item.

A firm always encounters a number of risks during the course of business, i.e. political instability, technical obsolescence, availability of skilled labour, extent of trade unionism, infrastructural bottlenecks and financial risks.

15.4.2 TYPES OF RISKS

The various types of risks that an international trader faces are divided into the following categories:

1. Commercial risks
2. Political risks
3. Risks arising out of foreign laws
4. Cargo Risks
5. Credit risks
6. Foreign exchange fluctuations risks.

Now, let us discuss these risks, in detail.

1. Commercial Risks

Causes of Commercial Risks:

Commercial risks are caused due to the factors:

(i) Lack of knowledge about the foreign markets:

(ii) Inadaptability of the export product to change to the conditions of the foreign market requirements

(iii) Longer transit time and

(iv) Varying situations to be handled, not anticipated before export.

Nature of Risk different in International Trade

Commercial risks exist in domestic market too. But, their impact in international market: is greater, in comparison. to domestic market. The changes in international market are hazardous and difficult to anticipate. Suitability and acceptability of the product international market is rather difficult to gauge. Variations in demand and supply conditions are more unpredictable.

Most of the commercial risk s are to he borne by the exporters. Exporters cannot shift these risks to the professional risk bearers, paying insurance premium. The exporter is not, aware of the conditions in the foreign market as the way he is aware of domestic market. Long distances to travel along with cost and time implications distinguish international trade from domestic trade. Exporter cannot visit Paris with the same ease he does Mumbai from Bhopal. If goods are not sold or price realization is lower than anticipated, due to changes in demand or supply, exporter has to bring back the goods, incurring additional freight cost or opt to sell the goods at a loss.

In international. market, as in domestic market, presence of competitors influences the demand and supply conditions and entry of new competitors depresses the market more. Further, local production may bring down the prices. Introduction of substitutes to capture the market may take away the exporter's share in the market.

The price realization of the product in export market is influenced by:

(a) Changes in Exchange Rates: Changes in home currency or foreign currency affects the price realization. If the home currency is devalued, the competitive capacity' of the exporter is enhanced. If the foreign currency is depreciated, there is ; considerable reduction in the exporter's competitive strength.

(b) Changes in import Duties or Tariff Barriers: Changes in import duties and creation of tariff barriers disturb even an established market. In this field, through the efforts of GATT, import duties have been fairly reduced and market has become stable. On account of these impediments, exporters open manufacturing facilities in the importing countries to overcome these problems.

(C) Changes in Transport costs: Transport costs constitute, generally, a major part the invoice value and so any change in transport costs affects the competitive edge of the exporter. Change in transport costs does not affect FOB price., There, is no problem even in CIF contracts, which have escalating clause in respect of transport costs. Exports Have to worry in CIF contracts, which have escalating clause in respect of transport costs have to worry in case of CIF contracts that are net with escalation clause:

d) Change in Foreign Market Characteristics: A classical example is change in styles soon after shipment of goods in particular, when the shipment is made without letter of credit , ready made garments suffer, greatly from this problem.

Minimization of Commercial Risks:

Commercial risks can be minimized by using forecasting techniques and keeping a careful watch on the changing business conditions in the concerned country, in particular, and also keeping a track of the changes in the world economy. Exporters have to be prepared to face any eventuality and wisdom lies in forecasti,44 and anticipating, of course, finally, quick responding, at the earliest hour.

2. Political Risks

These risks arise due to change in political situations in the concerned importing and exporting countries. Following are the factors, affecting the political situation:

(i) Changes in the party in power in the concerned countries, followed by the head of the Government;

(ii) Coups, civil wars and rebellions:

(iii) Wars between the countries or among- many countries and

(iv) Capture of cargo by enemies during war.
This risk includes:
(i) imposition of restrictions in buyer's country by the Government for remittance of sale proceeds which may block or delay the payment to the exporter:
ii) war, revolution or civil disturbances in the buyer's country;
(iii) new import restrictions in the buyer's country or cancellation of valid import licence, after the date of shipment or contract, as applicable
(iv) cancellation of valid export licence or imposition of new licensing restrictions after the date of contract, applicable under Contracts Policy;
(v) payment of additional transportation and insurance charges occasioned by interruption or diversion of voyage which can not be recovered from the buyer and
(vi) Any other loss that has occurred in buyer's country, which is not covered under general insurance and beyond the control of exporter and / or the buyer
In case where the buyer happens to be foreign government or government department and it refuses to pay, the default will fall under the category of political risks
Political risks can be avoided, to a certain extent, by judicious selection of the countries to which goods are exported. Insurance companies may agree to provide cover for some of these risks, by collecting additional premium. Export Credit. Guarantee Corporation (ECGC.) also 'covers seine of the risks.

3. Risks Arising out of Foreign Laws (Legal Risks)

Every country has its own commercial law. So, different laws prevail both in exporter and importer countries. Legal proceedings are complex as well as expensive. In every relationship, however cordial and long-standing may be, differences are likely to arise. Legal risks can be avoided to a great extent by incorporating the provision for appointment of an arbitrator, in case of dispute about contractual terms.

4. Cargo risks

Transportation of cargo has undergone radical improvements over a period. Most of the goods are transported by sea. Transit risks are a common hazard for those engaged in export/import business. The list of dreary and hazardous risks in transit is long viz. Storms, collisions, theft, leakage, explosion, spoilage, fire, and high sea robbery. Every exporter should have working knowledge of marine insurance so that he knows whether he is getting the required risk protection at the minimum cost, It is always possible to transfer the financial losses resulting from perils of sea and perils in transit to professional risk bearers known as underwriters Principles of marine insurance are also equally applicable to insurance of air cargo also.

5. Credit Risks

Risks are inherent in credit transactions; more so in international business. International business is invariably riskier than the domestic trade. Credit risk. is not the same whether one sells the goods in domestic market or in foreign market. Success, in international business depends, largely, on the ability of the exporters to give credit to importers on tree competitive and favorable terms.

Export business has become highly risky as selling on credit has become very common. Importers are sought after so it is but natural they dictate terms as there are many exporters competing for the cake of international trade. Insolvency rate is on the increase. Balance of payment difficulties has severely affected the capacity of many countries to pay the import price. However, offering credit has become unavoidable to the exporters to face competition. Two issues stand before the exporters:

(i) The exporter must have sufficient funds to offer credit to the buyers abroad and

(ii) The exporter should be prepared to take credit risks.

Meaning of Credit Risk

Once goods are sold on credit risks arising in realizing the sale proceeds are referred as credit risks. Risk may arise due to inability of the buyers to pay on the due date. Alternatively, even if the buyer makes the payment, situations may change in the buyer's country that the funds of 'buyer do not reach the exporter. An outbreak of war, civil war, coup or an insurrection may block or delay the payment for goods exported. Whatever the reason may be, if funds are not received, sufferer is, finally, exporter. Credit risk has assumed an alarming proportion on account of large volumes in international business and sweeping changes in political and economic conditions, globally. In such a high risky situation, credit risk insurance is of immense help to the exporters as well as banks that finance the exporters.

Organization covering Credit Risk

There are more than 40 organizations covering the credit risk, all the world over. In India, we have Export Credit Guarantee Corporation of India Limited to cover export credit risks. This is a Government of India enterprise, with its Head office located in Mumbai, under the administrative control of the Ministry of Commerce. Board of Directors representing Government, Banking, Insurance, Trade and Industry manages this organization.

Types of Cover issued by ECGC:

They are broadly divided into four groups:

I. Standard Policies: They are ideally suitable to exporters to cover payment risks involved in exports on short-term credit basis.

2. Specific Policies: These policies are specifically designed to protect Indian exporters from the risks involved in

(a) Exports on deferred payment contracts

(b) Services rendered to foreign parties and

e) Construction works and turnkey projects undertaken abroad.

3. Financial Guarantee: They are the policies issued to banks for covering risks in extending credit at pre-shipment as well as post shipment stages.

4. Special Schemes: They are meant to cover risks involved in confirmation to letters of credit opened by foreign banks, insurance cover for buyers credit,, line of credit and exchange fluctuations risks.

5. Foreign Exchange Fluctuations Risks

If the exporter has invoiced in the buyer's currency, he will be subjected to risk of foreign exchange fluctuations. If the foreign currency depreciates in terms of rupees, exporter will receive lesser amount in terms of rupees or vice versa. In the same circumstances, if the Indian currency depreciates, exporter stands to gain. If the export, bill is purchased or negotiated under letter of credit and the foreign currency undergoes fluctuation, the bank will be bearing the risk. However, if the exporter has sent the bill for collection, the exchange rate on the date of receipt of foreign currency in India will be given to the exporter. If there is intervening difference in the exchange rate between the date of giving the bill for collection and date of realization, exporter stands to lose or gain, depending on the trend in fluctuation. There will be no foreign exchange risk in case the invoice is made in Indian rupees. In such a case, the importer will be subjected to foreign exchange fluctuation risk.

6. Interest Rate Risk:

The fluctuations in interest rates over a period of time change the cash flow need of a firm, for interest payment. The rate of interest is decided and agreed among parties (i.e. lender and borrower) at the time of sanctioning of debt.

The interest rate may be constant or may be related to some other variable or benchmark. If it is constant, it is known as, 'Fixed Interest Rate Debt Instrument' (FXR). If the rate is linked to any other variable or benchmark say LIBOR (London Inter-Bank Offer Rate) then known as Floating Interest Rate Debt Instrument (FIR).

Interest Rate Exposure and Risk:

Interest rate uncertainty exposes a firm to the following types of risks. Borrowings on floating rate bring uncertainty relating to future interest payments, for the firm. The floating rate makes borrowing cost of capital unknown.

The problem is that there is a rise of variation in interest rate risk for the firm due to the fluctuating or floating rate clause in loan agreement. Hence, firm management not sure about the interest payment they have to make whenever interest amount is payable to financial institutions or lenders of the funds. Borrowings on fixed rate basis results in risk if future periods interest rates may come down, and the firm has to continue with a heavy burden on debt servicing.

In the Indian environment, the management of interest rate risks has been a comparatively new concern. The behaviour of interest rates during the period of 2003-2008 has upset the cost and return calculations of many industries.

The exchange rate fluctuation in the South East Asian Countries or the nosedive (sudden plunge or changes) of rupee in terms of dollars shows the extreme sensitivity of exchange rates, and in turn the extent to which the firm's exposures affected.

Interest rates in India were regulated and controlled by the dictates of the Reserve Bank of India. This ensured a stability of interest rate mechanism and the Indian business was not very much bothered about them. However, with changes being brought out by the Government and Reserve Bank of India, it is quite clear that interest rates will henceforth be market driven.

8. Liquidity Risk:

If the markets turn illiquid or the positions in market are such that cannot be liquidated, except huge price concession, the resultant risk is known as liquidity risk. It can also be termed that the risks which, though directly or indirectly, affect the liquidity and in turn long term solvency of the parties in the market, is known as liquidity risk.

The international financial system failed to support the increasing demands of expanding trade and finance due to lack of enough resources, efficient and quick actions of surveillance on capital flows and inadequate liquidity to meet emerging crisis situations.

9. Settlement Risk:

This is the risk of counterparty failing during settlement, because of time difference in the markets in which cash flows the two currencies have to be paid and received viz. settled. Settlement risk depends on the various risks like risk of the borrowing company's ability to meet its debt service obligation in time, represented by the risk of its business, financial risk, market risk, labour problems, restrictions on dividend distribution, fluctuations in profits and a host of other company related problems. Unanticipated depreciation of a country's currency might hurt a company which is net importer but it may benefit exporter.

15.5 RISK ANALYSIS

Risk analysis, being a component of risk management process, deals with the various kinds of events and causes and effects of these events which may resultantly cause harm to the functioning of the firm. Risk analysis supports the business managers to work out the proper decisions in business working.

Risk analysis is done on the basis of the possibility of an event taking place. Thus, the risk of an event can be measured through the possibility (probability) of the event taking place with regards to the frequency and severity.

An event can have wide variety of characteristics or possibility with respect to varying degrees of seriousness, depending upon its nature and the extent of damage it can create, and the perception of the event's occurrence taken by the management. Each project or activity can have many associated risks, and these risks can vary depending upon technology, funding, organisations involved etc.

However, in broad terms, the key sources of project or process risks are like:

1. Commercial risk
2. Financial risk
3. Legal risks
4. Political risks
5. Social risks
6. Environmental risks
7. Communications risks
8. Geographical risks
9. Geotechnical risks
10. Construction risks
11. Technological risks
12. Operational risks
13. Demand or product risks, and
14. Management risks etc.

These sources of risk directly influence the project-specific and non-project-specific performance. The analyst is supposed to define the boundaries of each risk driver and its detailed risk elements. Then, he/she has to move to estimate the impact of the same.

