International Banking and Forex Management

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Edited by:
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LOVELY PROFESSIONAL UNIVERSITY

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Unit 01: International Banking

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Objectives

After studying this unit, you should be able

- Understand the history of international banking
- Understand the features and reasons for the growth of international banking
- Rationale of Off-shore financial centres
- Types of Off-shore financial centres
- Understand what an offshore banking unit is
- Understand the working of an offshore banking unit
- Understand the motive behind establishment of SEZ
- Understand the historical perspective and profitability of international banking

Introduction

Banks in the 19th century promoted two different types of international lending:

a) Trade Financing,

b) Investment Banking

Trade financing was used to finance commodity exports and imports or to deal in foreign exchange. It is a short-term commercial lendingInvestment banking is concerned with investment of long-term funds in fixed interest securities and equity issues.Trade financing was a small part in the 19th century, more important was the development of investment banking

The international banking became one of the great victims of the Great Depression and the second world war. Bank failures, default shattered the confidence in international lendingThe most remarkable development was the internationalization of banking.The banks that took the lead were institutions from Canada, France, Germany, UK etc.

1.1 Characteristics and Dimensions

- The number of participants which at the beginning were mainly American banks has increased to German, UK, Japan etc.
- Many major banks have more international loans outstanding than domestic ones
- Large part of deficit of least developed countries has been financed by Commercial banks
- The amount of individual loans has increased thus increasing the risk from individual borrowers.

1.2 Global Trends- Reasons

Following points are leading to the changes in the trends in international banking:

- "Follow the Leader"
- Competition
- Inter country differences in the cost of capital
- Globalization
- Uses knowhow developed for domestic uses at a very low cost abroad
- Developments in communication
- Technological innovations and information about opportunities

International Banking can be defined as a subset of commercial banking transactions and activity having a cross border and/or cross-country element

International banking comprises a range of transactions that can be distinguished from domestic operations by:

1. The currency of denomination
2. The residence of the bank's customers
3. The location of the office

Correspondent Banking

- It is an informal linkage between banks in different countries
- It allows banks to help their customers who are doing business abroad, without having to maintain any personnel or offices abroad
- It is primarily for settling customer payments
- It can also be used for providing limited credit for each other's customers

Resident Representatives

- Banks open overseas offices to provide their customers with help on the spot from their own personnel
- The main purpose is to provide information about local business practices and conditions, creditworthiness of potential customers and the bank's clients

Foreign BRANCH NETWORK

- They are operating like local banks, but directors and owners reside elsewhere
- They are subject to local rules and rules at the home
- Their books are incorporated in those of parent bank, although they will also maintain separate books for tax purposes and for revealing separate performance

Foreign Subsidiaries and Affiliates

- It is a locally incorporated bank that happens to be owned either completely or partially by a foreign parent
- They are owned by foreign owners, even if foreign ownership is partial

1.3 Offshore Banking

- Offshore banking is simply a term used to refer to the use of banking services in a foreign jurisdiction outside of the country where one resides.
- So, any individual who owns a bank account in a foreign country outside of their country of residence is engaging in offshore banking.
- If you are a UK citizen and open an account in the US, that can be considered an offshore bank account.
- In the past, there were typically only a small number of jurisdictions in which banks offered offshore banking services, however, nowadays, one can open an offshore bank account almost anywhere.

Why offshore Banking?

- Offshore banking provides a number of benefits that can not be found in your regular domestic banking system.
- Additionally diversifying your assets across different channels, countries, accounts and currencies helps to protect your money and reduces the risk of being left unprepared in case of bank failures, currency depreciation or economic collapse.
- Having a plan B is important in times of uncertainty and having a foreign account outside of the country where you live is the first step to ensure your future financial longevity.
- Offshore accounts offer a wealth of opportunities as an insurance against the negligence of an irresponsible banking system that has overextended itself by having low interest rates, poor capital reserves, and mountains of debt practically making many banks insolvent.

Offshore Banking Benefits

- It generates foreign exchange
- License fee
- Tax revenue
- Employment
- Travelling facilities

- Infrastructural development
- Development of regional capital market
- Higher Returns in International Investments
- Economic and Political Stability
- Generate Higher Interest Rates
- Foreign Banking Systems Offer Security
- Diversify Your Wealth
- Higher Liquidity
- Hold Multiple Currencies
- Asset Protection
- Account Confidentiality

1.4 International Financial Centre

- An International Financial Centre, or IFC, is a physical area from which financial services are provided to people in other countries.
- An IFC has to be attractive to businesses not operating in the jurisdiction and meet a number of inter-related requirements, mainly relating to stability and resources. The markets IFCs operate in change over time in response to economic and political conditions and factors relevant to IFCs themselves.
- An IFC is a center operating from a physical location that facilitates international activity and operates under a regulatory framework that meets international norms.
- IFCs provide financial services to international clients as well as support services such as law, accountancy and technology.

1.5 Rationale of Off-shore Financial Centres

- Offshore financial centres exist primarily to facilitate international transfer of funds in a business environment.

  They have following advantages over other banking centres:
- Flexible regulatory climate
- Unrestrained transfer of capital among non-residents
- Minimal taxation
- Relatively small reserve requirements
- They are supported by political stability of host countries and flexible regulatory policies

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Types of Offshore financial centres

- Functional centres – Where actual deals are struck with the customers
- Paper centres – They serves as a location of record keeping & there is no real banking activity

1.6 Offshore Banking Units

- An offshore banking unit (OBU) is a financial service unit (normally a branch or subsidiary of a non-resident bank), which plays an intermediary role between non-resident borrowers and lenders.

- Generally, an offshore banking unit is located in an international financial center or in the case of India, found in Special Economic Zones.
- Offshore banking units are allowed to accept deposits from foreign banks, from some onshore banks that permit deposits and other offshore banking units, and the OBU may make loans to non-resident companies as well.
- The advantage of an offshore banking unit versus that of an onshore bank is that the offshore banking unit is free of regulations and restrictions normally imposed on domestic financial establishments as it pertains to foreign exchange and sometime tax concessions and relief packages.
- The activities of an offshore banking unit are not subject to the local restrictions as there might be on foreign exchange or other banking activities or regulations.
- Under law, offshore banking units (OBUs) are not authorized to take domestic deposits or conduct activity with local establishments or clients. All trade activity of the offshore banking unit must be offshore.
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Advantages of Offshore Banking

The advantages of offshore banking units for some is that the existence of the offshore banking unit establishment enables the company to conduct financial transactions with no currency restrictions; enables the company to make loans and payments in multi currencies; and enables the company to offer flexible international financial trade options that would not otherwise be possible with the domestic bank.

1.7 Working of an Offshore Banking Unit

- OBUs have gained worldwide popularity, especially in Europe, the Middle East, the Caribbean, and Asia since the 1970s. U.S. based offshore banking units prevail in the Cayman Islands, Panama, Hong Kong, Singapore, Bahamas, etc.
- Sometimes, OBUs can be subsidiaries of domestic and/or foreign banks, where the parent company is in complete charge.
- In some cases, it can operate as an individual entity as well.
- If an offshore banking unit adopts the parent company's name, its management system and accounts are considered to be independent.
- For saving taxes and maintaining privacy, investors can prefer transferring or investing their money into OBUs.

Benefits of Offshore Banking Units

Offshore banking is a lucrative business

- Generates foreign exchange
- License fee income
- Tax revenue
- Employment
- Infrastructure
- Development of regional capital markets & image building

1.8 Special Economic Zones

- A special economic zone (SEZ) is an area in a country that is subject to different economic regulations than other regions within the same country.
- The SEZ economic regulations tend to be conducive to—and attract—foreign direct investment (FDI).
- FDI refers to any investment made by a firm or individual in one country into business interests located in another country.
- When a country or individual conducts business in an SEZ, there are typically additional economic advantages for them, including tax incentives and the opportunity to pay lower tariffs.

Fundamentals of SEZs

- Special economic zones are fundamentally different from the traditional free zones:
- They are much larger in size; offer broader range of activities such as-
    - A single window management
    - Streamlined procedures
    - Duty free privileges
    - Access to the domestic market on a duty (paid basis)

1.9 Special Economic Zone (SEZ)

Whether the enclave is termed an EPZ, FTZ or SEZ the cardinal factor is the provision of:

- Appropriate infrastructure and transport facilities
- Low factor cost
- Flexible labour laws
- A low degree of tariff protection
- Convertibility of currency
- Stable legal and administrative regime and
- A commitment to the canons of an open economy

Incentives and Facilities Offered to the Special Economic Zones

The incentives and facilities offered the units of SEZs for attracting investments into the SEZs including foreign investment includes the following:

- Duty free import / domestic procurement of goods for development, operation and maintenance of sez units
- 100% income tax exemption on export income for SEZs units under section 10AA of the Income Tax Act for first 5 years, 50% for next 5 years thereafter and 50% of the ploughed back export profit for next 5 years
- Exemption from minimum alternate tax under Income Tax Act
- External commercial borrowings by SEZ units up to us $500 million in a year without any maturity restriction through recognised banking channels
- Exemption from central sales tax
- Exemption from service tax
- Single window clearance for central and state level approvals

- Exemption from state sales tax and other levies as extended by the respective state governments

Benefits derived from the SEZs

- Investment
- Employment
- Export and infrastructural developments
- Growth of SMEs and ancillary units
- Development of supply chain, warehousing & storage
- Technical know - how

1.10 Profitability of International Banking Operations

- During the past 70 years important changes have taken place in the area of international banking.
- International divisions became very powerful within the large banks throughout the 1950 and 1960.
- The typical experience was for growth in international earnings and for the mix of total earnings to shift progressively in favour of overseas profits

1) A period of stability- the 1950s and 1960s

The 1950 to 1973. Was relatively free of adversity for firms doing business abroad. Banks owned

- Cheap sources of funding and the sizeable float
- Privileged access to liquidity (discount windows, payment services, interbank market)
- Regulatory franchise
- International franchise
- Relatively limited competition

2) A decade of high risks the 1970s

- The sense of tranquillity was disrupted by the first oils shock, war in the middle east and the failure of the Herstatt Bank in West Germany.
- The global recession of 1974-1976 caused severe problems in overseas markets for the first time in the post war period.
- Major US banks were lending to less developed countries (LDCs) since 1950s & 1960s and experienced good profits
- The second oil shock in 1979, worldwide recession and flight of capital from LDCs led to the serious losses to the global banks.
- Latin economies were in deficits and that led to deteriorating loans conditions, losses for banks and for lenders.

3) Bankers' blues – 1980s

- Mexico's August 1982 announcement that it was broke sent shock waves and brought forth debt problems of LDCs.

- Loan restructuring led to more lending which further led to more losses to the banks.
- Real estate bubble in late 1980s further led to the problems
- Several US banks were technically insolvent

4) 1990s – era of consolidation, capitalization and return to profitability

- Last decades issues make banks risk averse and even M&A activity was on the decline.
- Banks preferred to continue as it is
- They entered in low margin businesses like asset management, broking and insurance to gradually improve profitability

5) Global financial crises & emerging scenario

The financial crises of 2007-08 further led to the problems of banks having global presence. It led banks to:

- Identify new ways to improve efficiency
- Enter into emerging markets
- New product offerings
- Shed unprofitable operations, capitalize new opportunities

Summary

International banking grew rapidly from the 1950s to the 2000s, propelled by banks avoiding regulations that burdened their domestic funding, by financial liberalization that expanded investment opportunities, and by financial innovation that offered new tools to manage risks. The core of the market is offshore, where lenders and borrowers transact in currencies foreign to them both. Competition among banks for market share contributed to surges in international lending that amplified credit booms preceding major financial crises. Losses during the Great Financial Crisis, and regulatory reforms in its wake, have constrained banks' expansion, making way for non-bank financial institutions to step in as major international creditors.Alongside structural factors, global financial imbalances have shaped and been shaped by international banking. Cross-border lending enabled the credit booms at the heart of several international financial crises, notably the Latin American debt crisis in the early 1980s, the Asian financial crisis in the late 1990s and the Great Financial Crisis (GFC) of 2007–09. Ahead of each crisis, competition among banks for market share contributed to surges in international credit.

Keywords

Offshore financial centres – An offshore financial centre (OFC) is defined as a "country or jurisdiction that provides financial services to nonresidents on a scale that is incommensurate with the size and the financing of its domestic economy

Functional centres – Functional center means a center which does not meet all the criteria established for a permanent facility, but is adequate to meet accreditation program standards to insure no substantial academic or building deficiency.

Correspondent banking - The term correspondent bank refers to a financial institution that provides services to another one—usually in another country. It acts as an intermediary or agent, facilitating wire transfers, conducting business transactions, accepting deposits, and gathering documents on behalf of another bank.

Resident representatives–The representative office provides their customers with counselling and other services relating to banking, especially the ethnic community who owe their origin to the home country of the bank. These are not banking offices and cannot accept local deposits and make local loans.

Special economic zone (SEZ)–A special economic zone (SEZ) is an area in a country that is subject to different economic regulations than other regions within the same country.

Self Assessment

Q1.Investmentbankingis concernedwithinvestment of_________________in_________________

A. long term funds, fixed interest securities and equity issues
B. short term funds, fixed interest securities and equity issues
C. fixed interest securities and equity issues, long term funds
D. fixed interest securities and equity issues, short term funds

Q2. International Banking can be defined as a subset of commercial banking transactions and activity having a(n) _______________

A. cross border and/or cross-country element
B. international trade
C. import and export activity
D. global lending

Q3. Which among the following statement is true regarding correspondent banking?

A. customers who are doing business abroad, need to maintain their own personnel or the offices abroad
B. Correspondent banks cannot give any kind of credit to their clients
C. There is no difference between a correspondent bank and a normal commercial bank
D. It allows banks to help their customers who are doing business abroad, without having to maintain any personnel or offices abroad

Q4. Which among the following is true regarding foreign branch network?

A. They are operating like local banks, but directors and owners reside elsewhere
B. They are subject to local rules and rules at the home
C. Their books are incorporated in those of parent bank, although they will also maintain separate books for tax purposes and for revealing separate performance
D. All of the above

Q5. Which among the following is true regarding offshore banking?

A. If you are a UK citizen and open an account in the US, that can be considered an offshore bank account.
B. If you are a UK citizen and open an account in the US based Multi-National Bank operating in UK, can be considered an offshore bank account.
C. Exporter from India having a bank account in HSBC bank at Bangalore can be considered an offshore bank account.
D. An importer based in USA opens a bank account in State Bank of India can be considered an offshore bank account.

Q6. Which among the following is not a benefit of offshore banking?

A. Political benefits
B. Foreign Banking Systems Offer Security
C. Diversify Your Wealth
D. Higher Liquidity

Q7. An International Financial Centre, or IFC, is a physical area from which _________ services are provided to people in _________ country.

A. Political. Other

B. Business, home
C. Financial, other
D. Agriculture, home

Q8. A special economic zone (SEZ) is an area in a country that is subject to different economic regulations than other regions within the same country.

A. True
B. False

Q9. Find out the incorrect statement

A. Importers can set up their businesses in SEZ to help the economy
B. The SEZs economic regulations tend to be conducive to—and attract—foreign direct investment (FDI).
C. SEZs help in generating employment and other related benefits
D. The overall benefit of establishing SEZs is to the economy as a whole

Q10. FDI refers to any investment made by a firm or individual into business interests located in home country.

A. True
B. False

Q11. When a country or individual conducts business in an SEZ, there are typically

A. additional economic advantages for them,
B. tax incentives and
C. the opportunity to pay lower tariffs.
D. all of the above

Q12. Which among the following statement(s) are true

1) A single window management
2) Streamlined procedures
3) Duty free privileges
4) Access to the domestic market on a duty (paid basis)

A. 1), 3) and 4)
B. All statements are true
C. Only 1) and 2)
D. 1), 2) and 3)

Q13. Which of the following is not a benefit offered by the SEZs

A. Employment
B. Export and infrastructural developments
C. Cultural exchange and transfer
D. Development of supply chain, warehousing & storage

Q14. The financial crises of 2007-08 further led to the problems of banks having global presence. It led banks to..

- Identify new ways to improve efficiency
- Enter into emerging markets
- New product offerings

A. True

B. False

Q15. When a country or individual conducts business in an SEZ, there are typically additional economic advantages for them, including tax incentives and the opportunity to pay lower tariffs.

A. True
B. False

Answers for Self Assessment

l.	A	2.	A	3.	D	4.	D	5.	A
6.	A	7.	C	8.	A	9.	A	10.	B
11.	D	12.	B	13.	C	14.	A	15.	A

Review Questions

1. What are the global trends in recent past in international banking? Is there any impact on global banking due to Russia – Ukraine issue?
2. How correspondent banking is different from resident representatives? Out of these two forms of global banking which one is practically more relevant from the perspective of banking clients?
3. What do you understand by the term offshore banking? What are the various benefits offered by the offshore banking to an economy?
4. What are international financial centres? What is the rationale of having offshore financial centres? Elaborate the types of offshore financial centres?
5. What are the advantages of an offshore banking unit? How does an offshore banking unit work?
6. What was the purpose of setting up special economic zones (SEZ)? What kind of Incentives and facilities offered to the special economic zones?
7. Give an historic perspective of global banking operations in a chronological order?
8. World is changing gradually from a globalized world to a protectionist world where developed economies are putting their interests first. In such a scenario what could be the probable impact on the global banking industry?