The decision with respect to division of risks into specific element; and later on evaluates. The parameters of evaluations are generally affected by personal subjectivity and belief of the financial analyst. The risk analysis explores the avenues for business managers to take informed decision.

15.6 SUMMARY

Although foreign exchange may be confusing, in today's global marketplace, there is a critical need for almost everyone to understand foreign exchange like never before. As the world shrinks, there is an ever-increasing likelihood that we will be required to address the risks associated with the fact that there are different currencies used all around the world and that these currencies will have an immediate impact on our world. We must be able to evaluate the effects of, and actively respond to, changes in exchange rates with respect to our consumption decisions, investment portfolios, business plans, government policies, and other life choices (both financial and otherwise). Moreover, there is an ever-increasing probability that we will have to transact in these foreign exchange markets—in our personal or professional life.

15.7 GLOSSARY

Liquidity Risk: If the markets turn illiquid or the positions in market are such that cannot be liquidated, except huge price concession, the resultant risk is known as liquidity risk. It can also be termed that the risks which, though directly or indirectly, affect the liquidity and in turn long term solvency of the parties in the market, is known as liquidity risk.

ETFs: exchange-traded funds

Currency forwards: Currency forwards can be effectively used to hedge currency risk. For example, assume a U.S. investor has a euro-denominated bond maturing in a year's time and is concerned about the risk of the euro declining against the U.S. dollar in that time frame.

15.8 SELF-ASSESSMENT QUESTIONS

1**. Explain various types of risks in international trade.**

2. Give the strategies for mitigating the exchange rate risks.

3.What do you mean by interest rate exposure and risk?

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STRUCTURE

16.1 INTRODUCTION

Globalization is the single most significant development changing business dynamics in this century. The reality of global markets and global competition is pervasive. The forces that are driving the world toward greater globalization are greater than the forces that restrain this move. With the improvements in transportation and communication technologies there is a sea change in the way the companies are run. International trade leads to international marketing, which in turn leads to growth in international business.

The phenomenal growth in international business brought about number of new concepts in international management.

The old theories of international trade focused upon natural resources and crude measures of factor endowments. Newer models focus upon the actual sources of competitive advantage of companies in industries. Ultimately, competitive advantage is based upon understanding what customers need and want and on knowing how to deliver these needs and wants with a competitive advantage.

The formula that guides this task is V=B/P: value = benefits divided by price. The greater the benefits and the lower the price, the greater the value. The task of the global company is to deliver value to customers located in global markets. The ability of corporations of all sizes to use globally available factors of production is an important factor in international competitiveness. A single Barbie doll is made in more than ten countries- designed in the United States, with parts and clothing from Japan, Korea, Italy, and Taiwan, assembled in Mexico and sold in different countries.

16.1.1 Evolution of Multinational Corporation:

The dynamics of international business created a great need for the evolution of Multinational corporation. The multinational corporation is a company engaged in producing and selling goods or services in more than one country. It normally consists of a parent company located in the home country and few or more foreign subsidiaries. Some MNCs have more than 100 foreign subsidiaries scattered around the world. It is the globally coordinated allocation of resources by a single centralized management that differentiates the multinational enterprise from other firms engaged in international business. MNCs make decisions about market-entry strategy; ownership of foreign operations; and production, marketing, and financial activities with an eye to what is best for the corporation as a whole.

The true multinational corporation emphasizes group performance rather than the performance of its individual parts. There are different types of multinational companies, such as;

a) Raw-Material Seekers: Raw-material seekers were the earliest multinationals and their aim was to exploit the raw materials that could be found overseas. The modern-day counterparts of these firms, the multinational oil and mining companies such as British Petroleum, Exxon Mobil, International Nickel, etc.,

b) Market Seekers: The market seeker is the archetype of the modern multinational firm that goes overseas to produce and sell in foreign markets. Examples include IBM, Toyota, Unilever, Coca-Cola.

c) Cost Minimizers: Cost minimizers are a fairly recent category of firms doing business internationally. These firms seek out and invest in lower-cost production sites overseas (for example, Hong Kong, Malaysia, Taiwan, and India) to remain cost competitive both at home and abroad.

MNCs have to follow the changes in macroeconomic factors, environmental and social issues, and business and industry developments. These factors will all profoundly shape the corporate landscape in the coming years. The following section deals with these trends.

16.2 Objectives: after reading this lesson student will be able to:

- To identify the main goal of the multinational corporation (MNC) and potential conflicts with that goal.
- To describe the key theories that justify international business.
- To explain the common methods used to conduct international business.

16.3 Foreign Investment

Foreign Investment refers to domestic companies investing in foreign companies with the objective of gaining stake and seeking active participation not only day-to-day operations of the business and but also for key strategic expansion. Suppose if an American company invests its capital in an Indian company then it will be called foreign investment.

Foreign investment involves capital flows from one country to another, granting the foreign investors extensive ownership stakes in domestic companies and assets. Foreign investment denotes that foreigners have an active role in management as a part of their investment or an equity stake large enough to enable the foreign investor to influence business strategy. A modern trend leans toward globalization, where multinational firms have investments in a variety of countries.

Foreign investment is largely seen as a catalyst for economic growth in the future. Foreign investments can be made by individuals, but are most often endeavours pursued by companies and corporations with substantial assets looking to expand their reach.

As globalization increases, more and more companies have branches in countries around the world. For some multinational corporations, opening new manufacturing and production plants in a different country is attractive because of the opportunities for cheaper production and labour costs.

Additionally, these large corporations frequently look to do business with those countries where they will pay the least amount of taxes. They may do this by relocating their home office or parts of their business to a country that is a tax haven or has favorable tax laws aimed at attracting foreign investors.

16.3.1 Advantages of Foreign Investment

- The creation of employment is a major advantage because when an investment will come then manufacturing will increase and the service sector will also improve.
- It provides access to the market of another country.
- It enhances the infrastructure of the country and helps in developing the backward area by setting up industries or plants.
- It also helps in enhancing the technologies and operational practices by sharing knowledge with each other.
- An increase in export, when manufacturing will boost by foreign investment then its export of the country will also increase.
- Increase in income and more job opportunity will arise and at the same time, wages of an employee also increase which result into increase in national per capita income.

16.3.2 Disadvantages

Disadvantages of foreign investment are as below:

- It is a risk or hindrance to domestic investment.
- Exchange rates are a very crucial factor, always there is a risk in foreign investment if exchange rates are highly fluctuating.
- Risk of the political environment because of the political environment of the country where investment is done because foreign investment depends upon many foreign policies and regulations which may change because of political conditions.
- Loss of control over the business, as there is a chance that a domestic company can lose its control on business and all the profit earned by the company will go out of the country.
- Risk for domestic or small traders, since foreign investment, come in great volume and their main motive is to gain the market share first without thinking about the profit & loss and they start selling their product in less than the market price and even below the cost, in such scenario, there is a chance that domestic or small trader will not survive and their business will shut down.

16.3.3 Types of Foreign Investments

Funds from foreign country could be invested in shares, properties, ownership / management or collaboration. Based on this, Foreign Investments are classified as below.

- Foreign Direct Investment (FDI)
- Foreign Portfolio Investment (FPI)
- Foreign Institutional Investment (FII)

Foreign Direct Investment (FDI)

FDI is an investment made by a company or individual who us an entity in one country, in the form of controlling ownership in business interests in another country. FDI could be in the form of either establishing business operations or by entering into joint ventures by mergers and acquisitions, building new facilities etc.

Foreign Portfolio Investment (FPI)

Foreign Portfolio Investment (FPI) is an investment by foreign entities and non-residents in Indian securities including shares, government bonds, corporate bonds, convertible securities, infrastructure securities etc. The intention is to ensure a controlling interest in India at an investment that is lower than FDI, with flexibility for entry and exit.

Foreign Institutional Investment (FII)

Foreign Portfolio Investment (FPI) is an investment by foreign entities in securities, real property and other investment assets. Investors include mutual fund companies, hedge fund companies etc. The intention is not to take controlling interest, but to diversify portfolio ensuring hedging and to gain high returns with quick entry and exit.

The differences in FPI and FII are mostly in the type of investors and hence the terms FPI and FII are used interchangeably.

The Securities Market in India is regulated by Securities and Exchange Board of India (SEBI). Refer to the article on SEBI to get more information on this topic.

16.4 APPROACHES TO INTERNATIONAL BUSINESS

International business approaches are similar to the stages of internationalization or globalization.

Douglas Wind and Pelmutter advocated four approaches of international business. They are:

1. Ethnocentric Approach
2. Polycentric Approach
3. Regiocentric Approach
4. Geocentric Approach.

1. Ethnocentric Approach

The domestic companies normally formulate their strategies, their product design and their operations towards the national markets, customers and competitors. But, the excessive production more than the demand for the product, either due to competition or due to changes in customer preferences push the company to export the excessive production to foreign countries. The domestic company continues the exports to the foreign countries and views the foreign markets as an extension to the domestic markets just like a new region. The executives at the head office of the company make the decisions relating to exports and, the marketing personnel of the domestic company monitor the export operations with the help of an export department.

The company exports the same product designed for domestic markets to foreign countries under this approach. Thus, maintenance of domestic approach towards international business is called ethnocentric approach. Fig. 1.2 makes the ethnocentric concept clearer.

This approach is suitable to the companies during the early days of internationalization and also to the smaller companies.

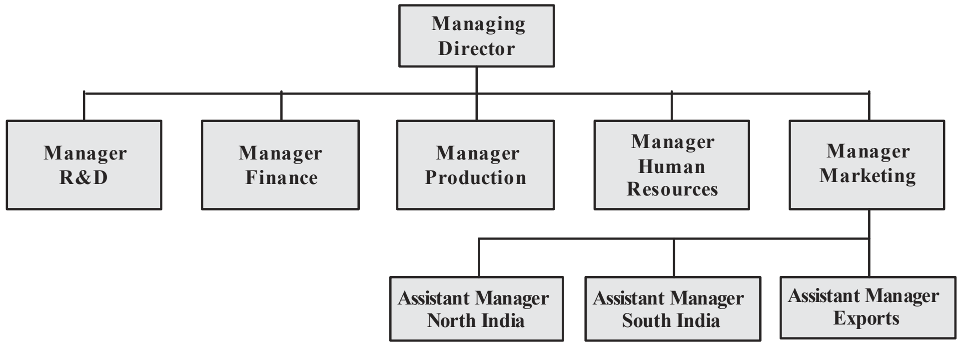

FIGURE 1.2 : Organizational Structure of Ethnocentric Company

2. Polycentric Approach

The domestic companies which are exporting to foreign countries using the ethnocentric approach find at the later stage that the foreign markets need an altogether different approach. (See Fig. 1.3). Then, the company establishes a foreign subsidiary company and decentralizes all the operations and delegates decision-making and policy-making authority to its executives. In fact, the company appoints executives and personnel including a chief executive who reports directly to the Managing Director of the company. Company appoints the key personnel from the home country and all other vacancies are filled by the people of the host country.

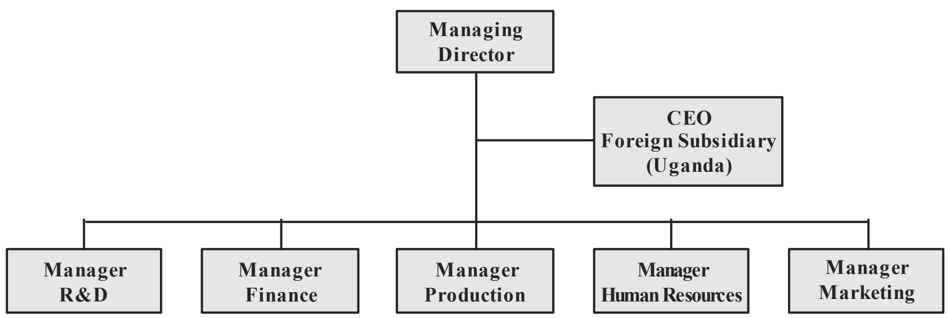

FIGURE 1.3 : Organizational Structure of Polycentric Company

3. Regiocentric Approach

The company after operating successfully in a foreign country, thinks of exporting to the neighbouring countries of the host country. At this stage, the foreign subsidiary considers the regional environment (for example, Asian environment like laws, culture, policies, etc.), for formulating policies and strategies. However, it markets more or less the same product designed under polycentric approach in other countries of the region, but with different market strategies. (See Fig. 1.4).

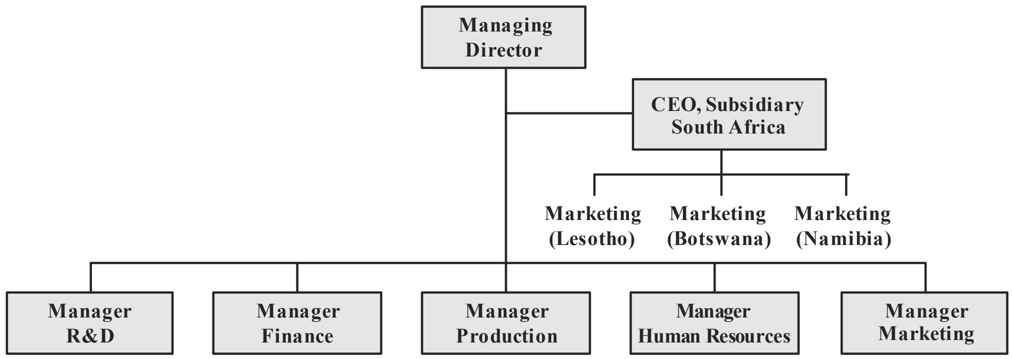

FIGURE 1.4 : Organizational Structure of Regiocentric Company

4. Geocentric Approach

Under this approach, the entire world is just like a single country for the company. They select the employees from the entire globe and operate with a number of subsidiaries. The headquarters coordinate the activities of the subsidiaries. Each subsidiary functions like an independent and autonomous company in formulating policies, strategies, product design, human resource policies, operations, etc. Fig. 1.5 helps to understand the concept of geocentric approach clearly.

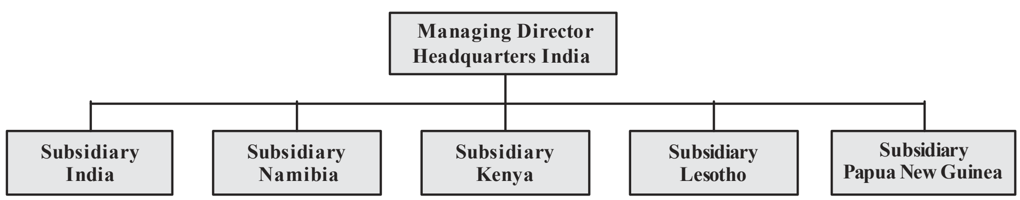

FIGURE 1.5 : Organizational Structure of Geocentric Company

16.5 SUMMARY

Foreign investment is just an investment but this is coming from another country. Since the investment is coming from the cross border, therefore, it's required more rules & regulations is applicable to foreign investment. It is beneficial for developing country because it helps in building infrastructure, creating employment, knowledge sharing and increasing the purchasing power, at the same time it is required for the developed country also because they want to expand their business and for that, it is required to go beyond to his country. In the era of globalization, foreign investment plays a very important role in business expansion. On the other hand, it is harmful to small and domestic businesses because they don't have so many funds to survive against these big companies.

16.6 GLOSSARY

MNC : Multinational corporations.

Foreign investment: Foreign investment involves capital flows from one country to another, granting the foreign investors extensive ownership stakes in domestic companies and assets.

Foreign Direct investment: FDI is an investment made by a company or individual who us an entity in one country, in the form of controlling ownership in business interests in another country.

Foreign portfolio investment: Foreign Portfolio Investment (FPI) is an investment by foreign entities and non-residents in Indian securities including shares, government bonds, corporate bonds, convertible securities, infrastructure securities etc.

16.7 SELFASSESSMENT

Q1. What do you understand by a Multinational firm ?

Ans.____

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Q2. Define the following terms :

(a) FDI

Ans.____

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(b) FPI

Ans.____

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(c) FII

Ans.____

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16.8 LESSON END EXERCISE

Q1. What is a Multinational firm ?

Q2. What are different approaches to international business?

Q3. Describe the different types of foreign investments.

16.9 SUGGESTED READINGS

1. Agarwal, Sanjiv, 1997. Manual of Indian Capital Market, Bharat Law House, New Delhi.

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Unit - IV **Lesson No. 17**
C.No. M.COM-FC 412 **SEM : Fourth**

STRUCTURE

17.1 INTRODUCTION

Depository Receipt (DR) is a negotiable instrument evidencing a fixed number of equity shares of the issuing company being an Indian company, denominated in foreign currency and is being traded in foreign exchanges.

17.1.1 Why do Companies Issue Depository Receipts ?

Company issues DRs as a tool to access Global capital markets. Following are the some reason for issuing DRs by a company –

- To raise capital;
- Diversify Shareholder base into extended geographies;
- Increase visibility & recognition in international market;
- Global Image;
- Set Up Employee Stock Option Plans;
- Facilitate Merger & Acquisition activity by creating a desirable acquisition currency.

17.1.2 Purpose of Investors to Invest in Depository Receipts

- Diversify Portfolio
- Convenience of holding foreign securities in their markets
- Simplification of trading and settlements(DRs trade and settle just like US or EURO securities)
- No restrictions on dealing: DRs are recognized as domestic securities
- Avoid Currency risk.

17.2 OBJECTIVES

After reading this lesson student will be able to:

- gain knowledge about Depository receipts
- understand the different types of Depositary receipts

17.3 AMERICAN DEPOSITORY RECEIPTS (ADRs)

American Depository Receipt (ADR) is a stock that trades in the United States but represents a specified number of shares in a foreign corporation ADRs are bought and sold on American markets just like regular stocks, and are issued / sponsored in the U.S. by a bank or brokerage.

ADRs were introduced as a result of the complexities involved in buying shares on foreign countries. Primarily, the difficulties are associated with trading at different prices and currency values. For this reason, U.S. Banks simply purchase a lot of shares from the company, bundle the shares into groups, and reissue them on the NYSE, AMEX, or NASDAQ. The depository bank sets the ratio of U.S. ADRs per home country share. This ratio can be anything less than or greater than 1. The reason they do this is because they wish to price the ADR high enough so as to show substantial value, yet low enough, so that the individual investors can purchase these shares. The majority of ADRs range between $10 and $100 per share. If, in the home country, the shares were worth considerably less, then each ADR would represent several real shares.

17.3.1 Different types of ADR issues:

Level 1 This is the most basic type of ADR where foreign companies either don't qualify or don't wish to have their ADR listed on an exchange. Level1 ADRs are found on the OTC market and are an easy and inexpensive way to gauge interest for its securities in North America. Level1 ADRs also have the loosest requirements from the SEC. • • •

Level 2: This type of ADR is listed on an exchange or quoted on NASDAQ. These ADRs have slightly more rigorous requirements from the SEC but they also get higher visibility and trading volume.

Level 3: The most prestigious of the three, this is when an issuer floats a public offering of ADRs on a U.S. exchange. Level 3 ADRs are able to raise capital at low cost and gain substantial visibility in the U.S. financial markets.

17.3.2 Characteristics of an ADR

ADRs are quoted in US dollars and are generally structured so that the number of the foreign company's securities will result in a trading price for each ADR in the range of \$10-\$30. The . multiple or fraction that an ADR is of the underlying shares is determined with this price range in mind. The depository receives dividends directly from the Indian company in rupees and issues dividend cheques to ADR holders in dollars. When an ADR is sold back to the depository, it is considered as cancelled and the stock of ADRs is not replenished.

The advantages of ADRs are twofold. For individuals, ADRs are an easy and cost effective way to buy shares in a foreign company. They save considerable money by reducing administration costs and avoiding foreign taxes on each transaction. Foreign entities like ADRs because they get more U.S. exposure and allow them to tap into the wealthy North American equity markets. In return, the foreign company must provide detailed financial information to the sponsoring bank.

A significant portion of public offering by non-US companies (and we're most concerned with Indian companies) in the US is in the form of ADRs, or American Depository Receipts (also called American Depository Shares or ADS).

ADRs are negotiable receipts issued to investors by an authorised depository, normally a US bank or depository, in lieu of shares of the foreign company which are actually held by the depository.

ADRs can be listed and traded in a US-based stock exchange and help the Indian company to be known in the highly liquid US stock exchanges.

ADRs also help the US-based and other foreign investors to have the twin benefits of having shareholding in a high growth Indian company and the convenience of trading in a highly liquid and well-known stock market.

17.4 GLOBAL DEPOSITARY RECEIPTS (GDRs)

GDR is a security issued abroad and is listed and traded on a foreign stock exchange.

GDR holder can at any time convert it into shares represented by it. Till conversion, GDRs do not carry any voting right. Depository receipts facilitate cross border trading and settlement, minimise transaction cost and broaden the potential investor base. The shares are issued by a company to an intermediary called the depository in whose name, the shares are registered. This depository subsequently issues the GDRs. The physical possession of equity shares is entrusted to another intermediary called the custodian who acts as an agent of depository .The advantage in GDR issue is that company does not assume any exchange risk. The dividend outflow from the company is in Rupees only but depository converts these rupee payments and pays the dividend in US dollar to the ultimate investors after deducting a withholding tax of 10 per cent on deposit. Once a GDR has been issued, it can be freely traded among international investors. GDR plays a crucial role in international corporate finance. GDR's are used to:

A) raise debt or equity capital;
B) diversify shareholder base;
C) increase demand for securities;
D) enhance global image; and
E) create dollar-denominated securities

17.4.1 The depository performs the following functions:

1. Issuing depository receipts upon delivery of the underlying security to its custodian account and releasing the underlying security into the home market upon cancellation of DR.
2. Processing DR transfers, maintaining records of registered holders, paying dividends and responding to shareholder enquiries.
3. Holding. consultations with the issuer to promote its DR programme, reporting on the progress, supplying trading and shareholding information and-providing assistance in ensuring regulatory compliance.

17.4.2 Procedure for GDR issue

In a GDR issue, the issuing company issues ordinary shares as per the scheme and delivers the ordinary shares to domestic custodian bank, which will, in terms of the agreement, instruct the overseas depository bank to issue global depository receipt. or certificate to the non-resident investors against the shares held by domestic custodian bank. GDR is normally issued in negotiable form and may be listed on any international stock exchange for trading outside India. Most companies list GDRs in Luxembourg or Dublin Stock Exchanges. The shares underlying the GDRs will be registered in the name of the overseas depository bank, which will be the holder in the books of the company.

The non-resident holder of GDR may transfer those receipts, or may ask the overseas depository bank (ODB) to redeem those receipts. In case of redemption, the ODB shall request domestic custodian bank (DCB) to get the corresponding shares released in favour of the non-resident investors for being sold directly on behalf of the non-resident investors or being transferred in the books of account of the issuing company in the name of the non-resident.

In case of redemption of GDRs into underlying shares, a request will be transmitted by the ODB to the DCB with a copy to the company. The cost of acquisition of the shares shall be the cost on the date on which the ODB advises the DCB for redemption. The price of the shares on the stock exchange shall be taken as the cost. Holders of GDRs will have no voting rights or other direct rights of a shareholder with respect to the shares underlying such GDRs. Registered holders of shares withdrawn from the depository arrangement will be entitled to vote and exercise other direct shareholders' rights in accordance with the Indian law. Withdrawn shares cannot be redeposited. Holders of GDRs will be entitled to receive dividends paid on the underlying shares, subject to the tens of the issue. So long as the GDRs are not withdrawn, the relevant ODB will, in connection with such outstanding shares, convert Rupee dividend into dollars. The outstanding shares of the company under the GDR issue will be listed on Indian Stock Exchanges.

17.5 DIFFERENCE BETWEEN ADRs & GDRs

ADRs are listed on an American stock exchange. The issue process is governed by American laws and Securities and Exchange Commission (SEC) - the market regulator monitors the issue. GDRs or global depository receipts are listed in a stock exchange other than American stock exchanges, say Luxembourg or London. A listing in America involves adhering to very stringent disclosure and accounting norms. The accounts of the company have to be represented according to US GAAP or generally accepted accounting principles. US GAAP requires representing a combined balance sheet of all group companies, and not just the company which is going for the issue.

Typically, a good company can expect its reported profits according to Indian accounting rules to be eroded by 20-30 per cent under US GAAP. Against this, the disclosure requirements for GDR issues are widely thought less stringent.

An ADR listing also allows the famed American retail investors to part-take in the offering and leads to wider interest and better valuations of a company's stock, thus enhancing shareholder value. Also, the Indian company can acquire US companies against issue of shares. The GDR market is mainly an institutional market with lower liquidity.

17.6 EXTERNAL COMMERCIAL BORROWINGS (ECBs)

ECB refer to commercial loans [in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments (e.g. floating rate notes and fixed rate bonds)] availed from non-resident lenders with minimum average maturity of 3 years.

ECB is basically a loan availed by an Indian entity from a non-resident lender. Most of these loans are provided by foreign commercial banks and other institutions. It is a loan availed of from non-resident lenders with a minimum average maturity of 3 years.

The significance of ECBs their size in India's balance of payment account. In the post reform period, ECBs have emerged a major form of foreign capital like FDI and FII.

During several years, contribution of ECBs was between 20 to 35 percent of the total capital flows into the country. Large number of Indian corporate and PSUs have used the ECBs as sources of investment.

Bulk of the overseas loans or ECBs into the country are obtained by private sector corporates. For the corporate, ECB is a dependable and easy to obtain fund and helps them to make business/investment expansion.