Further Readings

https://www.offshore-protection.com/what-is-offshore-banking-benefits

https://www.imf.org/external/pubs/ft/wp/1999/wp9905.pdf

https://www.ifsca.gov.in/

https://www.bis.org/publ/cgfs41.pdf

https://www.econstor.eu/bitstream/10419/74852/1/dp166.pdf

Unit 02: Types of Banking

CONTENTS

Objectives

After studying this unit, you should be able:

- Understand what is correspondent Banking and Inter -bank Banking
- Differentiate between normal banking operations and correspondent Banking
- Understand the concept of investment / merchant banking
- Exploring the services offered by the merchant bankers
- Understanding wholesale banking
- Exploring the services offered under wholesale banking
- Understand the retail banking operations
- Explore the services offered by the retail banking
- Understand basics of merchant banking

Introduction

International banking is the process in which financial institutions render their services to foreign clients. International banking involves the transactions relating to the acceptance of deposits and loans anywhere in a currency other than that of the country in which the bank is located. International banking refers to the activities of providing financial services (banking) to clients (both institutional and individual) located in many different countries. This encompasses a wide range of activities, including transactions with foreigners and domestic residents relating to deposits and lending in domestic and foreign currencies, facilitating foreign currency transactions and foreign exchange risk hedging, participating in international loan syndications, and facilitating international trade finance for clients.

2.1 Correspondent Bank

Correspondent bank: The term correspondent bank refers to a financial institution that provides services to another one—usually in another country. It acts as an intermediary or agent, facilitating wire transfers, conducting business transactions, accepting deposits, and gathering documents on behalf of another bank.

Correspondent banking allows a bank’s MNC client to conduct business worldwide through his local bank or its correspondents. The accounts held between correspondent banks and the banks to which they are providing services are referred to as Nostro and Vostro accounts.

Nostro and vostro are Latin terms used to describe the bank account that is shared by the correspondent or intermediary bank and the beneficiary bank. Nostro means ours, while vostro means yours.

Domestic banks generally use correspondent banks to gain access to foreign financial markets and to serve international clients without having to open branches abroad.

2.2 Working of Correspondent Banks

Correspondent banks are third-party banks. They act as middlemen between different financial institutions. As such, they provide Treasury services between sending and receiving banks, especially those in different countries—such as:

- Funds transfer
- Settlement
- Check clearing
- Wire transfers
- Currency exchange

2.3 Role of correspondent banks

- Correspondent banks are a pivotal part of the financial industry as they provide a way for domestic banks to operate when it isn't feasible for them to open up branches in a different location—especially in a foreign country.
- For instance, a small domestic bank with clients in different countries can partner with a correspondent bank in order to meet the needs of its client internationally. Doing so also gives them access to the foreign financial market. The correspondent bank will, therefore, charge a fee for this service, which is usually passed off from the domestic bank to the customer.

2.4 Correspondent Banking &Inter – Bank Banking

- Correspondent banking led to the interbank banking since one bank is doing transactions on behalf of the other banks.
- Correspondent banking led to the interbank banking in the following ways:

- Clearing house functions (payments, processing & clearing)
- Payments & collections
  - Settlement of terms of contract
  - Sale & purchase of merchandise
  - Security receipts and delivery services
  - Dividend receipts and collections
- Letters of credit and bankers' acceptance
- Credit services
  - Lines of credit to permit financing of trade transactions
  - Advance to finance imports / exports
  - Facilities to borrow for general purpose
  - Medium term loans to finance imports
  - Facilitating capital market access for correspondent banks
  - Issue of guarantees
- Foreign exchange services
- Travel services
  - Includes foreign currency notes & coins
  - Travelers cheque / drafts
  - Local drawings and cheque encashment
- Other facilities
  - Cash management facilities
  - Automated balance reporting
  - Purchase & sales of securities
  - Custodial
  - Underwriting
  - Future and options
  - New issue management
  - Advisory services on mergers & acquisitions

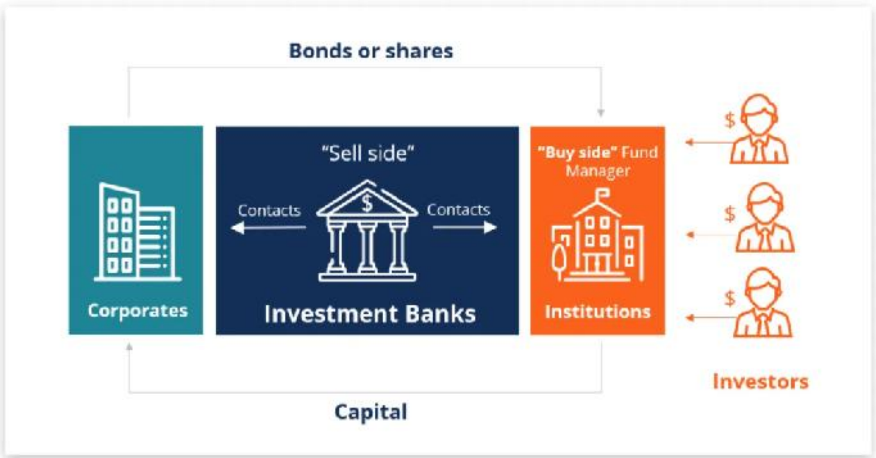
2.5 Investment Banking

- Investment banking is a special segment of banking operation that helps individuals or organizations raise capital and provide financial consultancy services. Investment banking is the division of a bank or financial institution that serves governments, corporations, and institutions by providing underwriting (capital raising) and mergers and acquisitions (M&A) advisory services. Investment banks act as intermediaries between investors (who have money to invest) and corporations (who require capital to grow and run their businesses).

2.6 What Do Investment Banks Do?

- There can sometimes be confusion between an investment bank and the investment banking division (IBD) of a bank. Full-service investment banks offer a wide range of services that include:
- Underwriting, (LIC is coming up with an IPO)
- M&A, (Tata motors acquired Jaguar
- Sales and trading,
- Equity research,
- Asset management (Mutual Fund Trusts)
- Commercial banking, and
- Retail banking.

The investment banking division of a bank provides only the underwriting and M&A advisory service.



2.7 Spectrum of Merchant Banking Services

- Project counselling (Auto companies are taking the EV route)
- Loan syndication
- Technology tie-up
- Raising of funds from capital markets
- Portfolio management

- Mutual funds
- Rehabilitation of sick units
- OTC market operations
- Mergers & acquisitions or amalgamations

2.8 Wholesale Banking

- Wholesale banking delivers financial products and services that meet the unique business needs of institutions such as large corporations, government agencies, and other banks.
- It also offers consulting, merger and acquisition assistance, and bulk currency conversion, which retail banking doesn't offer.
- Wholesale banking refers to providing financial services to large institutions.
- Such services include cash management, working capital loans, and trade transactions.
- This banking sector caters to large organizations such as government agencies, high-revenue corporations, and other banks.
- Wholesale banking differs from retail banking in the services it provides as well as the clients who need it

2.9 Wholesale Banking Services Includes

- Large fund management
- Bulk currency exchange
- Trade transactions
- Consultancy
- Working capital financing
- Mergers and acquisitions
- Bank-to-bank lending

2.10 Services Not Provided by Wholesale Banks

Wholesale banking doesn't offer retail and consumer products that are popular among small businesses and consumers, such as:

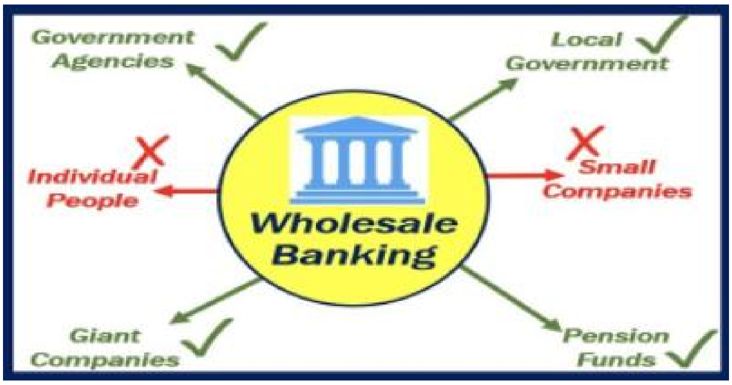
- Home mortgages
- Personal deposit accounts
- Small-business loans
- Small-farm loans
- Consumer loans

2.11 Wholesale Banking for Large Companies

For example, Wells Fargo's Wholesale Banking serves corporations with annual revenue sales of $5 million dollars or more.

- Corporations with that much revenue have more financial transactions to manage than the typical small business.
- Wholesale banking is designed to accommodate large currency exchanges and higher transaction volumes at a lower cost.

- Essentially, these large institutions receive discounted prices because of the sizes of the companies and the bulk of the services needed.
- In this way, wholesale banks are similar to wholesale stores whose consumers save money by buying groceries or home goods in bulk.



2.12 Retail Banking

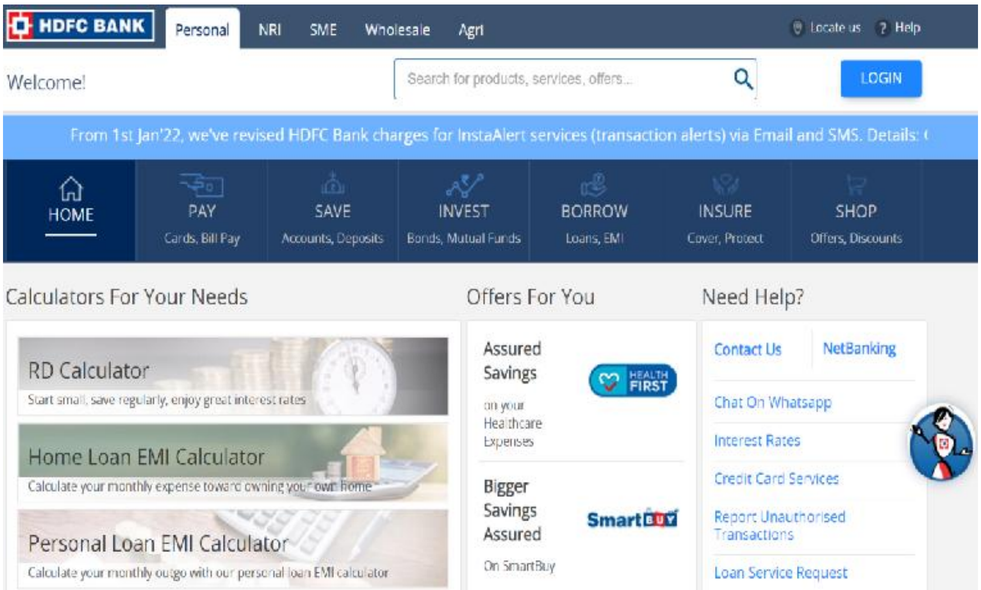
- Retail banking is everyday banking that happens between consumers and their personal banks. A retail bank offers consumers basic banking services, including checking accounts, savings accounts, and loans.
- You'll still interact with your retail bank on a regular basis even if you mostly bank online.
- Retail customers are members of the general public. They're taking care of their personal financial needs, unlike organizations such as governments or businesses that might need more complex services. Retail banks are designed to meet these needs. Their services are tailored to individuals.
- These services might be offered at a local branch or online. They can include daily deposits and withdrawals, checking and savings accounts, loans, credit cards, and more. Retail banking is designed for the everyday needs of the average consumer.
- Retail banks are for the general public to help them save and invest their money and handle their regular needs by providing various services like bank accounts, credit cards, debit cards, fixed deposits, loans, and many more.
- Certain services like withdrawals and deposits can also be availed online as well as in the nearest branch of your bank. Online retail banking has made the transfer of money and retailing easier for the retail customers.
- Some retail banks may or may not provide all the services you expect, so it will be good to check with the bank branch or visit the bank website if you want to avail a certain service from the retail bank.

2.13 How a Retail Bank Generates Income

- A retail bank stores the cash deposits of its retail clients. It then uses these deposits to make loans to other clients.
- The central bank formerly required that all banks keep a fix percentage of their deposits in the form of CRR & SLR.
- This is known as the reserve requirement and is seen as a safety and liquidity measure.
- This means that the remainder of the deposits is allowed to be loaned out.
- The banks charge interest rates on these loans at a higher rate than they pay on customer deposits, which is how banks earn income.

2.14 Retail Banking vs. Corporate Banking

- While retail banking services are provided to individuals in the general public, corporate banking services are only provided to small or large companies and corporate bodies.
- The scope of the products and services offered is also different: retail banking is customer-oriented and corporate banking is business-oriented.
- The financial worth of transactions is comparably higher in corporate banking than in retail banking.
- The source of profit is also different: the difference between the margin of interest of borrowers and lenders is the main source of profit in retail banking, while corporate banking's source of profit is the interest and fees charged on the services provided.



2.15 Merchant Banks

- The term merchant bank refers to a financial institution that conducts underwriting, loan services, financial advising, and fundraising services for large corporations and high-net-worth individuals (HWNIs).
- Merchant banks are experts in international trade, which makes them specialists in dealing with multinational corporations.
- Unlike retail or commercial banks, merchant banks do not provide financial services to the general public. (B2B)
- Some of the largest merchant banks in the world include J.P. Morgan Chase, Goldman Sachs, and Citigroup.
- Merchant banks are financial institutions and companies that deal with international finance for multinational corporations.
- These banks differ from other types of financial institutions. As such, they don't deal with the general public.
- They don't provide everyday financial services such as checking accounts, bill payments, or basic investments and don't take deposits or make withdrawals for their customers.

2.16 Functions of Merchant Banks

Merchant banks perform a number of functions, including the following:

- Equity Underwriting
- Credit syndication
- Portfolio management

A. Equity Underwriting

- Large companies often employ the services of merchant banks in acquiring capital through the stock market.
- Equity underwriting is achieved by evaluating the amount of stock to be issued, the value of the business, the use of proceeds, and the timing of issuance of the new stock.
- Merchant banks handle all the necessary paperwork and liaison with the appropriate marketing division to advertise the stock.

B. Credit Syndication

- Merchant banks help in processing loan applications for short and long-term credit from financial institutions. They provide these services by estimating total costs involved, developing a financial plan for the entire project, as well as adopting a loan application for commercial lenders.
- Also, they assist in choosing the ideal financial institutions to provide credit facilities and act on the terms of the loan application with the financiers.
- Merchant banks also ensure the lender's willingness to participate, organize bridge finance, and engage in legal formalities regarding investment to be approved and checking the working capital requirements.

C. Portfolio Management

- Merchant banks provide portfolio management services to institutional investors and other investors.
- They help in the management of securities to enhance the value of the underlying investment. Merchant banks may assist their clients in the purchase and sale of securities to help them attain their investment objectives.

Summary

Banking industry has become a one stop solution shop and as the world has moved from closed economies to open economies and currently protectionism is the buzz-word the role of international banking keeps on changing. Globalization led to the emergence of big corporates operating across countries which led to demand for more capital, management of forex and multiple challenges that are faced by the banks having global presence. Gradually banks developed expertise in liquidity/cash management, fund razing through debt and equity markets, retail banking, corporate banking, project consultancy and portfolio management etc. and prompt them to develop different verticals and specialized branches offering expert services to different set of clients.

Keywords

Correspondent banks - The term correspondent bank refers to a financial institution that provides services to another one—usually in another country. It acts as an intermediary or agent, facilitating wire transfers, conducting business transactions, accepting deposits, and gathering documents on behalf of another bank.

Merchant banks -The term merchant bank refers to a financial institution that conducts underwriting, loan services, financial advising, and fundraising services for large corporations and high-net-worth individuals (HWNIs). Merchant banks are experts in international trade, which makes them specialists in dealing with multinational corporations.

Investment banks -Investment banking deals primarily with the creation of capital for other companies, governments, and other entities.Investment banking activities include underwriting new debt and equity securities for all types of corporations, aiding in the sale of securities, and helping to facilitate mergers and acquisitions, reorganizations, and broker trades for both institutions and private investors.

Underwriting -Underwriting is the process through which an individual or institution takes on financial risk for a fee. This risk most typically involves loans, insurance, or investments. The term underwriter originated from the practice of having each risk-taker write their name under the total amount of risk they were willing to accept for a specified premium.

Wholesale banking -Wholesale banking refers to banking services sold to large clients, such as corporations, other banks, and government agencies. Typical services sold are mergers and acquisitions, consulting, currency conversion, and underwriting. Wholesale banking is the opposite of retail banking, which services individuals and small businesses.

Retail banking - Retail banking, also known as consumer banking or personal banking, is banking that provides financial services to individual consumers rather than businesses. Retail banking is a way for individual consumers to manage their money, have access to credit, and deposit their money in a secure manner. Services offered by retail banks include checking and savings accounts, mortgages, personal loans, credit cards, and certificates of deposit (CDs).

Portfolio management - Portfolio management is the art and science of selecting and overseeing a group of investments that meet the long-term financial objectives and risk tolerance of a client, a company, or an institution.

Merger & Acquisition - Mergers and acquisitions (M&A) is a general term that describes the consolidation of companies or assets through various types of financial transactions, including mergers, acquisitions, consolidations, tender offers, purchase of assets, and management acquisitions.

Self Assessment

Q1. It acts as an intermediary or agent, facilitating wire transfers, conducting businesstransactions, accepting deposits, and gathering documents on behalf of another bank.

A. True
B. False

Q2. Correspondent banking allows a bank's MNC client to conduct business________ through his_________ bank or its correspondents.

A. Worldwide, local
B. Domestically, offshore
C. Domestically, local
D. Worldwide, offshore

Q3. The accounts held between correspondent banks and the banks to which they are providing services are referred to as____________.