External Commercial Borrowings (ECBs) includes commercial bank loans, buyers' credit, suppliers' credit, securitized instruments such as Floating Rate Notes and Fixed Rate Bonds etc., credit from official export credit agencies and commercial borrowings from Multilateral Financial Institutions. ECBs are being permitted by the Government as a source of finance for Indian Corporate for expansion of existing capacity as well as for fresh investment. Following are the advantages of ECBs.

17.6.1 Advantages of ECBs

· ECBs provide opportunity to borrow large volume of funds

· The funds are available for relatively long term

· Interest rate are also lower compared to domestic funds

· ECBs are in the form of foreign currencies. Hence, they enable the corporate to have foreign currency to meet the import of machineries etc.

· Corporate can raise ECBs from internationally recognised sources such as banks, export credit agencies, international capital markets etc.

Unlike many other emerging market economies, India has a vibrant corporate sector at home. Many of them have overseas operations as well. The domestic financial market is not often able to provide big sized loans at competitive rate of interests to the corporate. Here, External Commercial Borrowings have emerged as a valuable source of investable resource of funds for domestic companies.

The government follows a well-designed ECB policy-putting restrictions on amount of loan that can be obtained by a company, end user restrictions, interest rate ceiling for ECBs, maturity period etc. In the same manner, government puts ceiling for the total amount of ECBs that can be obtained by all Indian firms through the ECB route during an year. At present, this aggregate limit is $40 billion.

17.7 SUMMARY

A depositary receipt (DR) is a negotiable certificate issued by a bank representing shares in a foreign company traded on a local stock exchange. The depositary receipt gives investors the opportunity to hold shares in the equity of foreign countries and gives them an alternative to trading on an international market.A depositary receipt, which was originally a physical certificate, allows investors to hold shares in the equity of other countries. One of the most common types of DRs is the American depositary receipt (ADR), which has been offering companies, investors, and traders global investment opportunities since the 1920s.

17.8 GLOSSARY

- **Depositary receipts:**

  A negotiable certificate that represents a company's publicly traded debt or equity. Depositary receipts are created when a company's shares or bonds are delivered to a depositary's custodian bank, which instructs the depositary to issue the receipts. Depositary receipts facilitate trading of foreign securities.

- **ADRs:**

  Certificates issued by a US depository bank, representing foreign shares held by the bank, usually by a branch or correspondent in the country of issue.

- **GDRs:**

  A receipt denoting ownership of foreign based corporation stock shares which are traded in numerous capital markets around the world.

- **ECBs:**

  External commercial borrowing (ECBs) are loans in India made by non-resident lenders in foreign currency to Indian borrowers. They are used widely in India to facilitate access to foreign money by Indian corporations and PSUs (public sector undertakings).

17.9 SELF ASSESSMENT

Q1. What do you understand by Multinational firm ?

Ans.____

____

Q2. Define the following terms :

(a) ADRs

Ans.

(b) GDRs

Ans.

(C) ECB

Ans.

17.10 LESSON END EXERCISE

Q1. What are the advantages of ADRs?

Q2. What do you mean by external commercial borrowings?

Q3. Describe the different types of Depositary receipts.

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Unit - IV | **Lesson No. 18**
C.No. M.COM-FC 412 | **SEM : Fourth**

STRUCTURE

18.1 INTRODUCTION

Foreign Direct Investment (FDI)

Foreign Direct Investments are commonly made in open economies that have skilled workforce and growth prospect. FDIs not only bring money with them but also skills, technology and knowledge. FDI is an important monetary source for India's economic development. Economic liberalisation started in India in the wake of the 1991 crisis and since then, FDI has steadily increased in the country. India, today is a part of top 100-club on Ease of Doing Business (EoDB) and globally ranks number 1 in the greenfield FDI ranking.

18.2 Objectives

After reading this lesson student will be able to:

- gain knowledge about Foreign direct investment
- understand the different theories of foreign direct investments

18.3 WHAT IS FOREIGN DIRECT INVESTMENT (FDI)?

Foreign direct investment (FDI) is an investment from a party in one country into a business or corporation in another country with the intention of establishing a lasting interest. Lasting interest differentiates FDI from foreign portfolio investments, where investors passively hold securities from a foreign country. A foreign direct investment can be made by obtaining a lasting interest or by expanding one's business into a foreign country. An investment into a foreign firm is considered an FDI if it establishes a lasting interest. A lasting interest is established when an investor obtains at least 10% of the voting power in a firm.

The key to foreign direct investment is the element of control. Control represents the intent to actively manage and influence a foreign firm's operations. This is the major differentiating factor between FDI and a passive foreign portfolio investment.

For this reason, a 10% stake in the foreign company's voting stock is necessary to define FDI. However, there are cases where this criterion is not always applied. For example, it is possible to exert control over more widely

18.3.1 Methods of Foreign Direct Investment

As mentioned above, an investor can make a foreign direct investment by expanding their business in a foreign country. Amazon opening a new headquarters in Vancouver, Canada would be an example of this.

Reinvesting profits from overseas operations, as well as intracompany loans to overseas subsidiaries, are also considered foreign direct investments.

Finally, there are multiple methods for a domestic investor to acquire voting power in a foreign company. Below are some examples:

- Acquiring voting stock in a foreign company
- Mergers and acquisitions
- Joint ventures with foreign corporations

· Starting a subsidiary of a domestic firm in a foreign country traded firms despite owning a smaller percentage of voting stock.

18.3.1 Types and Examples of Foreign Direct Investment

Typically, there are two main types of FDI: horizontal and vertical FDI.

Horizontal: a business expands its domestic operations to a foreign country. In this case, the business conducts the same activities but in a foreign country. For example, McDonald's opening restaurants in Japan would be considered horizontal FDI.

Vertical: a business expands into a foreign country by moving to a different level of the supply chain. In other words, a firm conducts different activities abroad but these activities are still related to the main business. Using the same example, McDonald's could purchase a large-scale farm in Canada to produce meat for their restaurants.

Conglomerate: a business acquires an unrelated business in a foreign country. This is uncommon, as it requires overcoming two barriers to entry: entering a foreign country and entering a new industry or market. An example of this would be if Virgin Group, which is based in the United Kingdom, acquired a clothing line in France.

Platform: a business expands into a foreign country but the output from the foreign operations is exported to a third country. This is also referred to as export-platform FDI. Platform FDI commonly happens in low-cost locations inside free-trade areas. For example, if Ford purchased manufacturing plants in Ireland with the primary purpose of exporting cars to other countries in the EU.

18.4 RELEVANT THEORIES OF FOREIGN DIRECT INVESTMENT

18.4.1 Capital Market Theory

This theory, also sometimes referred to as the "currency area theory", is considered one of the earliest theories which explained FDI. It postulated that foreign investment in general arose as a result of capital market imperfections. FDI specifically was the result of differences between source and host country currencies. According to Aliber (1970; 1971), weaker currencies have a higher FDI-attraction ability and are better able to take advantage of differences in the market capitalisation rate, compared to stronger country currencies. Aliber (1970; 1971) further adds that source country MNCs based in hard currency areas can borrow at a lower interest rate than host country firms because portfolio investors overlook the foreign aspect of source country MNCs. This gives source country firms the borrowing advantage because they can access cheaper sources of capital for their overseas affiliates and subsidiaries than what local firms would access the same funds for. While this capital market theory holds true in the case of developed countries such as the United States, United Kingdom and Canada. A major criticism of Aliber's theory was made by Lall (1979) when he highlighted that the theory does not apply in the case of less developed countries with highly imperfect or non-existent capital markets, and those with heavily regulated foreign exchange rates.

18.4.2 Location-based approach to FDI theories

Although FDI location is influenced by firm behaviour (a microeconomic element) insofar as the motives of its location, that is whether it is resource seeking, market-seeking, efficiency-seeking or strategic asset seeking; the overarching decision is in fact taken on the basis of economic geography, which is a macroeconomic decision as it takes cognisance of country-level characteristics. The theory explained the success of FDI among countries based on the national wealth of a country, such as its natural resources endowment, availability of labour, local market size, infrastructure and Government policy regarding these national resources. An off-shoot of this location-based theory is the gravity approach to FDI wherein it was assumed that FDI flows between two countries is highest, if those two countries are similar geographically, economically and culturally. Gravity variables such as size, level of development, distance, common language and additional institutional aspects such as shareholder protection and trade openness were regarded as important determinants of FDI flows. This is however a very basic approach to the economics of FDI, because FDI flows are more complicated than just being about commonalities between nations. Being close together geographically may reduce transportation costs, but not necessarily the cost of labour, for example. Also, sharing the same culture may not necessarily result in increased profitability or trade between the two countries.

18.4.3 Institutional FDI Fitness theory

Developed by Wilhems and Witter (1998), the term FDI fitness focuses on a country's ability to attract, absorb and retain FDI. It is this country ability to adapt, or to fit to the internal and external expectations of its investors, which gives countries the upper-hand in harnessing FDI inflows. The theory itself attempts to explain the uneven distribution of FDI flows between countries. Wilhem's institutional FDI fitness theory rests on four fundamental pillars – Government, market, educational and socio-cultural fitness. At the base of the pyramid are socio-cultural factors which according to Wilhelms are the oldest and most complex of all institutions. Above that is education, which the authors affirm to being necessary in ensuring an attractive environment for FDI as educated human capital enhances R&D creativity and information processing ability. The actual level of education does not seem to matter much for FDI as the requirements are dependent on the various skills needs of projects to be undertaken. However what is certain is that basic education may impact on the productivity and efficiency of FDI operations, making formative education such as the ability to speak, hear, understand, interpret and implement instructions key for attracting FDI. The third pillar, that of markets, accounts for the economic and financial aspects of institutional FDI fitness, in the form of machinery (physical capital) and credit (financial capital). Developed and well functioning financial markets are hence a prominent feature in the MNC's investment decision-making process. The fourth and final pillar as put forth by Wilhelms is the Government. The role of a country's political strength plays the biggest role in the FDI game. Government fitness requires the adoption of protective regulation to manage market fitness.

18.4.4 Internalization theory

This theory is developed by Coase in the year 1937, he examines the role that transaction costs play in the formation of organisations known as internalisation theory. In brief, Coase was concerned with why firms exist and why not all transactions in a n economy occur in the market. Coase also answered this in terms of the transactions costs involved in using the market, where this is the cost of searching and determining the market price, or, once the price is found, the cost of negotiation, signing and enforcement of contracts between the parties involved in the transaction. The process of internalisation is developed to explain international production and FDI. The operations of firm, especially large firms, take the form not only of producing services and goods, but activities such as marketing, training, development and research, management techniques and involvement with financial markets. These activities are interdependent and are connected by 'intermediate products', taking the form of either knowledge or material products, and expertise. A key intermediate product in the internalisation theory of FDI is knowledge. One reason is that knowledge takes a considerable period of time to generate, for example through development and research, but is highly risky, so that futures markets do not exist. Sellers of markets may be unwilling to disclose information, which has uncertain value to the buyer, causing market fail. Further, sellers and buyers of knowledge can often hold a degree of market power, which leads to a 'bilateral concentration of power' and uncertain outcomes. These problems indicate the severe difficulties in licensing and contracting where information is crucial.

18.4.5 Product Life Cycle Theory

This theory was developed by Raymond Vernon in the Mid 1960's, he was a Harvard Business School professor. This theory was developed after the failure of Hecksher Ohlin's Theory. The theory, detailed that a product goes through various stages in the course of its progress. These stages are:

(1) new product stage,

(2) maturing product stage, an

(3) standardized product stage.

This theory assumed that the production of a new product would take place in the nation where it was innovated.

In the 1960's this was a very useful theory. At that time, United States of America was dominating the whole globe in terms of manufacturing after the World War II.

Stage I: New Product

The stage begins with introducing a new product in the market. A corporation will begin from developing a new good. The market for which will be small and sales will be comparatively low. Vernon assumed that innovation or invention of products will mostly be done in developed nations, because of the economy of the nation. To balance the effect of less sales, corporations would keep the manufacturing local. As the sales would increase, the corporations would start to export the goods to different nations in order to increase the revenue and sales.

Stage II: Mature Product Stage

The product enters this stage when it has established demand in developed nations. The manufacturer, would need to open manufacturing plants in each nation where the product has demand. Due to local production, labour costs and export costs will decline which will in result reduce the per unit cost and increase the revenue.

This stage may include product development. Demand for the product will continue to rise in this stage. demand can also be expected from less developed nations. Local competition with other cooperation's will begin.

Stage III: Standardized Product Stage

In this stage exports to nations various developed and under developed nations will begin. Foreign product competition will reach its peak due to which the product will start losing its market. The demand in the nation from where the product originated will start declining and eventually diminishes as a new product grabs the attention of the people. The market for the product is now completely finished.

Then, the cycle of a new product begins.