A. Current and savings account
B. Nostro and Vostro accounts
C. NRE and NRO accounts
D. Offshore and onshore accounts

Q4. Correspondent banks are _________. They act as_______ between different financial institutions.

A. commercial banks, client
B. foreign entity, a network
C. third-party banks, middlemen
D. development institutions, an agent

Q5. Which of the following services is not offered by a correspondent bank?

A. Funds transfer
B. Settlement
C. Retirement solutions
D. Currency exchange

Q6. Investment banking is the division of a bank or financial institution that serves governments, corporations, and institutions by providing underwriting (capital raising) and mergers and acquisitions (M&A) advisory services.

A. True
B. False

Q7. Investment banks act as intermediaries between_________ and ___________

A. Investors, corporations
B. Savers, investors
C. Governments, public
D. Borrowers, lenders

Q8. Investment banking typically covers two key areas –

A. Borrowing money and lending
B. M & A advisory and underwriting
C. Issuing bonds and shares
D. Financial planning and investing

Q9. An investment bank and the investment banking division (IBD) of a bank are one and same thing.

A. True
B. False

Q10. Which of the following is not the services provided by investment banks?

A. Mergers and Acquisitions (M&A)
B. Research services
C. Deposit Account Services
D. Risk Management Services

Q11. Which of the following services does not fall under the Spectrum of merchant banking?

A. Project counselling
B. Loan syndication
C. Deposit services
D. Raising of funds from capital markets

Q12. Wholesale banking delivers financial products and services that meet the unique business needs of institutions such as large corporations, government agencies, and other banks.

A. True

B. False

Q13. Wholesale banking caters to –

A. Large corporations and institutions
B. Corporates and their cash management, working capital loans, and trade transactions.
C. Government agencies, high-revenue corporations
D. All of the above

Q14. Which of the following service is offered by the wholesale banking?

A. Home mortgages
B. Personal deposit accounts
C. Consumer loans
D. Mergers and acquisitions

Q15. A retail bank does not offer services like -

A. Retail loans
B. Basic banking services
C. Personal banking
D. Merger and Amalgamation

Answers for Self Assessment

1.	A	2.	A	3.	B	4.	C	5.	C
6.	A	7.	A	8.	B	9.	B	10.	C
11.	C	12.	A	13.	D	14.	D	15.	D

Review Questions

1. Define correspondent banking. What are its advantages and what were the reasons for its growth globally?
2. What are the reasons of gradual changes that has happened in the field of correspondent banking since 1980s?
3. What are the key functions of correspondent banks? How they are different from schedule commercial banks?
4. Write short note on
   a. Competitive importance of correspondent banking
   b. Services offered by correspondent banks
   c. Equity underwriting
   d. Portfolio management
5. What do you understand by the terms merchant banking and investment banking? How do they differ from commercial banking?
6. Describe the broad range of international merchant banking services.
7. Highlight the key functions of merchant banking.
8. In the current scenario of global unrest due to Russia-Ukraine issue and intermittent waves of COVID how global banking scenario is shaping out and how does global banks can help in the smooth functioning of the global economy?

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Unit 03: International Institutions

CONTENTS

Objectives

- Understand the functioning of major international financial institutions
- Understand the need for regulations in international banking and its intricacies
- Understand the various risks faced by banks

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. The common goals of the international financial institutions are:

- to reduce global poverty and improve people's living conditions and standards;
- to support sustainable economic, social and institutional development; and
- to promote regional cooperation and integration.

3.1 International Financial Institutions

International financial institutions have been established by the governments working together whose purpose is to maintain orderly international financial conditions and to provide capital and advice for economic development, particularly in those countries that lack resources to do it themselves.

Majority of these organizations were created towards the end of the World War II as part of an overall spirit of co-operation.

The source of funding is the contribution of capital while becoming a member and through borrowing.

3.2 Organization of International Financial Institutions

The organization includes:

1) The World Bank group – International bank for reconstruction and development (IBRD) and its three subsidiaries:
    a) International Development association (IDA)
    b) International Finance Corporation (IFC)
    c) Multilateral Investment Guarantee Agency (MIGA)
2) International Monetary Fund (IMF)
3) Bank of International Settlements (BIS)
4) Asian Development Bank (ADB)
5) African Development Bank
6) European Bank for Reconstruction and Development
7) Inter-American Development Bank

1. The World Bank group

- The World Bank Group is one of the world's largest sources of funding and knowledge for developing countries.
- Its five institutions share a commitment in reducing poverty, increasing shared prosperity and promoting sustainable development.

- World bank group was founded at the Bretton Woods conference in 1944
- The World Bank Group works with developing countries to reduce poverty and increase shared prosperity, while the International Monetary Fund serves to stabilize the international monetary system and acts as a monitor of the world's currencies.
- The World Bank Group provides financing, policy advice, and technical assistance to governments, and also focuses on strengthening the private sector in developing countries.
- The IMF keeps track of the economy globally and in member countries, lends to countries with balance of payments difficulties, and gives practical help to members.
- Countries must first join the IMF to be eligible to join the World Bank Group; today, each institution has 189 member countries.
- The World Bank Group is one of the world's largest sources of funding and knowledge for developing countries. Its five institutions share a commitment to reducing poverty, increasing shared prosperity, and promoting sustainable development.
- Together, IBRD and IDA form the World Bank, which provides financing, policy advice, and technical assistance to governments of developing countries.
- IDA focuses on the world's poorest countries, while IBRD assists middle-income and creditworthy poorer countries.

- IFC, MIGA (multilateral investment guarantee agency), and ICSID (international Centre for settlement of investment disputes) focus on strengthening the private sector in developing countries. Through these institutions, the World Bank Group provides financing, technical assistance, political risk insurance, and settlement of disputes to private enterprises, including financial institutions...

International Bank for Reconstruction and Development (IBRD)

- The International Bank for Reconstruction and Development (IBRD) is a global development cooperative owned by 189 member countries.
- As the largest development bank in the world, it supports the World Bank Group's mission by providing loans, guarantees, risk management products, and advisory services to middle-income and creditworthy low-income countries, as well as by coordinating responses to regional and global challenges.
- Created in 1944 to help Europe rebuild after World War II, IBRD join hands with IDA, to form the World Bank.
- They work closely with all institutions of the World Bank Group and the public and private sectors in developing countries to reduce poverty and build shared prosperity.

Let us discuss the three subsidiaries of the International Bank for Reconstruction and Development (IBRD)-

- International Development Association (IDA)
- International Finance Corporation (IFC)
- Multilateral Investment Guarantee Agency (MIGA)

(A)International Development Association (IDA)

- The International Development Association (IDA) is the part of the World Bank that helps the world's poorest countries. Established in 1960, IDA aims to reduce poverty by providing zero to low-interest loans (called "credits") and grants for programs that boost economic growth, reduce inequalities, and improve people's living conditions.
- IDA lends money on concessional terms. This means that IDA credits have a zero or very low interest charge and repayments are stretched over 30 to 40 years.
- More than half of IDA countries receive all, or half, of their IDA resources on grant terms, which carry no repayments at all. These grants are targeted to the low-income countries at higher risk of debt distress.
- In the fiscal year ending June 30, 2021, IDA commitments totaled $36 billion, of which $12.1 billion in grants.
- Africa region received 70 percent of the total commitments. Since 1960, IDA has provided $458 billion to 114 countries.
- Annual commitments have increased steadily and averaged about $29.4 billion over the last three years (FY19-FY21).
- Thirty-seven countries have graduated, and many have become IDA donors, including China, Chile, India, South Korea, and Turkey.

(B) International Finance Corporation (IFC)

- IFC, a member of the World Bank Group, advances economic development and improves the lives of people by encouraging the growth of the private sector in developing countries.

- IFC—a sister organization of the World Bank and member of the World Bank Group—is the largest global development institution focused exclusively on the private sector in developing countries.
- IFC apply financial resources, technical expertise, global experience, and innovative thinking to help the partners countries overcome financial, operational, and other challenges.

(C)Multilateral Investment Guarantee Agency (MIGA)

- The Multilateral Investment Guarantee Agency (MIGA) is a member of the World Bank Group.
- MIGA mandate is to promote cross-border investment in developing countries by providing guarantees (political risk insurance and credit enhancement) to investors and lenders.
- MIGA provide guarantees protect investments against noncommercial risks and can help investors obtain access to funding sources with improved financial terms and conditions.
- The Agency derives its unique strength from the World Bank Group and from its structure as an international organization whose shareholders include most countries of the world.
- This enables us to provide an umbrella of deterrence against government actions that could disrupt projects, and assist in the resolution of disputes between investors and governments.
- MIGA also offers their clients extensive knowledge of emerging markets and of international best practice in environmental and social management.

2. International Monetary Fund (IMF)

- The International Monetary Fund, or IMF, promotes international financial stability and monetary cooperation.
- It also facilitates international trade, promotes employment and sustainable economic growth, and helps to reduce global poverty.
- The IMF is governed by and accountable to its 190 member countries.
- Providing loans to member countries that are experiencing actual or potential balance-of-payments problems is a core responsibility of the IMF.
- Individual country adjustment programs are designed in close cooperation with the IMF and are supported by IMF financing, and ongoing financial support is dependent on effective implementation of these adjustments.
- In response to the global economic crisis, in April 2009 the IMF strengthened its lending capacity and approved a major overhaul of its financial support mechanisms, with additional reforms adopted in subsequent years.

- These changes enhanced the IMF's crisis-prevention toolkit, bolstering its ability to mitigate contagion during systemic crises and allowing it to better tailor instruments to meet the needs of individual member countries.

3. IMF lending and conditionality

- When it provides financial support to a member country, the IMF must be sure the member is pursuing policies that will ameliorate or eliminate its external payments problem.
- The explicit commitment that members make to implement remedial measures in return for the IMF's support is known as "conditionality."
- This commitment also ensures that members are able to repay the IMF in a timely manner, which in turn allows the IMF's limited pool of financial resources to revolve and be made available to other members with a balance of payments problem.

4. Bank of international settlements (BIS)

- BIS mission is to support central banks' pursuit of monetary and financial stability through international cooperation, and to act as a bank for central banks.
- As the bankers' bank, the BIS serves the financial needs of member central banks. It provides gold and foreign exchange transactions for them and holds central bank reserves.
- The BIS is also a banker and fund manager for other international financial institutions.

BIS provides central banks with –

- A forum for dialogue and broad international cooperation
- A platform for responsible innovation and knowledge sharing
- In-depth analysis and insight on core policy issues
- Sound and competitive financial services

Summary

All IFIs use country strategy documents, as these are fundamental to establishing an IFI's lending priorities for a particular country. Based on the country's own vision for its long-term development and written by the IFI, the document lays out the IFI's support program for the nation.

A country strategy begins by analyzing the causes of poverty within the population and identifying key areas where the IFI's assistance can reduce it most effectively. This establishes a foundation for the IFI's future activities in the country, which can range across the entire spectrum of economic and social needs.

The development of the country strategy involves extensive discussions with many stakeholders, including government authorities, representatives of civil society, non-government organizations, development agencies and the private sector. These discussions are crucial to the success of the strategy because they promote collaboration and coordination among the various national partners.

Keywords

International financial institutions- have been established by the governments working together whose purpose is to maintain orderly international financial conditions and to provide capital and advice for economic development, particularly in those countries that lack resources to do it themselves.

World bank group -The World Bank Group is one of the world's largest sources of funding and knowledge for developing countries. Its five institutions share a commitment in reducing poverty, increasing shared prosperity and promoting sustainable development.

Public – Private partnership – Public-private partnerships involve collaboration between a government agency and a private-sector company that can be used to finance, build, and operate projects, such as public transportation networks, parks, and convention centers. Financing a project through a public-private partnership can allow a project to be completed sooner or make it a possibility in the first place.

Venture capital –Venture capital (VC) is a form of private equity and a type of financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential. Venture capital generally comes from well-off investors, investment banks, and any other financial institutions.

International Bank for Reconstruction and Development (IBRD) - As the largest development bank in the world, it supports the World Bank Group's mission by providing loans, guarantees, risk management products, and advisory services to middle-income and creditworthy low-income countries, as well as by coordinating responses to regional and global challenges.

Self Assessment

Q1. International financial institutions have been established by the governments working together whose purpose is to maintain orderly international financial conditions and to provide capital and advice for economic development, particularly in those countries that lack resources to do it themselves.

A. True

B. False

Q2. Which of the following is not an international developmental financial institution?

A. International Monetary Fund (IMF)

B. Asian Development Bank (ADB)

C. International bank for reconstruction and development (IBRD)

D. US Treasury department

Q3. The World Bank Group works with developing countries to__________, while the International Monetary Fund serves to ____________and acts as a monitor of the world's currencies

A. reduce poverty and increase shared prosperity, stabilize the international monetary system

B. stabilize the international monetary system, reduce poverty and increase shared prosperity

C. improve the potential of economic development, meet the borrowing requirements

D. build the social infrastructure, establish the sustainable financial institutions

Q4. Countries must first join the _______to be eligible to join the World Bank Group

A. WHO – world health organization

B. IMF – international monetary fund

C. NATO – North Atlantic treaty organization

D. ADB – Asian development bank

Q5. Which of the following World Bank group institutions focuses on the world's poorest countries?

A. IBRD (International Bank for Reconstruction and Development)

B. IDA (international development association)

C. IMF (international monetary fund)

D. MIGA (multilateral investment guarantee agency)

Q6. Which of the following world Bank group institution supports the World Bank Group's mission by providing loans, guarantees, risk management products, and advisory services to middle-income and creditworthy low-income countries, as well as by coordinating responses to regional and global challenges.

A. IBRD (International Bank for Reconstruction and Development)

B. IDA (international development association)

C. IMF (international monetary fund)

D. MIGA (multilateral investment guarantee agency)

Q7. The following entities are subsidiaries of which of the World Bank group financial institution?

- International Development Association (IDA)
- International Finance Corporation (IFC)
- Multilateral Investment Guarantee Agency (MIGA)

A. IMF (international monetary fund)

B. MIGA (multilateral investment guarantee agency)

C. IDA (international development association)

D. IBRD (International Bank for Reconstruction and Development)

Q8. The need for regulating international banking arises on account of

A. The volume of financial flows are much higher than the trade flows

B. Heavily regulated banking industry

C. High degree of financial gearing in banking industry

D. All of the above

Q9. Financial institutions that are run on the principle of avoiding all risks will be ____________and will not adequately service the legitimate _________needs of the community.

A. stagnant, credit

B. competitive, banking

C. credit, stagnant

D. uncompetitive, growth

Q10. The ability of a bank to manage risk also affects investors' decisions. Even if a bank can generate large revenues, lack of _________can lower profits due to losses on loans.

A. financial planning

B. risk management

C. poor management

D. credit planning

Q11. _____________investors are more likely to invest in a bank that can provide profits and is not at an excessive risk of losing money.

A. Value

B. Growth

C. Conservative

D. Global

Q12. Difficulty in converting the assets to cash form at the need of the hour refers to

A. Credit risk

B. Market risk

C. Settlement risk

D. Liquidity risk

Q13. Risk arising due to changes in the price of securities, interest rate movement, inflation rate changes etc. indicates towards

A. Credit risk

B. Market risk

C. Settlement risk

D. Liquidity risk

Q14. _____________is the biggest risk for banks. It occurs when borrowers or counterparties fail to meet contractual obligations.

A. Credit risk

B. Market risk

C. Settlement risk

D. Liquidity risk

Q15. Which of the following risk is associated with human errors, system failures and inadequate procedures and controls?

A. Credit risk

B. Market risk

C. Operational risk

D. Liquidity risk

Answers for Self Assessment

1.	A	2.	D	3.	A	4.	B	5.	B
6.	A	7.	D	8.	D	9.	A	10.	B
11.	A	12.	D	13.	B	14.	A	15.	C

Review Questions

Q1. Analyse the significance of international financial institutions in the light of bringing economic growth and development in the

Q2. Critically analyse the developmental role of the international financial institutions in in the light of global poverty, healthcare, unemployment, food supply and education.

Q3. Differentiate the role of IMF (International monetary fund) and the World bank.

Q4. Elaborate the role of 'World Bank Group' and its key constituents.

Q5. How does Multilateral Investment Guarantee Agency (MIGA) is helping the member countries regarding trade related financial assistance?

Q6. Enlist the conditionality of IMF lending.

Q7. Elaborate the role of Bank of international settlements (BIS) and its cooperation with the central banks.

Q8. Which financial agency from the 'World Bank Group' is helping and encouraging the growth of the private sector in developing countries?

Q9. Russia – Ukraine issue has created a serious economic problem in the global economy. Give your views on the success or the failure of the international financial institutions in these crises.

Q10. Some economies are offering the freebies to their poor population (free ration, electricity etc.) instead of making them self-reliant for a sustainable lifestyle. What are your thoughts on the issue?