18.4.6 Investment Development Path Theory

John Dunning's 'investment development path (IDP)' theory (1981) and its latest version (Dunning an Narula 1994) are implicitly built on the notion that the global economy is necessarily hierarchical in terms of the various stages of economic development in which its diverse constituent nations are situated. The IDP essentially traces out the net cross-border flows of industrial knowledge, the flows that are internalised in foreign direct investment (FDI) and that restructure and upgrade the global economy, although there is also the non-equity type of knowledge transfer such as licensing, turn-key operations, and the like. In this way, the IDP can thus be view as a cross-border learning curve exhibited by a nation that successfully move up the stages of development by acquiring industrial knowledge from its more advanced 'neighbours'. A move from the 'U-shaped' (i.e negative NOI) portion to the 'wiggle' section of the IDP indicates an 'equilibration in knowledge dissemination' and that is, a narrowing of the industrial technology gap between the advanced and the catching-up countries. Thus, IDP curve conceptualised by Dunning is an idealised pattern based on free-market exchanged of knowledge among countries.

18.5 SUMMARY

A foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets in a foreign company. However, FDIs are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies. Foreign direct investments are commonly made in open economies that offer a skilled workforce and above-average growth prospects for the investor, as opposed to tightly regulated economies. Foreign direct investment frequently involves more than just a capital investment. It may include provisions of management or technology as well. The key feature of foreign direct investment is that it establishes either effective control of or at least substantial influence over the decision-making of a foreign business.

18.6 GLOSSARY

- **Foreign direct investment:** A foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country.

- **FII :** A foreign institutional investor (FII) is an investor or investment fund investing in a country outside of the one in which it is registered or headquartered. The term foreign institutional investor is probably most commonly used in India, where it refers to outside entities investing in the nation's financial markets.

18.7 SELF ASSESSMENT QUESTIONS

Q1. What do you understand by Foreign direct investment?
Ans.____

Q2. What are the Methods of Foreign Direct Investment?
Ans.____

18.8 LESSON END EXERCISE

Q1. What are the advantages of FDI?

Q2. What are the different methods of FDI?

Q3. Describe the different theories of foreign direct investments?

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EVALUATING DIRECT INVESTMENT PROJECTS

Unit - IV	Lesson No. 19
C.No. M.COM-FC 412	SEM : Fourth

STRUCTURE

19.1 INTRODUCTION

Although the original decision to undertake an investment in a particular foreign country may be the outcome of combination of strategic, behavioural and economic considerations, choice of a specific project within a particular product-market posture calls for evaluation of its economic feasibility. For this purpose, capital budgeting exercise has to be done. A firm should deploy funds in a project if the marginal revenue obtained there from exceeds the marginal cost. For an MNC, capital budgeting involves economic analysis of the firm's direct investment opportunities. Whatever be the motive for Direct Foreign Investment (DFI), an MNC's very survival and sustainable competitive position depends on its ability to identify and choose the most profitable investment opportunity. Capital budgeting technique provides the mechanism to identify opportunities and evaluate their economic viability. This is why MNCs evaluate international projects by using capital budgeting techniques. Proper use of capital budgeting techniques can help the firm in identifying the international projects worthy of implementation from those that are not.

19.2 OBJECTIVES:

After reading this lesson student will be able to:

- appreciate the capital budgeting techniques in evaluating overseas projects;
- understand the fundamentals of evaluating foreign projects;
- analyse important issues pertaining to cross-border investments and their implications in capital budgeting decisions; and
- explain various methods of incorporating risk in international investment decision.

19.3 EVALUATING DIRECT INVESTMENT PROJECTS

Once a firm has compiled a list of prospective investments, it uses capital budgeting techniques which have been explained earlier to you in the course MS-4, to select from among them that combination of projects that maximizes the firm's value to shareholders. The theoretical framework involved in evaluation of domestic projects is the same as for foreign projects and various considerations influencing choice of a project within the country are the, same as those for projects overseas. However, there are a host of factors which are unique to foreign investments that make cross border investment decisions complicated.

The basic steps involved in evaluation of a project are:

1. Determine net investment outlay;
2. Estimate net cash flows to be derived from the project over time, including an estimate of salvage value;

3. Identify the appropriate discount rate for determining the present value of the expected cash flows;

4. Apply NPV or IRR techniques to determine the acceptability or priority ranking of potential projects.

As stated earlier, the above evaluation process becomes complicated because of the factors peculiar to international operations.

Some of the factors unique to capital budgeting for MNCs are:

1. Conversion of cash flows from foreign projects into the currency of the parent firm;
2. Restrictions on full remittance of cash flows from foreign projects;
3. Exchange Rate fluctuations;
4. Application of different tax rates in the country of the project and in the parent's country;
5. Involvement of royalties and management fees;
6. Amenities and concessions granted by host country;
7. Benefits of international diversification to the shareholders of parent firm;
8. Lost exports;
9. Difficulty in estimating terminal value of foreign projects;
10. Differing rates of national inflation;
11. Knock-on effects of overseas investment projects on other operations elsewhere;
12. Political risk involved in foreign investment.

In view of the above, International finance manager encounters a number of complications in cross-border investment decisions. Overseas investment projects usually involve one or more foreign currencies, multiple tax rates and tax systems and foreign political risk. Overseas investment projects involve special problems, such as capital flow restrictions that do not allow the cash flows of projects to be remitted to the parent company. MNCs also face complexities because overseas investment projects have substantial knock-on-effects on other operations elsewhere within the group. For example, a foreign engineering company contemplating to setup a plant in Mexico may find that the proposed investment is likely to affect the operations of other units within the multinational group. This may occur partly through the new project's effect on sales of other parts of the group and partly through vertical integration. In case of knock-on-effects, the firm should consider all incremental cash flows accruing while appraising the project.

To make matters even more complicated, valuing an investment project in the local currency of the host country often provides different values from valuation in the parent's domestic country because the international parity conditions do not always hold.

19.4 INTERNATIONAL CAPITAL BUDGETING

Capital budgeting evaluates the investment decisions related to assets. The "capital" in capital budgeting refers to the investment of resources in assets, while the budgeting refers to the analysis and assessment of cash inflows and outflows related to the proposed capital investment over a specified period of time.

Objectives of capital budgeting is to

(1) determine whether or not a proposed capital investment will be a profitable one over the specified time period, and,

(2) to select between investment alternatives.

Capital budgeting at the international level addresses the issues related to (1) exchange rate fluctuations capital market segmentation,

(2) international financing arrangement of capital and related to cost of capital,

(3) international taxation,

(4) country risk or political risk etc.

19.4.1 PROCESS OF CAPITAL BUDGETING:

In capital budgeting process, main points to be borne in mind how much money will be needed of implementing immediate plans, how much money is available for its completion and how are the available funds going to be assigned to various capital projects under consideration. the financial policy and risk policy of the management should be clear in mind before proceeding to the capital budgeting process. The following procedure may be adopted in preparing capital budget.

1. Organization of investment proposal:

The first step in capital budgeting process is the conception of a profit making idea. The proposals may come from rank and file worker of any department or from any line officer. The department head collects all the proposals and reviews them in the light of financial and risk policies of the organization in or to send them to the capital expenditure planning committee for consideration.

2. Screening of proposals:

In large organizations, a capital expenditure planning committee is established for the screening of various proposals received by it from the heads of various departments and the line officers of the company. From the heads of various departments and the line officers of the company the committee screens the various proposals within the long-range policy-frame work of the organization. It is to be ascertained by the committee whether the proposals are within the criterion of the firm, or they do no lead to department imbalances or they are profitable.

3. Evaluation of projects:

The next step in capital budgeting process is to evaluate the different proposals in term of the cost of capital the expected returns from alternative investment opportunities and the life of the assets with any of the following evaluation techniques

Degree of urgency method (Accounting rate of return method)
Pay-back method
Discounted cash flow method

4. Establishing priorities:-

After proper screening of the proposals, uneconomic or unprofitable proposals are dropped. The profitable projects or in other words accepted projects are then put in priority. It facilitates their acquisition or construction according to the sources available and avoids unnecessary and costly delay and serious and cot-overruns. Generally, priority is fixed in the following order.

¨ Current and incomplete projects are given first priority.
¨ Safety projects and projects necessary to carry on the legislative requirements.
¨ Projects of maintaining the present efficiency of the firm
¨ Projects for supplementing the income
¨ Projects for the expansion of new product.

5. Final approval:

Proposals finally recommended by the committee are sent to the top management along with the detailed report, both of the capital expenditure and of the sources of funds to meet them. The management affirms its final seal to proposals taking in view the urgency, profitability of the projects and the available financial resources. Project are then sent to the budget committee for incorporating them in the capital budget.

6. Evaluation:-

Last but not the least important step in capital budgeting process is an evaluation of the program after it has been fully implemented. Budget proposals and the net investment in the projects are compared periodically and on the basis of such evaluation, the budget figures may be reviewer and presented in a more realistic way.

19.5 PROJECT EVALUATION CRITERIA

Capital budgeting decision is made under different criteria. How are these criteria determined? These criteria differ in concepts. Some use thumb rules and some use logic and scientific approach. So based on these criteria, the methods of capital budgeting can be classified as

1. Traditional methods
   a. Payback Period
   b. Accounting Rate of Return

2. Discounted cash flow methods or modern methods
   a. Internal Rate of Return (IRR)
   b. Net Present Value (NPV)
   c. Profitability Index (PI)

19.6 ACCOUNTING RATE OF RETURN (ARR)

Accounting rate of return refers to the ratio of annual profits after taxes to the average investment. The average investment equal to half of the original investment. According rate of return is also called average rate of return.

$$ARR = \frac{\text{Average income}}{\text{Average investment}}$$

Where the average investment is half of the outlay. Average capital employed is calculated to the usual accounting convention that the original investment gets exhausted steadily to zero over the life of the project.

It is assumed that the asset is depreciated as per straight line method usually it is expressed in terms of percentage. The higher the ARR is the better is the profitability and hence the projects with higher accounting rate of return are short listed for implementation.

19.6.1 ADVANTAGES

1) It is easy to understand and calculate.
2) It can be compared with the cut-off point of return and hence the decision to accept or reject is made easier.
3) It considers all the cash inflows during the life of the projects, not like payback method.
4) It is a reliable measure because it considers net earnings after depreciation interest and taxes.

19.6.2 DISADVANTAGES

1. The concept of time value of money is ignored.

2. Unless we have a cut-off point of return, accounting rate of return cannot be meaningful and effective.
3. The average concept is not reliable particularly in terms of high or wild fluctuations in the returns.
4. The average concept dilutes the profitability of the project.

To understand this measure of return, we will use a numerical example.

Table 19.6.2

EXHIBIT 2-5 **Net Income Calculating an Average Accounting Rate of Return ($)**

	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	100,000	150,000	240,000	130,000	80,000
Cash expenses	50,000	70,000	120,000	60,000	50,000
Depreciation	40,000	40,000	40,000	40,000	40,000
Earnings before taxes	10,000	40,000	80,000	30,000	-10,000
Taxes (at 40%)	4,000	16,000	32,000	12,000	-4,000*
Net income	6,000	24,000	48,000	18,000	-6,000

*Negative taxes occur in Year 5 because the earnings before taxes of –$10,000 can be deducted against earnings on other projects, thus reducing the tax bill by $4,000.

Assume a company invests $ 200,000 in a project that is depreciated straight - line over a five - year life to a 0 salvage value. Sales revenues and cash operating expenses for each year are as shown in Exhibit 2 - 5 . The table also shows the annual income taxes (at a 40 percent tax rate) and the net income.

For the five - year period, the average net income is $ 18,000. The initial book value is $ 200,000, declining by $ 40,000 per year until the final book value is $ 0. The average book value for this asset is ($ 200,000 – $ 0)/2 $ 100,000. The average accounting rate of return is

$$AAR = \frac{\text{Average net income}}{\text{Average book value}} = 18000/100000 = 18\%$$

The advantages of the AAR are that it is easy to understand and easy to calculate. The AAR has some important disadvantages, however. Unlike the other capital budgeting criteria discussed here, the AAR is based on accounting numbers, not on cash fl ows. This is an important conceptual and practical limitation. The AAR also does not account for the time value of money, and there is no conceptually sound cut-off for the AAR that distinguishes between profitable and unprofitable investments. The AAR is frequently calculated in different ways, so the analyst should verify the formula behind any AAR numbers that are supplied by someone else. Analysts should know the AAR and its potential limitations in practice, but they should rely on more economically sound methods like the NPV and IRR.

19.7 NET PRESENT VALUE (NPV)

Net present value refers to the excess of present value of future cash inflows over and above the cost of original investment.

NPV=(PVcFAT) MINUS (PVc)
Where

PVcFAT refers to the present value of cash flows after taxes.