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Unit 04: International Finance

CONTENTS

Objectives

- Understand the principles of lending by MNC banks
- Understand the risks involved in lending
- Analyse the risks in lending
- Explore the credit monitoring mechanism of banks

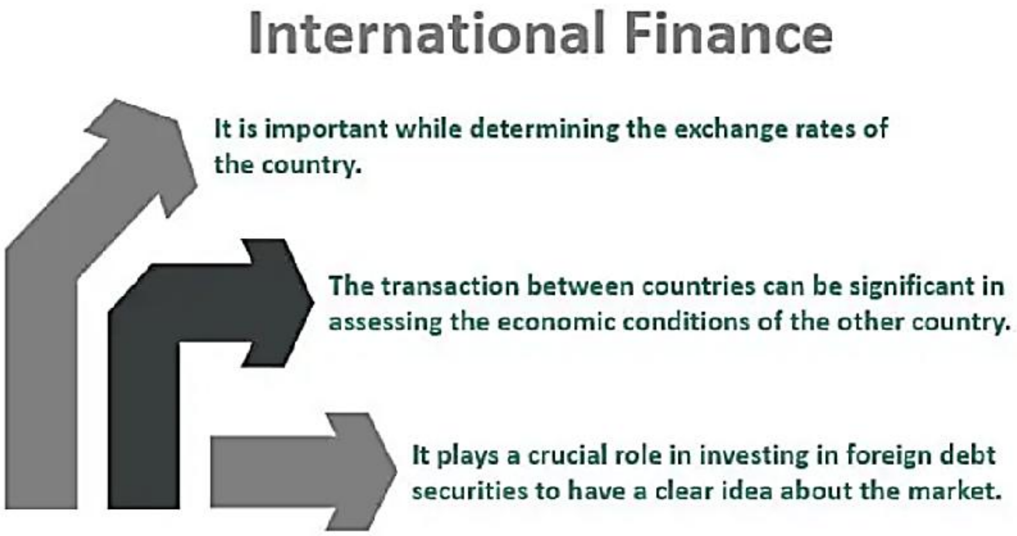
Introduction

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.

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.

We live in a globalized world. Every country is dependent on another country by some other means. Developed countries look for a cheap workforce from developing countries, and developing countries look for services and products.

When a trade happens between two countries, as in this case, many factors come into the picture and have to be considered during the execution of the business so that no violation of regulation happens. For any economy, international finance is a 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.



4.1 Significance and Importance

In a growing world moving towards globalization, its importance is growing in magnitude. Every day, the transaction between two countries for trade is scaling up with the supporting factors.

It considers the world a single market instead of individual markets and carries out the other procedures. For the same reason, the firms and corporations doing such research include institutions like the International Monetary fund (IMF), International Finance Corp (IFC), and the World Bank. Trade between two foreign countries is one factor in developing the local economy and improving economies of scale.

Currency fluctuations, arbitrage, interest rate, trade deficit, and other international macroeconomic factors are crucial in prevailing scenarios.

4.2 International Finance vs Domestic Finance

- When all the business and economic transactions occur within a domestic boundary of the country, it is said to be domestic finance. However, if the transactions occur across international borders, it refers to international finance.
- There is more than taxation; international finance's cultural and economic environment will be similar to domestic finance.
- Currency rates and currency derivatives are usually involved in international finance. Whereas in domestic finance, not many financial instruments as such are used.
- The stakeholders in domestic finance are usually uniform with a similar culture, language, and beliefs. Still, we can see diversity among stakeholders' cultures, languages, and values in international finance.
- There are numerous options to raise capital from international finance, so the challenge will be high. Whereas in domestic finance, not many opportunities to raise money will be there. Thus, resulting in fewer challenges.
- The accounting standards need to be as per GAAP in terms of international finance, whereas there is no need to maintain separate ones in domestic finance.

Benefits

- There is a range of options in international trade and finance to raise and manage the capital for the business.
- The scope of growth for companies concentrating on international trade is significantly higher than for companies that do not.
- Different currencies and more opportunities to manage the capital involved will improve its financial performance.
- The competitiveness improves when international trade is enabled in such markets. That is because the quality of goods and services will improve without much difference in price due to competition.
- Revenue from international trade can protect the company and not worry about domestic demand as they still need overseas.
- The company has operations in more than one country and can act swiftly in emergencies and conduct BCP (Business Continuity Protocol).

Disadvantages

- In political turmoil in one country, a stakeholder of international trade affect the other stakeholders of the same business.
- Depending on other countries' exchange rates is always risky, given that all currencies have significant volatility.
- One should carefully manage the credit risk because of international trade. Otherwise, it can hamper profitability to a greater extent.
- It requires the disclosure of sensitive data more than domestic finance; the chance of stolen confidential information is more in global markets.
- Local players cannot compete with big global players who are resource and research-backed to develop quality products and services.
- As more than one culture is involved, cultural differences can damage the brand's reputation if not tackled properly.

4.3 Fundamental Principles of Lending to MNCs

The function of lending may not be a difficult task but ensuring timely repayment of the loan and making a profit in the process is not so easy.

A banker will lend money to a customer only if he has total confidence in the customer's intention and ability to service the loan in terms of regular interest payments and to repay the loan on the due date.

- Purpose – the purpose to which money is borrowed plays a key role in determining the structure of the lending viz. term, repayment arrangement, control and security.
- Diversification / Concentration – lending to a specific sector
- character, capacity, capital, collateral and conditions
- Character implies honesty, integrity, creditworthiness, and capacity of the borrower to return the loan.
- Poor economic scenario may cause defaults even by financially strong entities.. It happened during COVID-19 outbreak

4.4 General Principles of Lending

(A) **Ability** – appraisal of the managerial capabilities of the borrower and the team

(B) **Margin** – stake / contribution of the borrower towards project cost reflects the financial commitment.

4.5 Assessment of Risk

With a volatile economy, domestic & globally, banks are required to focus with greater attention and concern with identification of risk, its measurement and monitoring.

Thus, managing risk has been an integral part of banking business.

4.6 Loan Monitoring

As all commercial bankers know, getting a loan on the books is just one part of the equation. After the loan is approved, the bank has to retain the borrower until the loan becomes due, which might not be for several years.

During this time, the borrower is likely to transition through different credit profiles, for example due to financial management decisions, industry trends, or the economic environment. Despite sound initial due diligence, things can go wrong with a loan before it gets repaid.

When monitoring commercial borrowers' financial health and their ability to meet obligations under loan agreements, banks have tended to be slow adopters of technology that could maximize efficiency and improve their risk management capabilities.

Banks' focus has been to develop customer relationships, build the opportunity pipeline, get the loan on the books as quickly as possible and move on to the next deal.

After the loan is written, conducting an annual risk review based on outdated information is still too common among lenders.

Who is at fault?

Can we blame the bankers? Under tremendous pressure to grow loans and revenues more efficiently in a highly competitive market, much of their effort and technology spend has focused on getting the loan approved and on board. Borrower assessment and loan monitoring technology can sometimes be a lower priority.

What does monitoring entail?

When a bank underwrites a new loan, it conducts a full credit assessment on the borrower, including the borrower's ability to pay back or refinance the loan at the time of maturity.

The bank expects the borrower's credit profile to remain the same as, or better than, at the time it extends the loan.

It puts in place covenants and other requirements to ensure that a minimum set of standards are met for a borrower's future conduct and financial performance.

4.7 Credit Monitoring

Most covenants establish benchmark metrics that are intended to ensure that the borrower remains financially healthy, and the bank's investment is protected.

These restrictions are based on the borrower's specific balance sheet, income statement, and cash flow characteristics, most commonly expressed in the form of financial ratios.

Other covenants monitor reporting and disclosure, to set a minimum standard of communication with the bank. For instance, the regular delivery of financial statements, or borrowing base certificates.

In more complex loans, the lender or group of lenders can impose certain restrictions on the borrower that govern what it can and cannot do with its business operations. For example, the lender might restrict key management changes, acquisitions, or asset disposals.

As part of agreeing to receive the loan, borrowers usually provide documentation demonstrating adherence to all the various requirements of their loan agreement, both at the outset and at frequent intervals during the loan term.

Borrowers also make themselves available to discuss their business and financial performance with the bank's officers throughout the loan period.

Why is Monitoring Important

Regular monitoring is undertaken to ensure the bank's investment is protected.

A good monitoring program will quickly identify any red flags that would suggest the borrower's financial health is starting to deteriorate. Being able to detect these early warning signals is critical, as it allows the bank to remedy the increased risk to its investment.

At a minimum, the lender might want to reprice the loan to charge for the additional risk.

In more severe circumstances, the bank might want to recall the loan by, for instance, defaulting the borrower and demanding immediate repayment.

Either way, if not captured early enough, the bank's options for remedying the situation become more limited.

Banks also face regulatory pressure to have strong risk management processes in place, to ensure that underwriting standards remain strong, and to put an effective monitoring regime in place.

Today, regulators are requesting more data, more often, and faster.

Timely monitoring ensures that the bank is not simply meeting regulatory oversight, but also adequately quantifying its risk, accurately calculating its capital, and setting aside proper reserves. All these things are critical in the eyes of regulators.

Transforming Monitoring with the use of an Integrated System

Technology can have a meaningful impact on loan portfolio monitoring, particularly by detecting early warning signals of risk deterioration.

With bankers being asked to do more with less resources, technology can help fill that gap by enhancing risk management capabilities and increasing efficiency. Let us look at the practical ways technology can help.

4.8 Risk Monitoring Using Technology

The first step is to monitor borrowers and collate the information related to their financial health in accordance with the loan agreement.

A robust system that can track requirements under the loan agreement and internal policy requirements is critical.

A good system can also alert the banker when items are due from borrowers, or certain tasks need completion internally, such as an annual review or a client due diligence visit.

It is also important for the system to track the timeliness of information receipt.

If items are past due, it is imperative to dedicate more attention to ensure that outstanding items are resolved as soon as possible.

Portfolio managers, senior risk executives, and auditors must know how teams are monitoring loan portfolios, and that they are doing so effectively.

They also must know where there are bottlenecks, and how these issues are being addressed. The old adage 'time is money' is seldom more true than in dealing with underperforming credits in a loan portfolio. 'Bad news never improves with age' is another relevant truism.

With new technology, financial statements can now be automatically captured in the lender's spreading tool without any manual data entry.

For example, the lender can use an application program interface (API) to pull information directly from the borrowers' accounting software package, or use optical character recognition (OCR) technology to read financial statements and the accompanying notes from scanned documents or non-readable PDFs.

Machine learning further refines the interpretation of information by learning how to replicate the manual processes currently performed by analysts spreading the financial information. Hence, significantly increasing accuracy with limited manual intervention.

The process of remotely capturing financial statements and automatically calculating financial covenant metrics substantially lightens the lender's administrative burden.

It also mitigates risk by reducing the time before the lender is alerted to any financial deterioration.

Summary

Global trade requires capital requirements from time to time and the business entities involved in the global trade depends on the financial institutions like banks for this capital. Lending is a tough and a challenging business for such financial institutions. Banks need to take each step very carefully while dealing with such borrowers who are spread across the world. Despite all the precautions taken by the lending institutions there is no guarantee that payment defaults would not happen. Hence the need of experts and professionals, risk management, awareness about the global macro-economic factors, international regulations etc play a crucial role in international financing.

The very existence of an international financial system means that there are possibilities of international financial crises. This is where the study of international finance becomes very important. To know about the international financial crises, we have to understand the nature of the international financial system.

Keywords

Globalization -Globalization is a term used to describe how trade and technology have made the world into a more connected and interdependent place. Globalization also captures in its scope the economic and social changes that have come about as a result.

International finance - International finance, sometimes known as international macroeconomics, is the study of monetary interactions between two or more countries, focusing on areas such as foreign direct investment and currency exchange rates.

Lending institutions - Lending institution means any bank, insurance company, savings and loan association or any other person or organization regularly engaged in the business of lending money or guaranteeing loans.

Risk assessment - Risk assessment is the process of analysing potential events that may result in the loss of an asset, loan, or investment. Companies, governments, and investors conduct risk assessments before embarking on a new project, business, or investment.

Loan monitoring - Financial institutions often execute loan monitoring activities on a prospective borrower's portfolio. Basically, they serve as an important aspect of the credit risk management process for a lending and banking institution.

Lending principles–Banks and lending institutions follow certain basic **principles of lending** while doing carrying out their lending and credit operations. Banks deals with public money accepting deposit and lend to their borrowers to earn profit. Banks follow some fundamental principles of lending in order to ensure safety, security and profitability on money it lend. Lending is one of the most important functions performed by the commercial banks and is major source of income of bank.The lending process in any banking institutions is based on some core principles such as safety, liquidity, diversity, stability, and profitability.

Review Questions

Q1. Evaluate the significance of the study of international finance is important for the entities involved in any kind of international trade? Elaborate the difference between international finance and domestic finance.

Q2. Enlist the benefits and disadvantages of international finance.

Q3. Elaborate the fundamental and general principles of lending to the MNCs (Multi-National Companies)

Q4. How does the 'loan monitoring' can help the lending institutions in identifying the default probabilities and setting up an effective risk management system?

Q5. Elaborate the use of technology in risk monitoring.

Q6. Being a head of a lending institution how will you make it sure that the quality lending should be there and the possibilities of default should be minimal?

Self Assessment

Q1. The function of lending may not be a difficult task but ensuring timely _______of the loan and making a ________in the process is a challenge.

A. Repayment, profit
B. Investment, loss
C. Disbursement, efficient system
D. Repayment, competitive organization

Q2. A banker will lend money to a customer only if he has total confidence in the customer's ______ and _________to service the loan in terms of regular interest payments and to repay the loan on the due date.

A. Will, capacity
B. Intention, ability
C. Character, collateral
D. Conditions, capital

Q3. __________ implies honesty, integrity, creditworthiness, and capacity of the borrower to return the loan

A. Capacity
B. Collateral
C. Conditions
D. Character

Q4. With a volatile economy, domestic & globally, banks are required to focus with greater attention and concern with identification of________, its measurement and monitoring.

A. Risk
B. Opportunity
C. Capital requirement
D. Collateral

Q4. Despite sound initial due diligence, things can go wrong with a loan before it gets repaid.

A. True
B. False

Q5. Which of the following statement is not true?

A. When a bank underwrites a new loan, it conducts a full credit assessment on the borrower
B. Banks check the ability to pay back or refinance the loan at the time of maturity.
C. Bank expects the borrower's credit profile to remain unstable during the loan repayment period
D. Banks ensure that a minimum set of standards are met for a borrower's future conduct and financial performance.

Q6. In more complex loans, the lender or group of lenders can impose certain restrictions on the borrower that govern what it can and cannot do with its business operations.

A. True

B. False

Q7. Loan monitoring is important from a bank's perspective

1) to ensure the bank's investment is protected.

2) to make sure the revenue stream should not get disturbed

3) to identify any red flags that may deteriorate the credit profile

4) to streamline the future lending practices

choose the applicable statements

A. 1) and 3)

B. 1), 3) and 4)

C. Only 2) and 4)

D. All the above

Q8. Technology can have a meaningful impact on loan portfolio monitoring, particularly by detecting early warning signals of risk deterioration.

A. True

B. False

Q9. The three C's of credit are:

A. Character, capital and charity

B. Character, capacity and charity

C. Charity, capital and censor

D. Character, capacity and capital

Q10. An established credit rating can be damaged if:

A. A person has no collateral.

B. A borrower fails to live up to the repayment terms of an agreement.

C. A person's income increases.

D. A person's expenses decrease.

Q11. A good credit rating is established by

A. being a nice person

B. making your payments on time

C. making your payments a little past their due date

D. not making any payments on your credit card

Q12. An indication of the level of risk that someone would pose if credit were granted to them, is called:

A. failure rate

B. risk management

C. liability

D. credit rating

Q13. a bank makes sure that the funds are utilized for the sanctioned purpose and at the same time complying with all sanction terms &conditions is called

A. credit monitoring

B. credit evaluation

C. credit analysis

D. credit synthesis

Q14. This "C" refers to the borrower's reliability and trustworthiness.

A. character

B. capacity

C. capital

D. collateral

Q15. Foreign exchange banks specialized in providing _________.

A. long term loans

B. short term loans

C. agricultural loans

D. foreign exchange

Answers for Self Assessment

1.	A	2.	B	3.	D	4.	A	5.	A
6.	C	7.	A	8.	D	9.	A	10.	D
11.	B	12.	B	13.	D	14.	A	15.	A

Further Readings

https://www.moodysanalytics.com/articles/2018/redefining-loan-monitoring

https://www.wallstreetmojo.com/international-finance/

https://www.bis.org/publ/bcbsc125.pdf

https://www.jstor.org/stable/40684665

https://www.moodysanalytics.com/articles/2018/redefining-loan-monitoring

Unit 05: International Banking

CONTENTS

Objectives

After studying this unit, you should be able:

- understand the credit rating agencies and their framework
- understand capital markets
- understand Eurobond market and other securities
- understand the syndicate loans and financial considerations

Introduction

Credit rating is an analysis of the credit risks associated with a financial instrument or a financial entity. It is a rating given to a particular entity based on the credentials and the extent to which the financial statements of the entity are sound, in terms of borrowing and lending that has been done in the past.Credit rating is an analysis of the credit risks associated with a financial instrument or a financial entity. It is a rating given to a particular entity based on the credentials and the extent to which the financial statements of the entity are sound, in terms of borrowing and lending that has been done in the past. A credit rating is an opinion of a particular credit agency regarding the ability and willingness an entity (government, business, or individual) to fulfill its financial obligations in completeness and within the established due dates. A credit rating also signifies the likelihood a debtor will default. It is also representative of the credit risk carried by a debt instrument – whether a loan or a bond issuance.