PVc refers to the present value of original investment or capital The concept of NPV is a logical extension to the concept of present value. Here the decision is based on the size of net present value. The projects with higher NPV S are selected. If the NPV is negative, that means the projects is not profitable. In other words, the NPV should always be positive and should be maximum. The present value factor tables are used here to determine the present value of the future cash inflows.

HOW IS NPV CALCULATED?

The following are the stages in the determination of NPV

1) From the PV factor table, identify the PV factors of Re 1 for the given discount rate.

2) Multiply the cash flows with the corresponding PV factor to find the product DCF=(PV)*(CFAT)

3) Find the sum of products.

4) If the sum is positive, that means the project is profitable. In case of projects with different NPV S choose the project with higher NPV because the higher the NPV, the higher is the profitability.

ACCEPTANCE RULE

According to NPV method the project should be accepted, if the NPV is positive or equal to zero. If the NPV is negative the project should be rejected.

NPV>1 which means that the project earns more than the discount rate.

NPV =1 which means that the project earns the same as the discount rate.

NPV <1 which means that the project earns less than the discount rate

19.7.1 ADVANTAGES

1. since the PV factor tables are available determination of NPV is relatively easier. It is easy to understand.

2. The goal of the financial management is wealth maximization and this method enables the finance manager to pursue this goal.

3. It is based on the concept of time value and considers the total earnings and expenses of the project.

4. NPV is a superior technique to IRR in case of mutually exclusive proposals.

5. Each project can individually be evaluated.

19.7.2 DISADVANTAGES

1. It is difficult to determine the appropriate discount rate.
2. The calculations are easier when compared to IRR, but is beyond the comprehension of a common businessman
3. It does not indicate the cost of capital.
4. Where projects differ in their duration and their cash flows, this method cannot be used. (It is her profitability index is used)

19.8 PROFITABILITY INDEX (PI)

Profitability Index is a capital budgeting tool used to rank projects based on their profitability. It is calculated by dividing the present value of all cash inflows by the initial investment. Projects with higher profitability index are better.

Where the projects differ in their duration and the cash flows these can be compared based on the profitability index.

INTERPRETATIONS :

If the profitability index is less than one reject the proposal.

If the profitability index is equal to one, the proposal is just break eve.

If the profitability is more than one accept the proposal.

The higher the index, the more profitable the proposal is
Formula
Profitability index can be computed using the following formula:

$$\text{Profitability Index} = \frac{\text{Present Value of Cash Flows}}{\text{Initial Investment}}$$

Since NPV equals the present value of cash flows minus initial investment, we can write the present value of future value as the sum of net present value and initial investment:

$$\text{Profitability Index} = \frac{\text{Initial Investment} + \text{Net Present Value}}{\text{Initial Investment}}$$

This gives us another formula for profitability index:

$$\text{Profitability Index} = 1 + \frac{\text{Net Present Value}}{\text{Initial Investment}}$$

Example
Your company has $100 million available for investment in the following potential investment opportunities:
Project NPV Initial Investment

Project	NPV	Initial Investment
A	$5 million	$15 million
B	$15 million	$50 million
C	$10 million	$10 million
D	$20 million	$60 million
E	$12 million	$35 million

Rank the projects based on profitability and identify the projects that should be accepted keeping in view the company's capital budget constraints.

Solution
Let's first find profitability indices of each project:
Project Profitability Index

Project	Profitability Index	
A	1 + 5/15	= 1.33
B	1 + 15/50	= 1.30
C	1 + 10/10	= 2.00
D	1 + 20/60	= 1.33
E	1 + 12/35	= 1.34

The ranking based on profitability index is: Project C, Project E, Project A and D and Project B. Now, we need to maximize total net present value that can be achieved using $100 million investment by applying the concept of capital rationing capital rationing.

19.8.1 ADVANTAGES

1. It is easy to calculate given the present values of cash flows.

2. Projects of different magnitude in terms of duration and cash flows can be short listed based on their profit is recommended for use particularly when there is shortage of funds because it correctly ranks the proposal.

19.9 INTERNAL RATE OF RETURN (IRR)

Internal rate of return is that rate of return at which the present value of expected cash flows of a project exactly equals the original investment. In other words, it equals the present value of a given project with its outlay. This is the cut –off point at which the income equals the expenditure or the investment breaks even.

At IRR, the net present value of a project is zero. The net present value refers to the excess of the present value of the future cash flows over and above the original investment.

EVALUATON OF IRR:

The internal rate of return is compared with the cost of the capital. If the IRR is more than the cost of the capital the project is profitable otherwise it is not where there are two projects with different IRR S select the project with higher IRR.

19.9.1 ADVANTAGES

1. IRR is based on the time value of money.
2. It is based on the earnings of all the years of the project.
3. It is a valuable tool to compare the projects with different cash flows and different life span.
4. It is independent of cost of capital.
5. Such projects with higher IRR are recommended.

Hence it directly contributes to the "wealth maximization goal" of the finance manager.

19.9.2 DISADVANTAGES

1. It is difficult to understand and tedious to calculate IRR by even trial and error.
2. It is based on certain assumptions one of which is that the intermediate cash flows are reinvested at IRR. This assumption may not hold good.
3. There could be cases of non-conventional projects with multiple IRR S which are difficult to understand.
4. There are cases where higher IRR does not necessarily contribute to wealth maximization.

19.10 SUMMARY

Although the original decision to undertake an investment in a particular foreign country may be the outcome of combination of strategic, behavioural and economic considerations, choice of a specific project within a particular product-market posture calls for evaluation of its economic feasibility. For this purpose, capital budgeting exercise has to be done. A firm should deploy funds in a project if the marginal revenue obtained there from exceeds the marginal cost. For an MNC, capital budgeting involves economic analysis of the firm's direct investment opportunities. Whatever be the motive for Direct Foreign Investment (DFI), an MNC's very survival and sustainable competitive position depends on its ability to identify and choose the most profitable investment opportunity. Capital budgeting technique provides the mechanism to identify opportunities and evaluate their economic viability. This is why MNCs evaluate international projects by using capital budgeting techniques. Proper use of capital budgeting techniques can help the firm in identifying the international projects worthy of implementation from those that are not.

19.11 GLOSSARY

1. International Capital Budgeting:

Capital budgeting evaluates the investment decisions related to assets. The "capital" in capital budgeting refers to the investment of resources in assets, while the budgeting refers to the analysis and assessment of cash inflows and outflows related to the proposed capital investment over a specified period of time.

2. Profitability Index:

Profitability Index is a capital budgeting tool used to rank projects based on their profitability. It is calculated by dividing the present value of all cash inflows by the initial investment. Projects with higher profitability index are better.

3. INTERNAL RATE OF RETURN :

Internal rate of return is that rate of return at which the present value of expected cash flows of a project exactly equals the original investment. In other words, it equals the present value of a given project with its outlay. This is the cut –off point at which the income equals the expenditure or the investment breaks even.

19.12 SELF ASSESSMENT

Q1. What do you understand by Capital budgeting ?

Ans.____

Q2. What are the discounted techniques of capital budgeting ?

Ans.____

Q3. Write a short note on:

a) Net present value method

Ans.____

b) Internal rate of return

Ans.

c) Profitability index

Ans.

19.13 LESSON END EXERCISE

Q1. What are the methods of capital budgeting ?

Q2. Differentiate between Discounted and non-discounted techniques of capital budgeting?

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COUNTRY RISK ANALYSIS

Unit - IV | **Lesson No. 20**

C.No. M.COM-FC 412 | **SEM : Fourth**

STRUCTURE

20.1 INTRODUCTION

International financial management is influenced by the political systems existing in different countries. Since multinational activities are operated in different parts of the globe, the impact of political, economic, social and cultural systems can not be denied. The investment decisions are affected by the political set up of a particular country causing political and country specific risk. Regulatory, taxation, economic and financial environments are the outcome of political behaviour of any country. Trade policies, exchange rate policies, monetary policies, fiscal policies of a particular country have a bearing on investment, capital budgeting, working capital decisions of a foreign firm operating as an MNC. It would be beneficial to understand the risk arising out of political and country specific conditions.

20.2 OBJECTIVES

After reading this lesson student will be able to:

- Understand and measure political risk and country risk involved in investment decisions at multinational levels;
- Know various factors having bearing on political/country risk; and
- Explain various approaches to political risk management.

20.3 COUNTRY RISK

Country risk includes the adverse political and economic risks of operating in a country. For example, a recession in a country, which reduces the revenues of exporters to that nation is a realization of country risk. Labour strikes by a country's dockworkers, truckers, and transit workers that disrupt production and distribution of products, thus lowering profits, also qualify as country risks. Clashes between rival ethnic or religious groups that prevent people in a country from conducting business activities can also be considered country risks.

Country risk is a broader concept than political risk or sovereign risk. Country risk involves the possibility of losses due to country specific economic, political or social events or because of company specific characteristics, therefore all political risks are country risk but all country risks are not political risks. Sovereign risks involve the possibility of losses on private claims as well as on direct investment. Sovereign risk is important to banks where as country risk important to MNCs. Sovereign risk is a subcomponent of country risk. Country Risk includes a variety of factors ranging from government's confiscation of a firm's assets to government's encouragement of a negative attitude towards foreign business. In other words, political risk can be defined as the possibility of unwanted consequences of political activity.

Country risk also affects investors who buy emerging market securities and the banks that lend to countries. In international bond markets, country risk refers to any factor related to a country that can cause a borrower in that country to default on a loan. The narrower risk associated with a government defaulting on its bond payments is called sovereign risk. Usually, the abilities of a private firm and its government to pay off international debt are highly correlated.

20.3.1 POLITICAL RISK

Political risk indicates the commencement of risk arises due to change in the governing body of a country and therefore poses a risk to the investors who have investments in financial instruments like debt funds, mutual funds, equity, etc. Specific terms like corruption, terrorism, etc., related to the politics of a country may arise due to change in a political scenario, which further might result in a change in the regulations of the nation.

Political risk can also be termed as geopolitical risks that arise due to conflict between two countries. There can be hindrance across the businesses and finally slash the confidence level of the investors.

This risk may arise at any level, such as the national level, federal level, state level, etc. Thus, based on the scenarios, political risks can be divided into two types, such as macro risks and micro risks.

A. Macro Risks

By macro risk we mean, risks affecting all the multinational firms alike. The major macro risks are:

(a) Forced Disinvestment
(b) Unwelcomed Regulations
(c) Interface with Operations, and
(d) Social Strife

(a) Forced Disinvestment:

Governments may, as a matter of political philosophy, force firms to disinvest. Forced disinvestment may take place for variety of reasons such as: (a) that the government believes that it may make better utilization resources, (b) it feels that such a take over may improve the image of the government, (c) government wants to control these resources for strategic or developmental reasons. The best example of forced disinvestment is the takeover of oil exploration and oil producing industry. In most of the countries, this industry was started by private entrepreneurs which later on was nationalised.

The forced disinvestments are legal under international law as long as it is accompanied by adequate compensations. Such a takeover does not involve the risk of total loss of assets, however, some times the compensation provided by the government may not match the expectations of company taken over by the governments. Forced disinvestments are practiced in following two forms: Takeovers/Nationalisation: Usually takeovers and nationalisation are done as a matter of political philosophy. While doing so, a general policy of takeover or nationalisation is announced with a package of compensation.

The company owners are asked to withdraw from the management for announced compensation which usually does not match with the expectation of the owners of company. Takeovers and nationalisations are usually done when the ideological base of the 4 government changes from right or centrist to socialist or to communist ideology. Confiscation/ Expropriation with or without Compensation: This is another form of forced disinvestment. In this the government expropriates legal title to property or the stream of income the company generates. Governments may also constrain the property owners in the way they use their property. Confiscation may be with a minimal compensation or even without compensation. This step may be taken by governments because of political rivalry among nations or because of idealistic shift in government's political philosophy.

(b) Unwelcomed Regulation:

The purpose of these regulations is to reduce profitability of MNC's. These regulations may relate to the tax laws, ownership, management, repatriation "of profits, re-investment, limitations on employment and location. Generally government regulates MNC's activities to increase revenue and to encourage a particular aspect of development. In doing so, the government may become liberal towards MNCs for some investments for some time and as soon as the objective is served, the returns from the project may drop due to unwe1comed regulations.

(c) Interface with Operations:

Interface with operations refer to any government activity that makes it difficult for business to operate effectively. This risk includes such things as government's encouragement of unionisation, government's expression of negative comments -about foreigners and discriminatory government support to locally owned and operated business.

The governments generally engage in these kinds of activities when they believe that a foreign company's operation could be detrimental to local development or would harm the political interest of the government. The political risk due to government interface with the business is difficult to assess and manage because the actions are usually done in a subtle way.

In contrast, forced disinvestment and unwe1comed regulations have identifiable and immediate impact on foreign business but the interface with the operations may be less obvious and the effects are unclear. One important thing to note is that interference of the governments in operation of the business is an important political risk and should not be ignored. Some times its ignorance may lead to huge losses even if the feasibility studies reflect profits from the operations.