5.1 How DoRatings Look?

Rating	What Rating Shows
AAA	Bonds and other financial products of this rating considered as the lowest credit risk and highest quality. In financial terms it means, that the bonds possess least investment risk.
AA1	Bonds and other financial products of this rating are believed as high quality and very low credit risk. In business term this rating shows high grade bonds.
AA2	same as above
AA3	same as above
A1	Bonds and other financial products of this rating are assumed as upper-medium grade and low credit risk. It shows high mid grade bonds with favourbale investment factors.
A2	same as above
A3	same as above
BAA1	Rated as medium grade, with some speculative elements and moderate credit risk. It shows mid grade bonds neither low grade nor high grade safety.
BAA	hose financial products have this rating; it shows they are covered with speculative factors.

Moody's	S&P	Fitch	DBRS
Aaa	AAA	AAA	AAA
Aa1	AA+	AA+	AA (high)
Aa2	AA	AA	AA
Aa3	AA-	AA-	AA (low)
A1	A+	A+	A (high)
A2	A	A	A
A3	A-	A-	A (low)
Baa1	BBB+	BBB+	BBB (high)
Baa2	BBB	BBB	BBB
Baa3	BBB-	BBB-	BBB (low)
Ba1	BB+	BB+	BB (high)
Ba2	BB	BB	BB
Ba3	BB-	BB-	BB (low)
B1	B+	B+	B (high)
B2	B	B	B
B3	B-	B-	B (low)
Caa1	CCC+	CCC+	CCC (high)
Caa2	CCC	CCC	CCC
Caa3	CCC-	CCC-	CCC (low)
-	D	D	D

- A credit rating is, however, not an assurance or guarantee of a kind of financial performance by a certain instrument of debt or a specific debtor. (Lehman Bros Rating was AAA)
- The opinions provided by a credit agency do not replace those of a financial advisor or portfolio manager.

5.2 Credit Rating Agencies

A credit agency evaluates the credit rating of a debtor by analyzing the qualitative and quantitative attributes of the entity in question. The information may be sourced from internal information provided by the entity, such as audited financial statements, annual reports, as well as external information such as analyst reports, published news articles, overall industry analysis, and projections. A credit agency is not involved in the transaction of the deal and, therefore, is deemed to provide an independent and impartial opinion of the credit risk carried by a particular entity seeking to raise money through loans or bond issuance. Presently, there are three prominent global credit agencies that control 85% of the overall ratings market:

- Moody's Investor Services,
- Standard and Poor's (S&P), and
- Fitch Group.

Each agency uses unique, but strikingly similar, rating styles to indicate credit ratings.

- S&P – Financial consulting, credit rating, analytical material on securities, Co's and banks
- Moody's investor service – Credit rating, research & risk analysis
- Fitch ratings – Credit ratings of varied securities – corporate, municipal bonds, preferred stocks, commercial papers and to non commercial organizations

Rating Criteria

Need for debt rating:to enhance the ability of the issuer to raise proposed new debt as cheaply as possible. Ratings are valuable for the less sophisticated investors

Credit ratings of global banks

While doing the ratings of the banks such agencies focus on –

- Detailed income statement for the last 5 years including subsidiaries
- Detailed balance sheet of the bank with schedules for major asset & liability accounts
- Loan portfolio details
- List of loans in excess of 5% of equity
- Comprehensive description of the organization and management structure of the bank
- Projections, including assumptions for the next 5 years

5.3 Capital Markets

- Capital markets are financial markets that bring buyers and sellers together to trade stocks, bonds, currencies, and other financial assets.
- Capital markets include the stock market and the bond market.
- They help people with ideas become entrepreneurs and help small businesses grow into big companies.
- They also give folks like you and me opportunities to save and invest for our futures.
- Here's an example. Meet John.
- John has an idea for a new business—delicious ice cream that's healthy enough to eat anytime of the day.
- Yum! He saved his money in the bank, earned interest, and used that to start his business.
- John tests the market, and BOOM, his product is a hit.
- In fact, there's so much demand he can't fill ice cream cones fast enough; the business is growing! John needs to hire people to help him produce, sell, and deliver his ice cream.
- He needs more ingredients from his suppliers, like the fruit seller and the cone baker.
- John doesn't have the money to pay for all of this right now, but according to his business plan and test market results, he's going to make millions in the first year.
- Enter: capital markets.
- Financial capital is money entrepreneurs and businesses use to buy resources and supplies.
- These are then used to make products or provide services to buyers.

- Financial capital is raised through capital markets in two ways—by selling bonds, which are like loans that the business will repay at a later date with interest, or by selling stocks, which are sold in exchange for the partial ownership of the business.
- Issuing or selling stocks takes place through an IPO or initial public offering.
- The amount buyers are willing to spend and sellers want to make determines the price of the stock.
- Unlike a loan, which has to be repaid, issuing an IPO or "going public" allows others to buy a share or a portion of a business and become a partial owner.
- The person or institution with the most shares at any time is the company's main owner.
- A company may issue bonds instead of stocks.
- A bond is a loan investors make to a company or government.
- Unlike stockholders, bond purchasers are not company owners. Instead, they receive interest payments and are repaid the loan amount at a future date.
- Businesses issue bonds and so do federal, state, and local governments.
- Bonds often help pay for big projects, such as new schools, hospitals, stadiums, and roads and power plants etc.
- Without markets for stocks and bonds, business owners would have fewer options to bring their ideas to life or to expand their businesses; they would have to save up enough cash to re-invest.
- With healthy capital markets, business owners can obtain the needed financial capital to build successful companies.
- They can also expand existing businesses to create new jobs and strengthen the economy.
- Capital markets also reduce the cost of doing business by providing the global economy with a reliable source of cash or liquidity.

Issuance of Stock in Foreign Markets

To improve their international reputation, some Australian businesses issue stock on foreign exchanges. Corporations in need of equity have an option because to the existence of several markets for new offerings.

The efficiency of new issues should rise as a result of the competition among different new-issues markets.

The choice of where to deposit an MNC's stock might be influenced by the locations of its operations. The MNC may very well want a nation where it is anticipated to produce sufficient future cash flows to pay dividends. Some MNCs with Australian headquarters have their shares actively listed on a number of international stock exchanges, making it simple for investors outside of Australia to purchase those shares.

In every nation where it issues shares, an MNC is required to have its stock listed on an exchange.

Foreign investors will only buy stock if they can later readily sell their interests on the domestic secondary market. The stock is valued in the local currency of the nation where it is located

Effect of the euro:

More MNCs with headquarters in the US, Australia, and Europe have offered stock in Europe as a result of the unification of numerous European nations under a single currency (the euro). In the past, an MNC had to borrow money from local banks in each of the countries where it did business since each one required a separate currency. It can now finance its activities across many European nations using the euro, and it might be able to raise all the money it requires in a single, euro-denominated stock offering. After then, the MNC can utilise a portion of its revenue (in euros) to provide dividends to stockholders. Additionally, thanks to the euro, European investors may buy stocks in numerous European nations without having to worry about exchange rate risk.

Issuance of foreign stock in United States

Because the US new-issues market is so liquid, foreign firms in need of substantial sums of money occasionally issue shares here (these are known as Yankee stock offerings). In other words, a foreign business has a greater chance of selling its whole issue of shares on the US market than it can in other, smaller markets.

A non-US company's shareholder base is quite small when it offers stock in that nation. Most of the shares may be held by a small number of sizable institutional investors. Non-US corporations may diversify their shareholder base by issuing stock in the US, which might minimise the share price volatility brought on by big investors selling shares.

Investment banks and other financial institutions frequently act as underwriters of stock intended for the US market, and they are compensated with underwriting fees equal to around 7% of the market value of the issued shares. Non-US corporations might be able to place their whole stock offering within the United States because many American financial institutions buy foreign equities as investments.

Recent stock offerings by non-US corporations in the US are frequently a result of privatisation initiatives in Latin America and Europe. In other words, companies that were formerly held by the government are being sold to US stockholders.

Their local stock exchanges are too small to process the stock offerings due to the size of some of these enterprises, which are rather significant.

As a result, many privatised companies situated abroad are being financed by US investors. Companies that sell shares in the US typically have to adhere to strict disclosure requirements regarding their financial situation. When they meet the requirements of a Securities and Exchange Commission guideline (known as Rule 144a) by selling stock directly to institutional investors, they are free from some of these regulations.

American Depositary Receipt

By issuing American depositary receipts (ADRs), certificates that represent bundles of the company's shares, non-US enterprises can also access equity financing.

The use of ADRs enables non-US enterprises to access the US market for financing while avoiding some disclosure restrictions placed on stock offerings in the US.

The ADR market expanded as national companies were privatized in the early 1990s because some of these companies issued ADRs to raise money.

Examples include Heineken (HINKY, Netherlands), Nokia (NOK, Finland), China Telecom Corp. (CHA, China), Cemex (ticker symbol CX, based in Mexico), and Credit Suisse Group (CS, Switzerland)

The price of an ADR fluctuates every day in reaction to supply and demand factors since ADR shares can be traded much like shares of a business.

But over time, an ADR's value ought to follow the value of the related stock listed on the foreign stock exchange (after exchange rate effects are taken into account). The price of an ADR is calculated using the formula:

$P_{ADR} = P_{FS}\ X S$

Here, PADR stands for the ADR price, PFS for the foreign stock price expressed in foreign currency, and S for the current foreign exchange rate.

The ADR price should fluctuate proportionally (against the US dollar) with changes in the foreign stock's currency, holding the foreign stock's price constant.

American investors who believe that a foreign stock will perform well and that the currency in which it is denominated will increase in value relative to the dollar are particularly drawn to American depositary receipts.

International Debt Market

- According to the Bank for International Settlements, the international debt market involves the buying and selling of corporate and government bonds issued by non-residents of the local debt market.

- In other words, an international debt market is a bond market where only foreign bonds are traded.

Eurobond

- A Eurobond is a debt instrument that's denominated in a currency other than the home currency of the country or market in which it is issued.
- Eurobonds are frequently grouped together by the currency in which they are denominated, such as Eurodollar or Euro-yen bonds.
- Since Eurobonds are issued in an external currency, they're often called external bonds.
- Eurobonds are important because they help organizations raise capital while having the flexibility to issue them in another currency.
- Eurobond refers only to the fact the bond is issued outside of the borders of the currency's home country; it doesn't mean the bond was issued in Europe.
- Issuance of Eurobonds is usually handled by an international syndicate of financial institutions on behalf of the borrower, one of which may underwrite the bond, thus guaranteeing the purchase of the entire issue.
- The global bond market totals over $100 trillion in outstanding debt.
- The fact many Eurobonds are unregistered, and trade-in bearer form makes definitive numbers for the sector impossible to obtain, but it is likely they account for about 30% of the total.
- A growing portion of Eurobond issuance is from emerging market nations, with both governments and companies seeking deeper and more developed markets in which to borrow.

How Do Eurobonds Work?

- The essence of Eurobonds is that a company can choose any country to issue bonds depending on its economic and regulatory environment (e.g., interest rates in the country, economic cycle, market sizes, etc.).
- What makes the bonds attractive among investors is a small notional amount of a bond (face value or par value), which means that the bond is relatively cheap to obtain.
- Importantly, Eurobonds are highly liquid and can be converted into cash within one fiscal year.
- The categorization of Eurobonds is dependent on the currency in which the bonds were issued. If a US-based company decides to release Eurobonds in China in British pounds, then the bonds will be categorized as euro-pound bonds.
- Typically, financial institutions, such as investment banks, issue bonds on behalf of the borrower. If a bank will be responsible for the underwriting process, it implies a guarantee to the borrower that the whole bond issue will be sold in the primary market during the initial debt offering process.
- Note that the term "Eurobond" refers only to the fact that the bond was issued in a different country and currency. It does not need to be a country in Europe. It can be whatever country in the world.
- For example, Eurobonds can be issued in China and denominated in US dollars.

How is a Eurobond Issued?

- Eurobonds are issued by many institutions, such as:
- Corporations
- Governments
- Syndicates
- The primary reason for issuing Eurobonds is a need for foreign currency capital. Since the bonds are fixed-income securities; they usually offer a fixed interest rate to investors.

Benefits to Issuers

- A list of benefits to Eurobond issuers consists of the following:
- Flexibility to choose a favorable country to originate bonds and currency
- A country choice with lower interest rates
- Avoidance of currency risk or forex risk by using Eurobonds
- Access to a huge range of bond maturity periods that can be chosen by the issuer
- International bond trade despite being issued in a certain country that broadens potential investor base

Zero-coupon bond

- A zero-coupon bond is a bond that pays no interest and trades at a discount to its face value. It is also called a pure discount bond or deep discount bond. U.S. Treasury bills are an example of a zero-coupon bond.

- As a zero-coupon bond does not pay periodic coupons, the bond trades at a discount to its face value. To understand why, consider the time value of money.
- The time value of money is a concept that illustrates that money is worth more now than an identical sum in the future – an investor would prefer to receive $100 today than $100 in one year. By receiving $100 today, the investor is able to put that money into a savings account and earn interest (thereby having more than $100 in a year's time).
- Extending the idea above into zero-coupon bonds – an investor who purchases the bond today must be compensated with a higher future value.
- Therefore, a zero-coupon bond must trade at a discount because the issuer must offer a return to the investor for purchasing the bond.

Pricing Zero-Coupon Bonds

- To calculate the price of a zero-coupon bond, use the following formula:

Where:

$$\text{Price of Bond} = \frac{\text{Face Value}}{(1+r)^n}$$

- Face value is the future value (maturity value) of the bond;
- r is the required rate of return or interest rate; and
- n is the number of years until maturity.

Note that the formula above assumes that the interest rate is compounded annually. In reality, zero-coupon bonds are generally compounded semi-annually. In such a case, refer to the following formula:

$$\text{Price of Bond} = \frac{\text{Face Value}}{(1 + r/2)^{n \times 2}}$$

- Note that the formula above looks similar to the previous one, with the only difference being the required rate of return (r) being divided by 2 and the number of years until maturity (n) being multiplied by two.
- Since the bond compounds semi-annually, we must divide the required rate of return by two and multiply the number of years until maturity by two to account for the total number of periods the bond will be compounded for.
- John is looking to purchase a zero-coupon bond with a face value of $1,000 and 5 years to maturity. The interest rate on the bond is 5% compounded semi-annually. What price will John pay for the bond today?
- Price of bond = $1,000 / (1+0.05/2)5*2 = $781.20
- The price that John will pay for the bond today is $781.20.

5.4 Raising Resources

What the Borrower Should Consider?

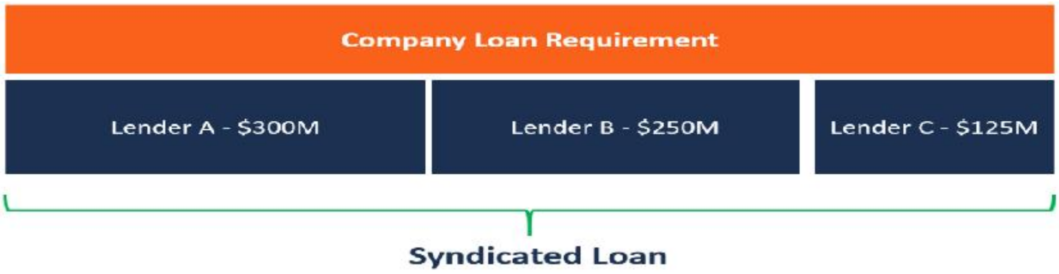
The various aspects the borrower intending to raise resources should take into account includes:

1) Identification of the need for such funds (R&D, expansion & diversification)
2) Assessment of market conditions (Int rates, economic cycle and stability)
3) Choice of currency ($ € £ ¥)
4) The various aspects the borrower intending to raise resources should take into account includes:
    1) Risk exposed to (currency fluctuation, Int rate changes, political risks etc.)
    2) Type and nature of debt instrument (Fix vs floating, redeemable vs irredeemable, convertible vs non convertible)

5) The various aspects the borrower intending to raise resources should take into account includes:
   1) Selection of the appropriate borrowing vehicle (issuing debentures, bank borrowing etc.)

Syndicated loans

- A syndicated loan is offered by a group of lenders who work together to provide credit to a large borrower.
- The borrower can be a corporation, an individual project, or a government.
- Each lender in the syndicate contributes part of the loan amount, and they all share in the lending risk.



One of the lenders act as the manager (arranging bank), which administers the loan on behalf of the other lenders in the syndicate.

- The syndicate may be a combination of various types of loans, each with different repayment terms that are agreed upon during negotiations between the lenders and the borrower.

Advantages of a Syndicated Loan

1) Less time and effort involved

- The borrower is not required to meet all the lenders in the syndicate to negotiate the terms of the loan. Rather, the borrower only needs to meet with the arranging bank to negotiate and agree on the terms of the loan.
- The borrower is not required to meet all the lenders in the syndicate to negotiate the terms of the loan. Rather, the borrower only needs to meet with the arranging bank to negotiate and agree on the terms of the loan.

2) Diversification of loan terms

- Since a syndicated loan is contributed to by multiple lenders, the loan can be structured in different types of loans and securities.
- The varying loan types offer different types of interest, such as fixed or floating interest rates, which makes it more flexible for the borrower.
- Also, borrowing in different currencies protects the borrower from currency risks resulting from external factors such as inflation and government laws and policies.

3) Large amount

- Loan syndication allows borrowers to borrow large amounts to finance capital-intensive projects.
- A large corporation or government can borrow a huge loan to finance large equipment leasing, mergers, and financing transactions in telecommunications, petrochemical, mining, energy, transportation, etc.
- A single lender would be unable to raise funds to finance such projects, and therefore, bringing several lenders to provide the financing makes it easy to carry out such projects.

4) Positive reputation

- The participation of multiple lenders to finance a borrower's project is a reinforcement of the borrower's good market image.
- Borrowers that have successfully paid syndicated loans in the past elicit a positive reputation among lenders, which makes it easier for them to access credit facilities from financial institutions in the future.

Advantages to the participating banks

- Credit risk is spread / distributed among many banks
- Strengthens the relationship between the borrower and banks
- Small banks can also participate in lending to big corporates
- Convenient for participating banks as agent bank administers the loan
- There is a secondary market for the syndicated loans

Financial considerations

In a syndicated loan arrangement, the borrower has to pay several types of fee in addition to interest payments. In working out the cost of funds, all costs payable has to be taken into consideration.

The various costs are as under:

- Interest rates basis and spreads
- Front end fee
- Agency fee
- Commitment fees – payable on undrawn amount after a prescribed time
- Out of pocket expenses
- Signing of the agreement is followed by compliance of conditions. These are divided into conditions precedent (CPs) i.e. before drawing the loan and condition subsequent (CSS) i.e. after drawing the loan which need to be complied within specified time limits.
- After the compliance and the receipt of the legal opinion that the agreement is legal, valid and binding on the parties, the lead manager declares the loan 'effective' and he syndication process formally comes to an end.

Summary

MNCs are significantly impacted by investor trading of financial assets like equities on global financial markets. First, because it effects demand for the stock of the MNC, it can alter the price of the MNC's stock and, consequently, the cost of equity to an MNC. Additionally, it permits MNCs to offer securities on international markets. The actions and performance of an MNC might therefore be indirectly impacted by overseas investing by individual and institutional investors, even though it is not the most important activity for MNCs. Therefore, in order to predict how the global flow of capital may change in the future and how that shift may influence MNCs, it is vital to comprehend the drivers and practices of international investing in equity markets. The financial needs of an MNC may be funded through the euromarkets. The eurocurrency, Eurobond, euro note, and euro-commercial markets are all included in the phrase "Euromarkets." Long-term sources of funding are generally used by multinational corporations to finance long-term initiatives. They have access to both domestic and international funding sources. Before making a final decision, MNCs should carefully weigh all available funding options. To finance foreign initiatives in a way that maximizes the wealth of the MNC, financial managers must be aware of their sources of long-term funding.

Key words

American depositary receipts: certificates demonstrating ownership of foreign equities that are traded on American stock exchanges

International mutual funds (IMFs) Portfolios of stocks from numerous nations.

Exchange-traded funds: Exchange-traded funds (ETFs) were developed so that investors may invest directly in a stock index representing any one of numerous countries. ETFs are indexes that reflect composites of equities for specific countries. Be aware that some people refer to ETFs as iShares or world equity benchmark shares (WEBS).

Self Assessment

1. Which of the following is wrong about Eurobonds and foreignbonds?
A. A eurobond issue is denominated in a particular currency and sold to investors in a capital market other than the country that issued the denominating currency.
B. A foreign bond, on the other hand, is one offered by a foreign borrower to investors in a national capital market denominated in the nation's currency.
C. Australian dollar-denominated bonds issued by Apple Corporation and sold to Australian investors are foreign bonds.
D. The bond issued by an Australian company denominated in Australian dollars to New Zealand investors is foreign bond.

2. Which of the following is wrong about Eurobonds?
A. Bonds denominated in Chinese renminbi and sold to offshore investors are called dim sum bonds.
B. Bonds denominated in Indian rupees and sold to overseas investors are called masala bonds. Some foreign bonds also carry interesting appellations.
C. Yankee bonds are US dollar-denominated foreign bonds sold originally to US investors.
D. Australian dollar-denominated bonds issued into the domestic market by non-resident investors are known asBulldogs bonds.

3. Which of the following is wrong about Eurobonds?
A. The eurobond is free from regulation and is instead self-regulated by the Association of International Bond Dealers.
B. Borrowers in the eurobond markets are generally large MNCs with excellent credit ratings.
C. The major rationale for the existence of the eurobond market is the lack of regulation and taxation.
D. Eurobonds are issues in non-bearer form and are hence registered, with record of ownership.

4. Which of the following is wrong about American depositary receipts?
A. Non-US companies also obtain equity financing by issuing American depositary receipts (ADRs), which are certificates representing bundles of the company's stock.
B. The use of ADRs circumvents some disclosure requirements imposed on stock offerings in the United States while enabling non-US companies to tap the US market for funds.
C. The ADR market grew when national businesses were being privatised in the early 1990s, since some of these businesses issued ADRs to obtain financing.
D. Because ADR shares can-not be traded just like shares of a stock, the price of an ADR does not change each day in response to demand and supply conditions.

5. Offerings of stock by non-US companies in the US markets is called….
A. Yankee stock offerings)

B. masala bonds.
C. dim sum bonds
D. Bulldogs Bonds

6. Which of the following is wrong about syndicate loans?
A. A syndicated loan is offered by a group of lenders who work together to provide credit to a large borrower.
B. The borrower can be a corporation, an individual project, or a government.
C. Each lender in the syndicate contributes part of the loan amount, and they all share in the lending risk.
D. The borrower can only be a government

7. Which of the following is not an advantage of syndicate loan?
A. The participation of multiple lenders to finance a borrower's project is a reinforcement of the borrower's good market image.
B. A single lender would be unable to raise funds to finance such projects, and therefore, bringing several lenders to provide the financing makes it easy to carry out such projects.
C. Loan syndication allows borrowers to borrow large amounts to finance capital-intensive projects.
D. It leads to non-diversification of loan terms

8. Which of the following is wrong about credit rating?
A. Credit rating is an analysis of the credit risks associated with a financial instrument or a financial entity.
B. It is a rating given to a particular entity based on the credentials and the extent to which the financial statements of the entity are sound, in terms of borrowing and lending that has been done in the past.
C. A credit rating is alegal verdict by a specific credit agency of an institution's capacity and willingness to meet its financial commitments in full and by the specified due dates, whether that entity is a government, business, or individual.
D. A credit rating is an opininon by a specific credit agency of an institution's capacity and willingness to meet its financial commitments in full and by the specified due dates, whether that entity is a government, business, or individual.

9. Which of the following is right about credit rating agencies?
A. The financial performance of a particular debt instrument or a specific debtor can be assured or guaranteed by a credit rating, however. (Lehman Brothers was rated AAA)
B. The advice offered by a credit bureau takes the place of that of a portfolio manager or financial advisor.
C. By ignoring the qualitative and quantitative characteristics of the subject entity, a credit agency assesses the credit rating of a debtor.
D. A credit agency is considered to offer abiased assessment of the credit risk borne by a specific organisation because it is a party to the transaction.

10. S&P credit agency is based in
A. US
B. UK

C. Canada
D. France

11. Fitch is dual-headquartered in
A. New York City and London
B. Los Angeles and Chicago
C. Houston and Texas
D. California and San diego

12. While doing the ratings of the bank'scredit agencies focus on Detailed income statement for the last…. years including subsidiaries
A. 5
B. 6
C. 7
D. 8

13. While doing the ratings of the banks credit agencies focus on List of loans in excess of …….% of equity
A. 5
B. 6
C. 7
D. 8

14. While doing the ratings of the banks credit agencies focus on Projections, including assumptions for the next …. years
A. 5
B. 6
C. 7
D. 8

15. ….is the highest rating across all three rating agencies
A. "AAA"
B. BBB
C. BBA
D. CCC

Answers for Self Assessment

1.	D	2.	D	3.	D	4.	D	5.	A
6.	D	7.	D	8.	C	9.	B	10.	A
11.	A	12.	A	13.	A	14.	A	15.	A

Review Questions

1. Describe how the Eurobond and international bond markets operate.

2. Elucidate how an MNC decides to issue debt in order to reduce its exposure to exchange rate risk and interest costs.
3. Give a summary of the world's equities markets
4. Describe the procedure and advantages of investing in global equities markets.
5. Describe how credit rating companies work and their advantages.

Further Readings

- International Financial Management 2ndEdition by Jeff Madura Ariful Hoque Chandrasekhar Krishnamurti, 2018
- International Accounting by Timothy S Doupnik_ Hector Perera, McGraw-Hill Education (2014).

Unit 06: Project Finance

CONTENTS

Objectives

After studying this unit, you will be able to:

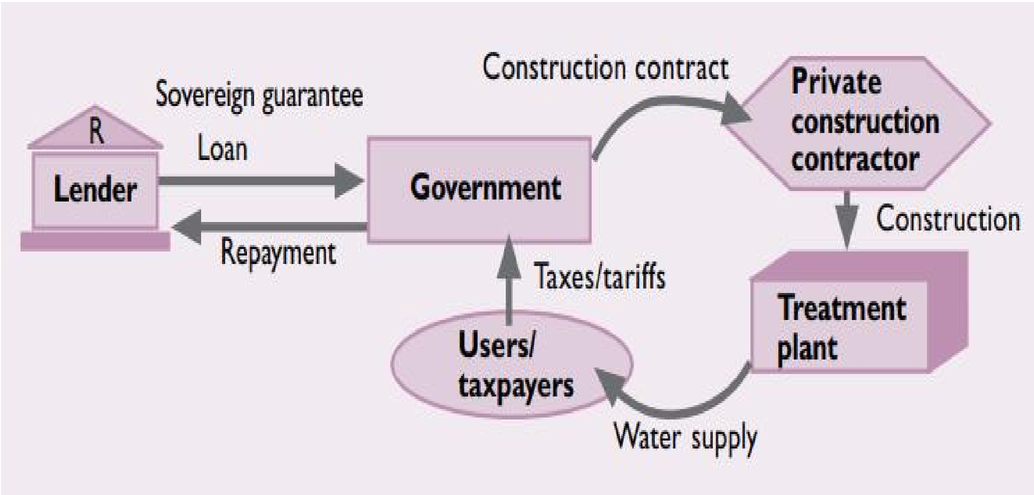
- understand project financing
- exploring the sources of project financing
- analysing considerations in project financing
- understand FIIs and FDI from project financing perspective
- explore different types of FDI
- difference between FDI and FIIs
- understand the ADR, GDR and external commercial borrowings
- understand the merger and acquisition activity and financing of merger and acquisitions.

Introduction

- Project finance refers to the funding of long-term projects, such as public infrastructure or services, industrial projects, and others through a specific financial structure. Finances can consist of a mix of debt and equity. The cash flows from the project enable servicing of the debt and repayment of debt and equity. Project finance refers to the funding of long-term projects, such as public infrastructure or services, industrial projects, and others through a specificfinancial structure. Finances can consist of a mix of debt and equity. The cash flows from the project enable servicing of the debt and repayment of debt and equity. Project finance is the financial analysis of the complete life-cycle of a project. Typically, a cost-benefit analysis is used to determine if the economic benefits of a project are larger than the economic costs. The analysis is particularly important for long-term projects of growth CAPEX.

6.1 Public Finance

A government borrows funds to finance an infrastructure project and gives a sovereign guarantee to lenders to repay all funds. Government may contribute its own equity in addition to the borrowed funds. Lenders analyses Government's total ability to raise funds through taxation and general public enterprise revenues including new tariff revenue from the project. The sovereign guarantee shows up as a liability on Government's list of financial obligations.



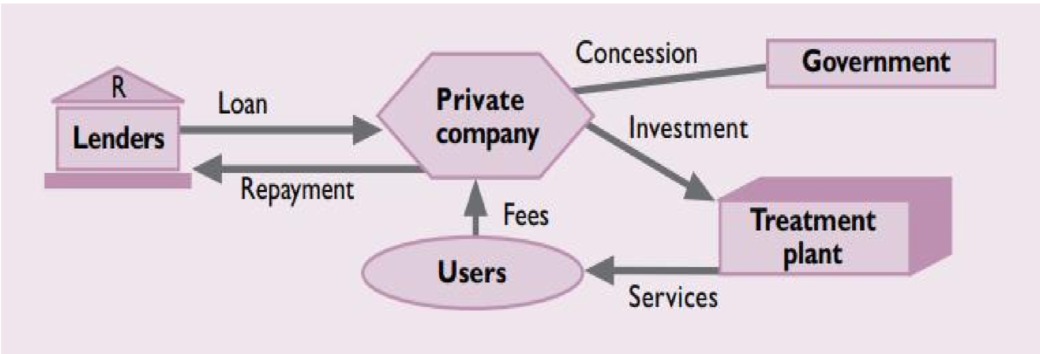
6.2 Corporate Finance

A private company borrows funds to construct a new treatment facility and guarantees to repay lenders from its available operating income and its base of assets.

The company may choose to contribute its own equity as well.

In performing credit analysis, lenders look at the company's total income from operations, its stock of assets and its existing liabilities.

The loan shows up as a liability on the company's balance sheet ("Mining the Corporate Balance Sheet")



6.3 Sponsors of Project Finance

Four types of sponsors are very often involved in such transactions:

1. Industrial sponsors – They see the initiative as upstream and downstream integrated or in some way as linked to their core business.
2. **Public sponsors** – Central or local government, municipalities, and municipalized companies whose aims center on social welfare.
3. **Contractor sponsors** – Who develop, build, or run plants and are interested in participating in the initiative by providing equity and or subordinated debt.
4. Financial sponsors/investors – Invest with a motive to invest capital in high-profit deals. They have a high propensity for risk and seek a substantial return on investments.

6.4 Long-Term Sources of Finance

The project can be financed by way of anyone or more of the following sources:

- Issue of ordinary / preference shares
- Issued of secured debentures
- Issue of convertible debentures / bonds
- Term loan from financial institutions and banks
- Unsecured loans
- Foreign investments
- Deferred credit from suppliers of equipment and machinery
- Leasing finance

6.5 Long-Term Capital and Related Issues

- Risk
- Ownership
- Duration
- Debt capacity
- Equity finance

6.6 Foreign Institutional Investors (FIIs)

- 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.
- FIIs can include hedge funds, insurance companies, pension funds, investment banks, and mutual funds.
- FIIs can be important sources of capital in developing economies, yet many developing nations, such as India,
- Have placed limits on the total value of assets an FII can Purchase and the number of equity shares it can buy, Particularly in A single company.
- This helps limit the influence of FIIs on individual companies and the nation's financial markets, and the potential damage that might occur if FIIs fled the capital markets in masses during a crisis.
- (Itshappened in India in last 1 year where FIIs has withdrawn more than 3 lakh crores and its an historic high)

- If a mutual fund in the United States sees a high-growth investment opportunity in an India-listed company, it can take a long position by purchasing shares in an Indian stock market.
- This type of arrangement also benefits private U.S investors who may not be able to buy Indian stocks directly.
- Instead, they can invest in the mutual fund and take part in the high-growth potential.

Regulations on Investing in Indian Companies

- FIIs are allowed to invest in India's primary and secondary capital markets only through the country's portfolio investment scheme.
- This scheme allows FIIs to purchase shares and debentures of Indian companies on the nation's public exchanges.

Portfolio Investment Scheme and FIIs

- Securities and Exchange Board of India (SEBI) acts as the nodal point in the entire process of FII registration.
- Under the general permission given by RBI under FEMA, FIIs are permitted to buy or sell the securities and open foreign currency and Non –resident rupee accounts with a designated bank.
- A registered FII may purchase /sell the shares and convertible debentures of an Indian company, units of domestic mutual funds under portfolio investment scheme (PIS).
- The shares and convertible debentures of an Indian company are to be purchased by the registered FII through registered brokers on recognized stock exchanges in India.
- There are certain restrictions and ceilings with regard to holding by each FII.
- For new projects Indian companies are taking the capital market route to raise the capital (either debt or equity) and FIIs play a key role in providing the required capital in anticipation of attractive interest rates, healthy capital gains along with ownership rights.

6.7 Foreign Direct Investment (FDI)

- A foreign direct investment (FDI) is a purchase of an interest in a company by a company or an investor located outside its borders.
- Generally, the term is used to describe a business decision to acquire a substantial stake in a foreign business or to buy it outright in order to expand its operations to a new region.
- It is not usually used to describe a stock investment in a foreign company.
- Foreign direct investment frequently goes beyond capital investment. It may include the provision of management, technology, and equipment as well.
- A key feature of foreign direct investment is that it establishes effective control of the foreign business or at least substantial influence over its decision-making.

Types of Foreign Direct Investment

- Foreign direct investments are commonly categorized as horizontal, vertical, or conglomerate.
- With a horizontal direct investment, a company establishes the same type of business operation in a foreign country as it operates in its home country.
- A U.S.-based cell phone provider buying a chain of phone stores in China is an example.
- A U.S.-based cell phone provider buying a chain of phone stores in China is an example.
- In a vertical investment, a business acquires a complementary business in another country.
- For example, a U.S. manufacturer might acquire an interest in a foreign company that supplies it with the raw materials it needs.

- In a conglomerate type of foreign direct investment, a company invests in a foreign business that is unrelated to its core business.
- Since the investing company has no prior experience in the foreign company's area of expertise, this often takes the form of a joint venture.

What Is the Difference Between FDI and FPI?

- Foreign portfolio investment (FPI) is the addition of international assets to the portfolio of a company, an institutional investor such as a pension fund, or an individual investor.
- It is a form of portfolio diversification, achieved by purchasing the stocks or bonds of a foreign company
- Foreign direct investment (FDI) requires a substantial investment in, or the outright acquisition of, a company based in another country.
- FDI is generally a larger commitment, made to enhance the growth of a company.