(d) Social Strife:

In any country there may be social strife arising due to ethnic, racial, religious, tribal or civil tensions or natural calamities such as drought, etc. may cause economic dislocation. Social strife means general breakdown of government machinery leading to economic disturbances giving rise to political risk.

B. Micro Risks

Micro risks are firm specific and affect every firm differently. The micro risks are:

a) Goal conflicts with economic policies, and

b) Corruption and bureaucratic delays

a) Goal Conflicts with Economic Policy

Conflicts between objectives of multinational firms and host governments have risen over such issues as the firm's impact on economic development, perceived infringement on national sovereignty, foreign control of key industries, sharing of ownership and control with local interests, impact on host country's balance of payment, influence on the exchange rate and control over export market, and of domestic versus foreign executives.

The economic policies of the government are geared to achieve sustainable rate of growth in per capita, gross national product, full employment, price stability external balance and fair distribution of income. The policies through which these objectives are to be achieved are as follows:

• Monetary Policies
• Fiscal Policies
• Trade Policies and Economic controls
• Balance of Payment and Exchange Rate Policy
• Economic Development Policies Each of these policies may conflict with the goals of MNCs. These conflicts are discussed below.

Monetary policies and goal conflicts: Through monetary policy, government wants to control the cost and availability of domestic credit and long term capital as a means of achieving the national economic priorities. The multinational corporation can circumvent the policy by turning to the parent. If credit flow is restricted and it has become costlier, the MNC can implement its spending plans with the help of parent but local competitors face the crunch thus changing the competitive position of the domestic companies. National policy is thus frustrated when large amounts of foreign currency is changed into domestic currency for buy-outs or for speculative purposes.

Fiscal policies and the goal conflicts: To attract FDI the government commits tax concession and some times even provide subsidies. After some time when the government wants to achieve revenue targets, because of the commitments the MNCs are insulated, therefore the achievement falls short of targets.

Trade policies and economic protectionism: Nationalistic economic policies are often made to protect domestic industry. To protect domestic industry from competition tariff and non-tariff barriers are used. Although, negotiations under GATT have reduced level of tariff barriers, but nontariff barriers remain. Non-tariff barriers restrict imports by some procedure other than direct financial costs. These barriers are difficult to identify because these barriers may be in the name of ecological balance, health, safety, quality and other social clauses and security. In Uruguay Round, the removal of non-tariff barriers was the main issue. Balance of payment problems: Repatriation by MNCs put pressure on the much needed foreign exchange resources. The outflow is in the form of dividend, management fees, royalty, etc. which puts pressure on balance of payment. This makes the balance of payment situation more bad, therefore the governments are forced to regulate the activities of MNC.

Economic policies and goal conflicts: Infant industry argument or old industry arguments are sometimes advanced as valid arguments for protective tariffs or restrictions on foreign investments, even though many industries are protected long after they have matured. India, Mexico, Brazil and Argentina induct indigenisation clauses in the agreements with MNCs. Other clauses, such as, ownership component or a clause asking a minimum percentage of local manufacture, are also inducted in agreements.

b) Corruption and Bureaucratic Delays

Political corruption and blackmail contribute to the risk. Corruption is endemic to developing countries. If these bribes are not paid, either the projects are not cleared or delayed through bureaucratic system to make the project infructuous. Delay in clearing the project costs the company and the nation alike.

20.3.2 SOCIAL RISK

Social risk for a business includes actions that affect the communities around them. Examples include labor issues, human rights violations within the workforce, and corruption by company officials. Public health issues can also be a concern as they can impact absenteeism and worker morale.

Political uncertainty can be a social risk if the company doesn't have a good understanding of the local power structure and who the power brokers are. Land use is another politically related stumbling block. For example, a business trying to open a new location can run into zoning issues with the local community planning board.

Companies that have problems with social risk face political backlash, public outcry, and a damaged legal standing and may not be sustainable in the long term.

The socio-cultural environment is important for multinational companies. There are various socio-cultural factors that significantly affect the economic activity as well as the performance of multinational companies. The key socio-cultural factors that have a major impact on the operation of the multinational companies are):

1. Culture
2. Language
3. Religion
4. Level of education

5. Customer preferences

1. Culture

There are many definitions of culture. culture is defined as „shared motives values, beliefs, identities, and interpretations or meaning of significant events that result from common experiences of members of collectives and are transmitted across age generations". In general, culture is considered as the accepted behaviors, customs, and values of a given society. Many components can be considered as elements of culture. These elements arise and are related to the beliefs and behavior of people. Form multinational companies' perspective, a culture of every foreign country through its elements affects their business activities.

Òhe main elements of culture that may have an impact on the operation of multinational companies are

1. Attitude and beliefs – In every host country, there are norms of behavior based on attitudes and beliefs that constitute a part of its culture. The attitudes and beliefs vary from country to country. Multinational companies face a different set of attitudes and beliefs of a culture in each foreign country separately, and it influences all aspects of human behavior, providing organization and directions to a society and its individuals. Identifying the difference in attitudes and beliefs among various countries helps the multinational managers more easily understand people's behavior.
2. Attitude toward time – It refers to people's behavior about punctuality, responses to business communication, responses to deadlines and the amount of time that they spent waiting for an appointment. For instance, Americans are known to be punctual and the phrase time is money exactly explains their attitude towards time. In contrast, people from other countries may show more flexibility towards time. Analogically, multinationals operating in various countries should take into consideration these differences in attitudes towards time.
3. Attitude toward work and leisure – There are differences in attitude towards work and leisure among various countries. In some countries, people work much more hours than is necessary to satisfy their basic needs of living. This attitude is indicative of their views towards wealth and material gains.
4. Attitude toward achievement – Cultural diversity in the general attitudes towards work is related to people's achievement motivation.

5) Attitude toward change – Multinational companies should anticipate a difference in attitudes toward change between separate countries. They should take into consideration some key cultural issues, such what aspects of a culture resist change, how the process of change takes place in different foreign countries, how the areas of resistance differ among them, and how long it takes time for implementing same change.

6) Attitude toward job – The importance of certain profession in country significantly determinate a number and quality of people who want and seek to join that profession. Consequently, if the business is considered as a prestigious occupation in some country, multinational companies will have at their disposal broader pool of local professionals.

2. Language

The diversity of language among various foreign countries is a source of many challenges for multinational companies. Although there is a tendency of accepting the English language as a universal business language, the companies are aware that it also provokes resistance by locals in many of countries where they operate. Table 1 highlights the most common languages in the world. Business communication is further complicated by the nonverbal components of the language. Nonverbal communication creates difficulties for multinational companies due of various meanings of its elements in the separate countries, such as eye contact, facial expressions, gestures, etc. (nonvocal elements of speaking) and pitch, volume, speaking rate, etc.

From the perspective of the multinational company, it is very notable to have good knowledge of the local language. The lack of knowledge of a local language is reflected on the performance of foreign subsidiaries and their managers. The languages difficulties can be reduced by appointing expatriates on the top managerial positions in the local subsidiary or nationals that have good knowledge of parent company's language and corporate culture.

The most common problem is that a large proportion of the parent company's staff has limited or no knowledge of local language and that contributes the parent-subsidiary communication to be reduced to subsidiary's staff who knows the parent's language or to the translators. Consequently, the volume of information that parent company's staff receives and processes are significantly decreased. This problem is significantly enhanced if several languages are spoken by the local workforce.

The presence of more than one language in a given country is an indicator of diversity in its population. In some European countries, such as German, which employ a large number of guest workers, the language difficulties increase from the linguistic variety. In German, for instance, many companies employ guest workers from Turkey and Spain. Consequently, the periodic meetings with workers are held in German, Turkish and Spanish.

3. Religion

Religion is considered as "a socially shared set of beliefs, ideas, and actions that relate to a reality that cannot be verified empirically yet affects the course of natural and human events-a way of life woven around people's ultimate concerns".

The largest religion groupings in the world are Christianity and Islam Christianity numbers about 2.1 billion followers or approximately 33% of the world's population. On another hand, Islam is considered as the world's second most practiced religion with 1.3 billion followers or about 21% of the world's population.

In many countries around the world, religion plays a significant role in people's life. Religion even determines the way people think of work. Consequently, religion considerably affects on business activity and corporate culture. Many companies adapt their working process according to a predominant religion of a given country in terms of the holidays, working hours, food habits, a way of dressing, etc. From the perspective of the multinational company, religion is an important social factor that should take in consideration when some company decides to operate in a given country. Religion, through its effects on people, affects a multinational company and its operations. Multinational companies, for instance, should be aware of religious holidays in each country where they operate. The most of the Islamic countries have significantly lower productivity during the month of the Ramadan fast. Likewise, the pace of work in many Asian countries is slow down during the celebrations of the Chinese New Year. The situation is similar during the Easter holidays in many European countries as well.

4. Level of Education

Education significantly affects the lifestyle of a population of any country in the world, the way of their thinking, their attitude toward work, etc. The level of education varies among countries. However, in many countries, the level of education has a tendency to increase. Education level and level of literacy of population of a given country are indicators of the quality of their potential workforce. Economic potential and progress of any country depend on the education of its population. Analogously, education has notably impact on international business. The most significant economic implications of education that are reflected on the operation of multinational companies are

1. Countries with a well-educated population attract high-wage industries. Every country that invests in education tends to create high-wage industries that are known as "brain power" industries;
2. The market potential of any country primarily depends on education. The counties rich in educational facilities, such Germany and England, are more likely to attract high-tech industries than the less educated countries such as Romania and Poland. The technology level of the company's products may depend on the education level of the local population;
3. The level of education and the level of literacy of population in a given country considerable determine the way of marketing research, packaging and advertising conducted by multinational companies.

In a country where the level of education of local population is higher, it is considered that expectations from multinational companies are proportionally higher. Buyers with a higher level of education require more quality products and services, a better price-quality ratio (a better VALUE-for-MONEY RATIO) and know their right as customers. Also, well-educated local workforce requires better working conditions, more stable work, and greater opportunities for further improvement as the business environment changes.

5. Customer References

The needs and tastes of consumers in various countries are significantly becoming similar. According to some experts, this social trend is known as "global convergence". As a result of the spread of global communication and facilitated travel opportunities, certain social behaviors are getting similar globally. Today, people around the world watch same movies, listen to the same music, play the same video games and use the same Internet websites. Consequently, the needs, tastes, and habits become identical on a global level. The global convergence is most present among the younger population. Therefore, many multinational companies with global strategy offer same or very similar products in many various countries. As result, global market convergence is created whereby the world is considered as a global market of same products and services.

20.3.3 Economic Risk

Economic risk is referred to as the risk exposure of an investment made in a foreign country due to changes in the business conditions or adverse effect of macroeconomic factors like government policies or collapse of the current government and significant swing in the exchange rates.

Types of Economic Risk

Many factors can be a cause of economic risk, although the chances mentioned below are not an exhaustive one. The following are types of Financial Risk.

1. Sovereign Risk

This type of economic risk is one of the most critical risks that can have a direct impact on the investment since the repercussions arising out of these risks can trigger other troubles that are related to the business. Sovereign Risk is the risk that a government cannot repay its debt and default on its payments. When a government becomes bankrupt, it directly impacts the businesses in the country. Sovereign Risk is not limited to a government defaulting but also includes the political unrest and change in the policies made by the government. A change in government policies can impact the exchange rate, which might affect the business transactions, resulting in a loss where the business was supposed to make a profit.

2. Unexpected Swing in Exchange Rate

This type of sovereign risk is the risk if the market moves drastically to impact the exchange rate. When the market moves considerably, it affects international trade. This can be due to speculation or the news that can cause a fall in demand for a particular product or currency. Oil prices can significantly impact the market movement of other traded products. As mentioned above, government policies can also result in a dip or hike in the market movement. Change in inflation, interest rates, import-export duties, and taxes also impact the exchange rate. Since this directly impacts trade, exchange rates risk seeming to be a significant economic risk.

3. Credit Risk

This type of sovereign risk is the risk that the counterparty will default in making the obligation it owes. Credit risk is entirely out of control since it depends on another entity's worthiness to pay its debts. The counterparty's business activities need to be monitored on a timely basis so that the business transactions are closed at the right time without the risk of counterparty default to make it payments.

20.4 REACTION TO RISKS

The political risk index tries to incorporate all these economic, geographical and social aspects, so that political risk may be indicated in a concise manner. These indices measure over all business climate of a country.

On the basis of the above type of analysis, BERI (Business Environment Risk Information) categorises nations in four categories as per four level, of risk perceptions: (i) low risk countries, (ii) medium risk countries, (iii) high risk countries, and (iv) prohibitive risk countries.