Benefits of FDI

- FDI can foster and maintain economic growth, both in the recipient country and in the country making the investment.
- Developing countries have encouraged FDI as a means of financing the construction of new infrastructure and the creation of jobs for their local workers.
- On the other hand, multinational companies benefit from FDI as a means of expanding their footprints into international markets.

Methods of Foreign Direct Investment

- 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 intra-company loans to overseas subsidiaries, are also considered foreign direct investments.
- 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

6.8 American Depository Receipts

- ADR stands for American Depository Receipts, which are a type of negotiable instrument that are basically stocks of foreign companies which are traded in US stock markets.
- American Depository Receipts (ADR) are issued by a US Depository bank and offer investors in the US to invest in foreign companies.
- ADRs are traded on the US Stock exchange and are a great option for foreign companies to attract investors from the US.
- ADRs are traded in New York Stock Exchange (NYSE) or NASDAQ, but can also be sold over the counter. ADRs are priced in US Dollars.
- They represent some of the most familiar companies in global business, including household names such as Nokia, Royal Dutch Petroleum (maker of Shell gasoline), and Unilever.

- These and many other companies based outside the US list their shares on US exchanges through ADRs.
- ADRs are a form of equity security that was created specifically to simplify foreign investing for American investors.
- An ADR is issued by an American bank or broker. It represents one or more shares of foreign-company stock held by that bank in the home stock market of the foreign company.
- The ratio of foreign shares to one ADR will vary from company to company, but each ADR for any one company will represent the same number of shares.

ADR risk factors and expenses

Because ADRs are issued by non-US companies, they entail special risks inherent to all foreign investments. These include:

- Exchange rate risk — the risk that the currency in the issuing company's country will drop relative to the US dollar.
- Political risk — the risk that politics or regime changes in the issuing company's country will undermine exchange rates or destabilize the company and its earnings.
- Inflation risk — the risk that inflation in the issuing company's country will erode the value of that currency.

How American Depositary Receipts Work

- Investors willing to invest in American Depositary Receipts can purchase them from brokers or dealers. The brokers and dealers obtain ADRs by buying already-issued ADRs in the US financial markets or by creating a new ADR.
- Creating a new ADR involves buying the stocks of the foreign company in the issuer's home market and depositing the acquired shares in a depository bank in the overseas market.
- The bank then issues ADRs that are equal to the value of the shares deposited with the bank, and the dealer/broker takes the ADR to US financial markets to sell them.
- The decision to create an ADR depends on the pricing, availability, and demand.
- Investors who purchase the ADRs are paid dividends in US dollars.
- The foreign bank pays dividends in the native currency, and the dealer/broker distributes the dividends in US dollars after factoring in currency conversion costs and foreign taxes.
- Such a practice makes it easy for US investors to invest in a foreign company without worrying about currency exchange rates.
- The US banks that deal with ADRs require the foreign companies to furnish them with their financial information, which investors use to determine the company's financial health.

6.9 Global Depositary Receipts (GDR)

- GDRs represent ownership of an underlying number of shares of a foreign company and are commonly used to invest in companies from developing or emerging markets by investors in developed markets.
- Prices of global depositary receipt are based on the values of related shares, but they are traded and settled independently of the underlying share.
- Typically, 1 GDR is equal to 10 underlying shares, but any ratio can be used.
- Example, an Indian company which has issued ADRs in the American market wishes to further extend it to other developed and advanced countries such as in Europe, then they can sell these ADRs to the public of Europe and the same would be named as GDR.

- GDR can be issued in more than one country and can be denominated in any freely convertible currency.

Trading of Global Depositary Receipt Shares

- To draw interest from foreign investors, GDRs are issued by companies. It is a low-cost method which allows investors to invest in these foreign shares.
- The trade of these shares is just like that of domestic shares but they are purchased in an international marketplace.
- The purchase and the sale of GDRs is managed by the representative broker. Usually, the brokers belong to the home country, and they act as sellers in the foreign market.
- The purchasing of a GDR is a multistep process.
- It involves a local broker for the investor, a broker in the marketplace where the company issued its shares, a bank that represents buyers and the custodian bank.
- During the transaction, a custodian bank holds possession of the shares. This ensures that both the parties are protected during the transaction.

GDRs vs ADRs

- Global depositary receipts allow a company to list its shares in more than one country outside of its home country.
- For example, a Chinese company could create a GDR program that issues its shares through a depositary bank intermediary into the London market and the United States market.
- Each issuance must comply with all relevant laws in both the home country and foreign markets individually.
- An American depositary receipt (ADR), on the other hand, only lists the company's shares on U.S. stock exchanges.
- To offer ADRs, a U.S. bank will purchase shares on a foreign exchange.
- The bank will hold the stock as inventory and issue an ADR for domestic trading.
- A bank issues a sponsored ADR on behalf of a foreign company.
- The bank and the business enter into a legal arrangement. Usually, the foreign company will pay the costs of issuing an ADR and retaining control over it, while the bank will handle the transactions with investors.

6.10 External Commercial Borrowings (ECBs)

- External Commercial Borrowings (ECB) refers to the debt shouldered by an eligible entity in India for solely commercial purposes, that has been extended by external sources, i.e. from any recognized entity outside India.
- These borrowings are expected to conform to norms and conditions put forth by the RBI. The ECBs fall under the umbrella of RBI regulations.
- ECBs have proven to be instruments that greatly aid Indian firms and organizations in their efforts to raise funds from beyond India's borders, especially with regard to bringing in fresh investments.
- One might recognize that structures similar to ECBs include those of Foreign Currency Convertible Bonds (FCCBs) and Foreign Currency Exchangeable Bonds (FCEBs).
- It is vital to note that while the main purpose underlying the issuance of FCCBs is the raising of capital.

Availing of External Commercial Borrowing

- As of today, there exist two paths to raise funds by employing ECBs- the approval route, and the automatic route.
- There are a variety of eligibility regulations created by the government for availing of finance under the automatic route. These regulations are in relation to amounts, industry, the end-use of the funds, etc.
- Companies that desire to raise finance via ECB must necessarily meet these eligibility criteria; thereafter, funds can be raised without the need for approval.
- The approval route, on the other hand, mandates that companies which fall under certain pre-specified sectors must obtain the RBI's or the government's explicit permission, prior to raising funds through External Commercial Borrowing.
- The RBI has issued circulars and formal guidelines, specifying the borrowing structure.

Benefits of External Commercial Borrowing

- The value of funds is generally lower when borrowed from external sources.
- For instance, some economies have a lower interest rate, and Indian firms and organizations can borrow money at lower interest rates from the Eurozone and the United States as the rates are comparatively low.
- Since the markets are larger when raising funds through ECB, companies can meet larger requirements from international players in comparison with what can be achieved through domestic players.
- External Commercial Borrowing is just a way to take a loan.
- It does not necessarily have to be of an equity nature, and therefore the company's stakes will not be diluted.
- The investor base can be diversified by the borrower.
- ECB offers access to global markets so that borrowers have greater exposure to worldwide opportunities.
- ECB offers benefits to the economy as well.
- Inflows can be directed into the sector by the government of India, thereby increasing its growth potential.
- For instance, a greater percentage of funding through ECB can be allowed by the government for the SME and infrastructure industry.
- This aids significantly in the overall growth of the country.
- Companies can become increasingly profitable through ECB.

6.11 Mergers and Acquisitions

- Acquisition and mergers both involve one or multiple companies purchasing all or part of another company.
- The main difference between a merger and an acquisition is how they are financed.
- Mergers are often financed by a stock swap, in which owners of stock in both companies normally are about equivalent.
- On the other hand, the term acquisition is used to refer to two unequal companies becoming one (one is bigger than the other).

Businesses may be driven to participate in cross-border M&A transactions in order to improve their competitive positions in the global market by acquiring unique assets from other businesses or by making more extensive use of their own assets. Cross-border M&As have two major advantages over greenfield investments as a means of FDI entry: speed and access to proprietary assets. Why companies select mergers and acquisitions as a strategy of investment is appropriately covered in a new United Nations report.

By selling off divisions that lie beyond the purview of their core competencies and acquiring strategic assets that boost their competitiveness, mergers and acquisitions are a common strategy of investment for companies looking to protect, consolidate, and improve their worldwide competitive positions. For those companies, "ownership" assets acquired from another company, such as technical expertise, well-known brands, and already-existing supplier networks and distribution systems, can be used right away to better serve international clients, boost profits, increase market share, and boost corporate competitiveness by more effectively utilizing global production networks.

Chinese businesses have recently started to actively employ cross-border M&As as a means of acquiring brand strength and cutting-edge technologies. For instance, Volvo, a Swedish automaker renowned for its safety innovations, was purchased by Zhejiang Geely Holding Group from Ford Motor Company for $1.3 billion in 2010. By doing this, Geely instantly acquired the brand recognition, technological capabilities, and dealer networks of Volvo. The renowned New York City hotel, Waldorf Astoria, was purchased by the Chinese insurance firm Anbang in 2014 for $1.95 billion. In 2015, China National Chemical, also known as ChemChina, paid $7.9 billion for the Italian tyre manufacturer Pirelli and $48 billion for the Swiss agricultural giant Syngenta AG.

Clearly, free capital markets enable businesses to strategically leverage cross-border M&A transactions to acquire the brand power, managerial expertise, and technological know-how located in target businesses.

Cross-border M&A transactions don't always go as planned. An illustration of this is the merging of Daimler and Chrysler. Initially, it was anticipated that the combined business would reduce expenses by up to $3 billion annually and close geographic and product gaps. Stock prices of both companies increased following the news of a $40.5 billion acquisition as investors anticipated the synergistic benefits. The cost reductions, technology synergies, and increased marketing power that both parties anticipated, however, did not occur. Following a nine-year transatlantic merger, Chrysler was sold to private equity firm Cerberus for $7.4 billion in May 2007 as a result of ongoing earnings reduction. The DaimlerChrysler tale amply demonstrates that cross-border corporate mergers are not always successful.

Since most nations desire to maintain local control of domestic firms, cross-border corporate acquisitions are a politically delicate topic. Therefore, whereas nations may welcome greenfield investments because they are seen as providing new investment and employment prospects, efforts by foreign corporations to buy indigenous firms are frequently received with resistance and perhaps even resentment.

Thus, from the standpoint of shareholder welfare and public policy, it is crucial to consider whether or not cross-border acquisitions result in synergistic gains and how such gains are allocated between acquiring and target enterprises. When the combined firm's worth exceeds the individual (target and acquiring) firms' stand-alone valuations, synergistic gains are realized. One can argue that cross-border acquisitions are mutually beneficial and shouldn't be hindered from a national and global perspective if they produce synergistic gains and both the acquiring and target shareholders experience wealth growth at the same time.

Financing of Mergers and Acquisitions

- And Debt Combination
- All Cash
- Stocks or Other Equity ofthe Company

- Sometimes, a smaller company is able to acquire a much larger one through the use of junk bonds, which are high yield bonds issued by less creditworthy issuers and therefore carry high risk to investors.
- Some companies may decide their needs will be better met as part of a larger company – that the company has made enough money and no longer wants the company to be independent.
- Some companies may decide that their needs will be better met as part of a larger company.
- Absorbing a competitor enables the newly combined company to control more of the market share.
- A company might acquire a debt ridden company in order to take advantage of its tax write – offs.
- Geographical diversification

- One company might acquire another to obtain access to its customer base.
- Synergy – using joint resources to offer abetter product or service.

Equity Financing

Equity financing, in the context of M&A financing, can mean two things:

1) The company selling its equity to raise cash to fund the deal, and

2) A stock swap or the company using equity as a currency (instead of cash) to acquire the shares of the target company.

A stock swap or the exchange of one company's equity for another helps the acquirer preserve cash.

- Those without a lot of cash reserves can save on their borrowing costs.
- The seller's shareholders get an opportunity to gain from the future gains of the combined business.
- Sellers also get to defer tax payments related to any gains on the sale of their shares.
- On the flip side, equity financing involves issuing new shares, leading to dilution of ownership for existing shareholders.

Debt Financing

- Debt financing is raising money from lenders on the condition of repaying the borrowed amount later.
- For startups and less mature companies, debt financing is harder to obtain when compared to equity financing.
- However, in times of low-interest rates, it is a comparatively cheaper source of funding.
- In M&A financing, the amount of debt financing depends on the combined firm's consolidated debt capacity.
- It is typically based on an EBITDA multiple (e.g., a Debt/EBITDA of 6x would mean the company can get debt of up to 6 times its EBITDA).
- The interest rate charged depends on the consolidated risk of the combined entity. Debt financing can adversely affect the borrowing company's credit ratings.

Difference between Equity Financing and Debt Financing

	Positives	Negatives
Equity Financing	• Does not increase leverage • Good if a company's share valuation is high • Does not need to be repaid	• More expensive than debt • Can lead to loss of control • Net income will increase due to synergies, but the EPS might fall if management have to issues lots of shares
Debt Financing	• Cheaper than equity • Does not reduce control • Shareholders enjoy all the benefits of synergies	• Limit on the amount of financing that can be raised • Can result in a credit rating downgrade • Cash drain to pay interest and repay the debt

Example Deal

- So, let's put this all together in an example deal. Let's say you found an ecommerce company to buy, that is generating $2MM in cash flow. Assuming that company is growing 20% a year, it could be worth 5x cash flow, or $10MM.
- You think it is important to keep the founder involved, and you are willing to have him take a 10% stake in Newco, so you really only need to finance $9MM to buy the 90% stake.
- That could be funded $3MM by a private equity firm, $3MM by a bank and $3MM by a seller note (if amenable to the seller). And, the private equity firm would most likely want you to have some "skin in the game," so maybe their portion is split $300K from you and $2.7MM from them.
- Ninety days and lots of negotiations later, you should be ready to close.

Summary

When businesses make international direct investments, they become multinational enterprises (FDI). FDI frequently entails the construction of new production facilities in foreign nations, such as Ohio factory for Honda. FDI may also include acquisitions of and mergers with existing foreign companies. Ford, a company that just gained actual control of Mazda, a Japanese automaker, serves as an illustration. FDI gives the multinational corporation (MNC) a degree of control, whether it entails a greenfield investment (i.e., constructing brand-new manufacturing facilities) or cross-border mergers and acquisitions of existing enterprises. FDI can occur either through greenfield investments, which entail constructing brand-new production facilities abroad, or through cross-border mergers and acquisitions, which entail joining forces with or purchasing already-existing international corporations. Cross-border mergers and acquisitions now make up a rising percentage of FDI, accounting for more than half of FDI flows in terms of dollar volume.

Keywords

The over-the-counter (OTC) market: It is a dealer market. OTC stocks are generally unlisted stocks.

Crowd Trading: Crowd trading is a different kind of discontinuous exchange trading system. Crowd trading is a different kind of non-continuous exchange trading system.

Cross-listing: It describes a company that lists its equity shares on one or more overseas exchanges in addition to the stock exchange in its native country.

Self Assessment

1. ………………..arises from uncertainty about cross-border flows of capital, payments, know-how, and the like.

A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

2. …..is associated with uncertainty about the host country's policies affecting the local operations of MNCs.

A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

3. …………arises from uncertainty about the host country's policy regarding ownership and control of local operations

A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

4. ……….refers to the potential losses to the parent firm resulting from adverse political developments in the host country.
A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

5. Unexpected changes in environmental policies is an example of…………..
A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

6. sourcing/local content requirements is an example of…………..
A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

7. minimum wage law is an example of………….
A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

8. restriction on access to local credit facilities is an example of…………
A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

9. As Mao Ze-dong took power in China in 1949, his communist government nationalized foreign assets with little compensation. It is an example of…………..
A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

10. withholding taxes on dividend and interest payment is an example of…………..
A. Transfer risk
B. Operational risk
C. Control risk

D. Political risk

11. unexpected imposition of capital controls, inbound or outbound is an example of…………..

A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

12. restrictions imposed on the maximum ownership share by foreigners is an example of………….

A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

13. mandatory transfer of ownership to local firms over a certain period of time is an example of………….

A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

14. nationalization of local operations of MNCs is an example of………….

A. Transfer risk
B. Operational risk
C. Control risk
D. Political risk

15. fade-out requirements is an example of………….
16. Transfer risk
17. Operational risk
18. Control risk
19. Political risk

Answers for Self Assessment

1.	A	2.	B	3.	C	4.	D	5.	B
6.	B	7.	B	8.	B	9.	D	10.	A
11.	A	12.	C	13.	C	14.	C	15.	C

Review Questions

1. How would you interrelate political risks and FDI?
2. How would you interrelate control risks and FDI?
3. How would you interrelate operational risks and FDI?

4. How would you interrelate transfer risks and FDI?
5. What is the difference between FII and FDI?

Further Readings

- International Financial Management 2ndEdition by Jeff Madura Ariful Hoque Chandrasekhar Krishnamurti, 2018
- International Financial management by Eun,Resnick and Chuluun. Ninth edition. McGraw-Hill Education
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Unit 07: Foreign Exchange Evolution

CONTENTS

Objectives

After studying this unit, you will be able to:

- define and describe foreign exchange
- explain operations of foreign exchange market
- understand the various exchange rate systems in chronological order
- understand the monetary system and role of key financial institutions

Introduction

The forex market has a direct impact on a country's economy. Financial institutions, companies, governments and other entities use this market to adjust their currency holdings. Centuries ago, people from around the world exchanged goods or services rather than paying money – this was called a barter system. But nowadays, barter arrangements are not practical anymore. Instead, governments and organizations exchange currencies when conducting international transactions. Some of the different types of money in the world are more volatile than others, making it difficult for investors in the currency industry to predict their returns. A low, stable exchange rate, on the other hand, encourages exports but discourages imports. A high exchange rate has the opposite effect. For instance, developing countries tend to have weak currencies – and that's why many European and American companies purchase supplies from Vietnam, Thailand, Sri Lanka, or Indonesia. For the same reason, it's much cheaper to open a factory and hire people in Vietnam compared to the U.S. or other developed nations. The exchange rate influences wages, international trade, foreign investments and other economic variables. In the long run, it impacts consumers and the economy as a whole. If, say, you plan to buy a house in Italy, and the Euro depreciates against the dollar, you'd get better value for the money. You could purchase a bigger house or two smaller properties without spending extra and then sell them for profit. Such investments can benefit local communities and drive economic growth. Foreign exchange is the trading of different national currencies or units of account.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.