Capital Flight and Political Risk: Some of the finance consultants believe that Capital flight is one good indicator of the degree of political risk. By capital flight we mean the export of savings by a nation's citizens because of the fears about the safety of their capital. It is very difficult to measure capital flight accurately because it is not completely observable. Apparently one can use the item errors and omissions on the balance of payment to assess the extent of capital flight. Capital flight occur for several reasons. These reasons are:

Government Regulations and Controls: Some times governments try to control and regulate the use of savings to channelise the resources to a particular sector. In this case, government enacts the rules for using capital. The return on investment is fixed by the government.

Taxes: If the government imposes heavy taxes on returns from investment the net return, becomes low. The capital flight occur in search of better returns.

Low Returns: If the economy itself is providing low returns, the capital flight would occur.

High Inflation: The countries having high inflation also face capital flight, because domestic hedging against inflation becomes difficult therefore the citizens try to hedge through a foreign currency which is less likely to depreciate.

Political Instability: Perhaps the most powerful motivation to capital flight comes from political instability because no one is sure about the return on investment.

Econometric Modeling: Econometric modeling can also be used to assess the- sovereign [political) risk. This type of risk is being assessed by banks to assess the capacity of the Government to repay the loans without default. Basically econometric modeling requires quantification of the variables discussed above. If the subjective variables are quantified on different scales, then econometric modeling is done as follows:

Suppose yt refers to a particular level of risk measured as an index given economic, geographical and social variables then we can write:

$$yt = a + bX1 + cX2 + dX3 + et$$

Where Xl is the variable capturing economic factors, X2 is a variable capturing geographical factors and X3 is the variable that captures sociological factors. In this equation, 'e' is error term following normal distribution with zero mean and constant variance, 'a' is the intercept of the regression line indicating the minimum level of political risk that will exist in the absence to other factors, and 'b', 'c' and 'd' are slope parameters which provide the sensitivity of political risk index to the economic, geographical and sociological factors.' With the help of above equation we can identify a critical level above which if the index climbs, the country may be referred as having political risk.

Delphi Method: The Delphi Method involves the collection of independent opinions on country risk from various experts without group discussion. The MNC can average these country risk scores and assess the degree of disagreement by measuring dispersion of opinions.

Risk Rating Matrix: An MNC may evaluate country risk for several countries to determine location of investment. One approach to compare political and financial ratings among countries, advocated by some foreign risk managers is called foreign investment risk matrix, which shows the financial risk intervals ranging across the matrix from acceptable to unacceptable. It also shows political risk by interval ranging from stable to unstable. The matrix is based on ratings provided by rating agencies.

20.5 NEED FOR RISK EVALUATION

Risk evaluation is about doing simple things, but doing them continuously, systematically and early enough. Risk evaluation should be done in different levels in the company, starting from enterprise risk evaluation into project risk management. Very basic risk evaluation process phases and simple tools can be used to manage risks in international business, by stretching the scope of the actions and using suitable tools for the situation. Risk evaluation process definitions typically include 6 phases: identifying risks, assessing risks, prioritizing them, planning activities for mitigating or avoiding risks, implementing actions and following up the status.

The First phase, identifying the risks is the most important step. You cannot manage risk without identifying it. The Identification of risks is not a one-time action. It needs to be done continuously and by large representation of the personnel. Risk identification should be a normal part of regular meetings (e.g. project meetings), and the personnel should be motivated to identify and raise the risk level. The more risks are talked about, the more people become aware of them, and the more they are able to identify new risks. In this phase, information gathering techniques like brainstorming, interviews, expert evaluations and further analysis with tools like SWOT, root cause analysis or different diagramming techniques are very useful.

In the Next phase, the identified risks need to be assessed. The definition of risk includes the components of probability and impacts. When assessing the risk, both components need to be analyzed. As environment changes, the impacts and probabilities of risk also change. Therefore, this is an activity that needs to be done continuously. Different assessment- or simulation tools can be used in the assessment here, but also for example expert evaluation or interviews give good facts for assessment. After the assessment, risks should be prioritized so that the resources are allocated towards the most important risks. One very simple and useful tool for risk prioritisation is risk matrix that combines both probability and impact of the risk.

After these phases, the most dangerous risks would be known and it is then time to make mitigation plan. An effective mitigation plan includes; who owns of the risk, clear description of the actions and the people responsible for them, and the schedule for implementing the actions. The plan is followed up in regular meetings, and the results are monitored. If the actions implemented are not effective as anticipated not taken into, further actions will need to be defined. In an ideal situation, the risk will be eliminated or decreased so that it is dropped from list of most important risks after the actions are implemented.

For successful implementation of these risk evaluation process phases, company needs to build a risk management culture where employees, managers and stakeholders are aware of the value risk management brings to the company and its projects. When risk management is part of the normal working culture, the company is stronger against risks and their impacts.

20.6 INTERNATIONAL TAXATION

International taxation is the study or determination of tax on a person or business subject to the tax laws of different countries or the international aspects of an individual country's tax laws as the case may be. Governments usually limit the scope of their income taxation in some manner territorially or provide for offsets to taxation relating to extraterritorial income. The manner of limitation generally takes the form of a territorial, residence-based, or exclusionary system. Some governments have attempted to mitigate the differing limitations of each of these three broad systems by enacting a hybrid system with characteristics of two or more.

20.7 DOUBLE TAXATION AVOIDANCE AGREEMENT (DTAA)

The Double Taxation Avoidance Agreement (DTAA) is essentially a bilateral agreement entered into between two countries. The basic objective is to promote and foster economic trade and investment between two Countries by avoiding double taxation.

Objective of tax treaties:

International double taxation has adverse effects on the trade and services and on movement of capital and people. Taxation of the same income by two or more countries would constitute a prohibitive burden on the tax-payer. The domestic laws of most countries, including India, mitigate this difficulty by affording unilateral relief in respect of such doubly taxed income (Section 91 of the Income Tax Act). But as this is not a satisfactory solution in view of the divergence in the rules for determining sources of income in various countries, the tax treaties try to remove tax obstacles that inhibit trade and services and movement of capital and persons between the countries concerned. It helps in improving the general investment climate.

The double tax treaties (also called **Double Taxation Avoidance Agreements** or "DTAA") are negotiated under public international law and governed by the principles laid down under the Vienna Convention on the Law of Treaties.

Need for DTAA

The need for Agreement for Double Tax Avoidance arises because of conflicting rules in two different countries regarding chargeability of income based on receipt and accrual, residential status etc. As there is no clear definition of income and taxability thereof, which is accepted internationally, an income may become liable to tax in two countries.

In such a case, the two countries have an Agreement for Double Tax Avoidance, in which case the possibilities are:

1. The income is taxed only in one country.
2. The income is exempt in both countries.
3. The income is taxed in both countries, but credit for tax paid in one country is given against tax payable in the other country.

In India, The Central Government, acting under Section 90 of the Income Tax Act, has been authorized to enter into double tax avoidance agreements (hereinafter referred to as tax treaties) with other countries.

Types of DTAA

DTAA can be of two types.

i. Comprehensive.

ii. Limited or

Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention. Many a time a treaty covers wealth tax, gift tax, surtax. Etc. too. Limited DTAAs are those which are limited to certain types of incomes only, e.g. DTAA between India and Pakistan is limited to shipping and aircraft profits only.

Role of tax treaties in international tax planning

A tax treaty plays the following role:

1. Facilitates investment and trade flow, preventing discrimination between tax payers;
2. Adds fiscal certainty to cross border operations;
3. Prevents international evasion and avoidance of tax;
4. Facilitates collection of international tax;
5. Contributes attainment of international development goal, and
6. Avoids double taxation of income by allocating taxing rights between the source country where income arises and the country of residence of the recipient; thereby promoting cooperation between or amongst States in carrying out their obligations and guaranteeing the stability of tax burden.

Choice of Beneficial Provisions under DTAA/Tax laws

The Provisions of DTAA override the general provisions of taxing statute of a particular country. It is now well settled that in India the provisions of the DTAA override the provisions of the domestic statute. Moreover, with the insertion of Sec.90 (2) in the Indian Income Tax Act, it is clear that assessee have an option of choosing to be governed either by the provisions of particular DTAA or the provisions of the Income Tax Act, whichever are more beneficial.

For example under DTAA between Indian and Germany, tax on interest is specified @ 10% whereas under Income Tax Act it is 20%. Hence, one can follow DTAA and pay tax @ 10%. Further if Income tax Act itself does not levy any tax on some income then Tax Treaty has no power to levy any tax on such income. Section 90(2) of the Income Tax Act recognizes this principle.

How to apply for DTAA ?

The process of operation of a double taxation convention can be divided into a series of steps, involving the different types of provisions.

1. Determine if the issue is within the scope of the convention:

This involves determining firstly whether the taxpayer is within the personal scope in Article 1- that is, “persons who are residents of one or both Contracting States”. This may involve confirming that the taxpayer is a “person” within in the definition of Article 3(1) (a); it will involve confirming that the taxpayer is resident of a Contracting State according to Article 4(1).

2. Check that the treaty applies to the tax in issue- is it a tax listed in Article 2 (or a tax substantially similar to such a tax).

3. Thirdly, check that the treaty is in operation for the taxable period in issue – that the treaty is in force (Article 29) and has not been terminated (Article 30).

4. Apply the relevant definitions: At this stage the relevant definition provisions (if any) can be applied. Thus, for example, if the taxpayer is a resident of both Contracting States, the tiebreakers in Article 4(2) and (3) have to be applied to determine a single residence for treaty purposes, similarly, if it is necessary to decide whether the taxpayer has a permanent establishment in a state, then Article 5 is relevant.

5. Determine which of the substantive provisions apply: The substantive provisions apply to different categories of income, capital gains or capital; it is necessary to determine which applies. This is a process of characterization. In many cases this may be straightforward; in others the task may not be easy. For example, payments, which are referred to as "royalties", may in fact fall under Article 7 (Business Profits), 12 (Royalties), 13 (Capital Gains) or 14 (Independent Personal Services). Assistance in characterizing the items can be gained from the Commentaries, case law and reports of the Committee on Fiscal Affairs

6. Apply the substantive article: Substantive articles generally take one of three forms

(i)The state of source may tax without limitation. Examples are: income from house property situated in that state, and business profits derived from a permanent establishment there.

(ii) The state source may tax up to a maximum: here the treaty sets a ceiling to the level of taxation at source. Examples in the OECD Models are: dividends from companies resident in that state and interest derived from there.

(iii) The state of source may not tax: here, the state of residence of the tax payer alone has jurisdiction to tax. Examples in the OECD Model are: business profit where there is no permanent establishment in the state of source.

7. Apply the provisions for the elimination of double taxation : Every one of the substantive articles must be considered along with article 23 which sets out the methods for the elimination of double taxation.

20.8 SUMMARY

Country risk assessment, also known as country risk analysis, is the process of determining a nation's ability to transfer payments. It takes into account political, economic and social factors, and is used to help organisations make strategic decisions when conducting business in a country with excessive risk. Country risk assessments are generally segregated into different categories, which take a closer look at some of the factors we mentioned prior. Let's discuss some of the most common and what they mean, so you can determine how they might impact your clients' transactions and, thus, premiums on TCI products.

20.9 GLOSSARY

1. **Political risk**: Political risk determines a country's political stability, either internally or externally. For instance, a recent military coup would increase a nation's internal political risk for businesses as rules and regulations suddenly shift. Other risks in this category could include war, terrorism, corruption and excessive bureaucracy (i.e. host government red tape is preventing certain fund transfers or other transactions).

2. **Sovereign risk**: There is some crossover between political and sovereign risk, although the latter – also known as sovereign default risk – primarily examines debt. Specifically, this risk category measures the build up of debt that is the obligation of a government or its agencies (or that is guaranteed by the government), and how much said government is anticipated to fulfil these obligations.

3. **Economic risk:** Economic risk encompasses a wide range of potential issues that could lead a country to renege on its external debts or that may cause other types of currency crisis (i.e. recession). A major factor here is economic growth – the health of a nation's GDP and the outlook for its future. For instance, if a country relies on a few key exports and the prices for these are dropping, this creates a negative outlook and may increase the economic risk for foreign trading partners.

4. **Exchange risk**: Any predicted loss created by sudden changes in exchange rate are generally covered under the exchange risk factor. This is another all-encompassing term as fluctuations in the foreign exchange can be caused by a wide variety of factors. Economic and political factors such as those mentioned above can be significant drivers of exchange risk, although currency reserves, interest rates and inflation are also potential factors.

20.10 SELF ASSESSMENT

Q1. What do you understand by country risk analysis?

Ans.____

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Q2. What are the discounted techniques of capital budgeting ?

Ans.

Q3. Write a short note on:

a) Cultural risk

Ans.

b) Political risk

Ans.

c) Economic risk

Ans.

20.11 LESSON END EXERCISE

Q1. What do you understand by international taxation?

Q2. Write a note on double taxation avoidance agreement?

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