7.1 Foreign Exchange

Foreign exchange (Forex or FX) 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. The most traded currencies in the world are the United States dollar, Euro, Japanese yen, British pound, and Australian dollar. The US dollar remains the key currency, accounting for more than 87% of total daily value traded.

Rate of Exchange

- The rate of exchange is the price of one currency in terms of another.
- The number of units of one currency which exchange for a given number of units of another currency is the rate of exchange. ($1 = Rupee 77.85)
- This rate varies from time to time, day to day
- The main causes of fluctuations in the exchange rates are demand and supply of a currency.

7.2 Factors that Affect Foreign Exchange Rates

- Many factors can potentially influence the market forces behind foreign exchange rates.
- The factors include various economic, political, and even psychological conditions.
- The economic factors include a government's economic policies, trade balances, inflation, and economic growth outlook.
- Political conditions also exert a significant impact on the forex rate, as events such as political instability and political conflicts may negatively affect the strength of a currency.
- The psychology of forex market participants can also influence exchange rates.

Foreign Exchange Market

- The foreign exchange market is a decentralized and over-the-counter market where all currency exchange trades occur.
- It is the largest (in terms of trading volume) and the most liquid market in the world. On average, the daily volume of transactions on the forex market totals $5.1 trillion, according to the Bank of International Settlements
- The foreign exchange market is a decentralized and over-the-counter market where all currency exchange trades occur.
- It is the largest (in terms of trading volume) and the most liquid market in the world. On average, the daily volume of transactions on the forex market totals $5.1 trillion, according to the Bank of International Settlements
- The forex market major trading centers are located in major financial hubs around the world, including New York, London, Frankfurt, Tokyo, Hong Kong, and Sydney.
- Due to this reason, foreign exchange transactions are executed 24 hours, five days a week (except weekends).

- Despite the decentralized nature of forex markets, the exchange rates offered in the market are the same among its participants, as arbitrage opportunities can arise otherwise.
- The foreign exchange market is probably one of the most accessible financial markets.
- Market participants range from tourists and amateur traders to large financial institutions (including central banks) and multinational corporations.
- Also, the forex market does not only involve a simple conversion of one currency into another.
- Many large transactions in the market involve the application of a wide variety of financial instruments, including forwards, swaps, options, etc.

7.3 Market Participants

- To name a few the participants include wealthy individuals, corporates, multinationals, banks, wholesale, retail, investments and central banks, pension funds, insurance companies and brokers etc.
- However, they can be broadly classified under the following categories:

1. **Retail Clients**

   Individuals and organizations engaged in the business of import and export of goods and services.

2. **Banks**

- They form the cream in the forex market. They are the central point for all other market participants and deal in the market on behalf of their retail clients and also on their own account.
- Professionals with good skills of currency trading are required and
- Central banks often intervene in the market to buy or sell currencies to influence the exchange rates.

3. **Brokers**

- Brokers do not trade on their own but serve as an intermediary between prospective counter parties.
- Their chief value is to diffuse information since they maintain close contact with all banks.

7.4 Characteristics of Foreign Exchange Market

- An over the counter market
- Only market open 24 hours
- No single location – no barriers
- Affected by other markets like – money market, capital market and the debt market
- Affected by control and policies of respective governments

7.5 How is a Currency Valued?

- A currency of a country is valued according to supply and demand.
- So, it always is in a state of flux.
- Such kind of exchange rate is known as floating exchange rate. It is the case in a free economy.
- Similarly, the value of a rupee is determined by market forces.
- Factors like imports and exports, interest rates, and inflation affect the value of the rupee.
- It would also depend on political conditions, internally and internationally.

- Tourism is another factor that influences foreign exchange value.
- This is why large companies have strategies to manage the currency. The idea is to protect their business from currency fluctuations.

7.6 The Era of Gold standard

- The gold standard was formally accepted as an IMS (international monetary system) in the 1870s when major countries like United States, Germany and Japan adopted it.
- Great Britain was the first country to adopt it in 1821.
- Under this system, each country pegged its domestic currency to gold.
- In simple words, each country's currency was set in value per ounce of gold.
- For example, one ounce of gold was worth \$20.67 in United States and £4.24 in Great Britain. So the exchange rate between US dollar and pound sterling was determined as:
- i.e. one pound was exchanged for \$4.87.

$$\frac{\$\,20.67 \text{ per ounce of gold}}{£4.24 \text{ per ounce of gold}} = \$\,4.87/£ \qquad (1£ = \$4.87)$$

- Under this system, each nation was allowed to change its currency into gold on demand and there were no restrictions on movement of gold from one nation to another.
- Each country maintained gold stocks to back the value of its currency.
- The payments between countries were mainly settled by exchange of gold.
- If a country imported more than it exported, gold moved out and vice versa.
- The gold standard facilitated automatic correction in balance of payment (BOP) disequilibrium of a country.
- For example, if Germany had a trade deficit (imports more than exports), then gold flowed out of Germany for settlement of trade leading to contraction in Germany's money supply.
- This brought down the prices in Germany making its goods cheaper and competitive.
- This in turn led to increase in demand for Germany's exports, thus wiping out the deficit.
- The gold standard was abandoned in 1914 with the onset of I World War.
- During the war, the countries started printing money to provide for the war activities.
- The countries restricted the disengaged movement of gold among nations and also put the convertibility of currency into gold on hold.
- The printing of currency resulted into inflation. The war also led to loss of workforce and productive capacity which pushed up the price levels further.
- After the termination of the first world war, the countries started returning back to the gold standard.
- After the world war, the \$ became stronger and European countries became weak. As a result, US became the first nation to adopt the gold standard back in 1919.
- The Great Britain adopted it in 1925; and France and Switzerland in 1928.
- The US made continuous efforts to fully revive the gold standard. (Bcz US was holding the max gold reserves)
- But, all the efforts to reinstate the gold standard came to a halt with the starting of great depression in 1929.
- There was substantial outflow of gold from Great Britain due to recurring BOP deficits.
- Britain's gold stocks were depleting at a very fast pace and it became impossible for them to retain gold standard.

- So in September 1931, the Government of Britain brought an end to the convertibility and let the pound float.
- Many countries like Japan, Austria, and Sweden followed suit by the end of 1931.
- Investors started preferring gold to foreign currency denominated securities.
- This affected the US gold reserves adversely and led the US government to disregard the gold standard in April 1933.

7.7 Bretton Woods System

- In July 1944, while the Second World War was still going on, the representatives of 44 nation states met at Bretton Woods to design a new IMS.
- An agreement was reached to establish two multinational institutions-
    - IMF (International Monetary Fund)
    - IBRD (International Bank for Reconstruction and Development)
- IMF (International Monetary Fund) to monitor IMS, maintain exchange rate stability and oversee national monetary policies and also provide financial cooperation to member countries for meeting short term BOP shortfall.
- IBRD (International Bank for Reconstruction and Development) was established to primarily finance the post war reconstruction of the member countries
- After the end of Second World War, US was holding about 74% of the world's gold stock and accounted for about half of the world's real GNP.
- So under the Bretton woods system, each country agreed to fix the par value of its currency in relation to US dollar.
- This par value determined the exchange rate among different currencies.
- The US dollar was in turn pegged to gold at $35 per ounce.
- US dollar was the main reserve currency held by central banks and the only currency that was directly convertible to gold.
- Each country was required to maintain the market value of its currency within ± 1 percent of its adopted par value by purchasing or selling foreign exchange as necessary.
- This system was addressed with different names such as fixed parity system, par value system, pegged exchange rate system and dollar based gold exchange standard.
- During 1960s, US undertook welfare programs.
- The increase in government expenditure was financed by raising the domestic money supply, which led to inflation.
- With increased money supply, people started spending more. Consequently, the demand for imports increased while exports became uncompetitive (due to higher prices of US goods).
- Thus, US BoP swung into deficit.
- The member countries began to lose confidence in dollar and started converting their dollar reserves into gold.
- The gold stock with US treasury began to fall drastically.
- To supplement the existing reserves and to reduce the pressure on dollar, the IMF in 1970 also created international reserve asset called as SDR (Special Drawing Rights) which could be utilized by the countries for making payments internationally.
- The SDRs were allocated to all the member countries in proportion to their quotas.
- All the attempts to solve the disparities failed.
- US BoP continued to deteriorate.

- The dollar stood overvalued against German mark and Japanese yen as a result of which the German and Japanese central banks had to make massive intercession in the foreign exchange market to maintain their par values.
- As a result of all this, in August 1971, the then US President Richard Nixon terminated the convertibility of dollar into gold and also levied a surcharge of 10 percent on imports until the revaluation of other currencies against dollar.
- This shook the foundation of Bretton Woods System.
- By March 1973, the eminent currencies were allowed to float and the Bretton Woods System came to an end.
- After the end of Bretton Woods System, IMF came out with a new set of rules which were formally accepted by all member countries.
- With this came the system of flexible exchange rates where the exchange rate is not fixed by government authorities rather it is determined by the forces of market i.e. supply and demand of the currencies in the international market.

7.8 Exchange Rate Regime Since 1973

Under the new exchange rate system, a country can choose from one of the following options:

a. Managed float system
b. Free float system
c. Crawling PEG system
d. Currency board arrangement
e. Target zone arrangement

1) Managed float system

- In this system of managed floating, a country's monetary authorities interfere directly or indirectly to stabilize the exchange rate and to keep it within desired limits.
- It is also known as dirty floating.
- In case of direct intervention, the monetary authorities attempt to stabilize the exchange rate by purchasing and selling foreign currency in the domestic market.
- When it buys foreign currency, its demand increases and the domestic currency depreciates against foreign currency.
- When it sells foreign currency, its supply increases and the domestic currency appreciates against foreign currency.
- In case of indirect intervention, the monetary authorities bring changes in the interest rates to stabilize the exchange rates and flush out the excess volatility.
- Some of the countries which are following this system are India, Russia, Egypt, Singapore, Thailand and Czech Republic.

2) Free float system

- Under this system, the exchange rate is determined solely by the market forces and it does not involve intervention.
- However, in practice some intervention is found in the system of free float as well, typically to prevent any unnecessary fluctuations in the exchange rate.
- This system is also known as clean float or independent float system.
- Some of the countries following this system are United States, United Kingdom, Japan, Switzerland, Australia, Brazil, Canada and Mexico.

3) Crawling PEG system

- This system is a synthesis of fixed and floating exchange rate system.
- Under this system, the country establishes the par value of its currency in relation to a foreign currency and then allows the par value to change gradually along with changes in the factors like inflation.
- A country can either peg its currency to a single currency or to a basket of currencies.
- Countries like Jordan, Bahamas, Iraq, Lebanon, Maldives, Saudi Arabia and Qatar have pegged their currencies to a single currency.
- Countries like Fiji, Libya and Morocco have chosen basket of currencies for pegging.

4) Currency board arrangement

- In this system, the currency board is required to build reserves of the foreign currency (at the fixed exchange rate) equivalent to the amount of domestic currency it has issued.
- A country following this system has a currency board which pegs the domestic currency to a foreign currency and allows the unlimited exchange of domestic currency for the foreign currency at the fixed exchange rate.
- With this system, the money supply can be controlled effectively because additional currency will be issued only if there are foreign currency reserves to back it.
- It also helps to keep check on inflation. The example for this system includes Hong Kong pegged to US dollar.

5) Target zone arrangement

- In this system, a cluster of nations with common goals and interests agree to either maintain exchange rates within a specified band or to replace their domestic currency with a common currency.
- An example of this system is European Monetary System which was introduced in 1979.

7.9 International Monetary System

An international monetary system is a set of internationally agreed rules, conventions and supporting institutions that facilitate international trade, cross border investment and generally the reallocation of capital between states that have different currencies.

Why do economies need money?

- Money as a unit of account that is used as a medium of exchange in transactions.
- Without money, individuals and businesses would have a harder time obtaining (purchasing) or exchanging (selling) what they need, want, or make.
- Money provides us with a universally accepted medium of exchange.
- International monetary system refers to the system and rules that govern the use and exchange of money around the world and between countries.
- Each country has its own currency as money and the international monetary system governs the rules for valuing and exchanging these currencies.

Historical Perspective

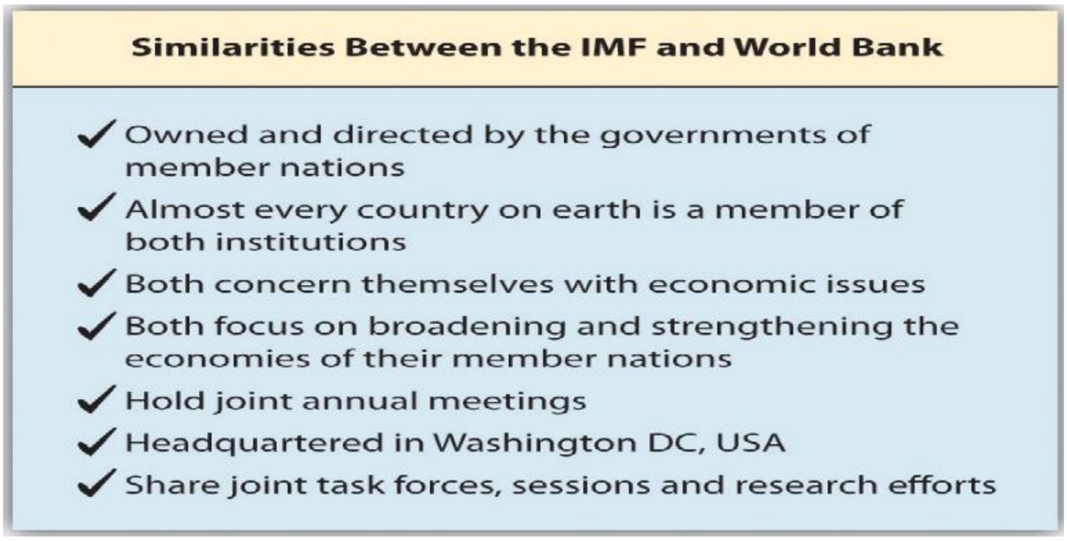
- Ancient societies started using gold as a means of economic exchange.
- Gradually more countries adopted gold, usually in the form of coins or bullion, and this international monetary system became known as the gold standard.
- The international monetary system had many informal and formal stages.
- For more than one hundred years, the gold standard provided a stable means for countries to exchange their currencies and facilitate trade.

- With the Great Depression in 1930s, the gold standard collapsed and gradually gave way to the Bretton Woods system.
- The Bretton Woods system established a new monetary system based on the US dollar.
- This system incorporated some of the disciplinary advantages of the gold system while giving countries the flexibility they needed to manage temporary economic setbacks, which had led to the fall of the gold standard.
- The Bretton Woods system lasted until 1971 and provided the longest formal mechanism for an exchange-rate system and forums for countries to cooperate on coordinating policy and navigating temporary economic crises.

What Is the International Monetary System?

- In 1944, the Bretton Woods Agreement established a new international monetary system.
- The creation of the International Monetary Fund (IMF) and the World Bank were two of its most enduring legacies.
- The World Bank and the IMF, often called the Bretton Woods Institutions, are twin intergovernmental pillars supporting the structure of the world's economic and financial order.

7.10 World Bank and IMF



World Bank vs. IMF

The fundamental difference is this –

- The World Bank is primarily a development institution; whereas,
- The IMF is a cooperative institution that seeks to maintain an orderly system of payments and receipts between nations.

The IMF's Key Roles are the Following

The IMF is playing an expanding role in the global monetary system.:

- To promote international monetary cooperation.
- To facilitate the expansion and balanced growth of international trade.
- To promote exchange stability.
- To assist in the establishment of a multilateral system of payments.
- To give confidence to members by making the IMF's general resources temporarily available to them under adequate safeguards.

- To shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

Key Role of the World Bank

- The World Bank promotes long-term economic development and poverty reduction by providing technical and financial support to help countries reform certain sectors or implement specific projects—such as building schools and health centers, providing water and electricity, fighting disease, and protecting the environment.
- World Bank assistance is generally long term and is funded both by member country contributions and through bond issuance.
- World Bank staff are often specialists on particular issues, sectors, or techniques.

7.11 Financial Stability & Business Environment

- Businesses seek to operate in a stable and predictable environment by reducing risks and unexpected issues that can impact both operations and profitability.
- Global firms monitor the policies and discussions of the G20 and other economic organizations so that they can identify new opportunities and use their leverage to protect their markets and businesses.
- Global business in the private sector is heavily impacted by the IMF, the World Bank, and other development organizations.
- Many of the projects that the World Bank Group funds in specific countries are managed by the local governments, but the actual work is typically done by a private sector firm.

Summary

Because changing exchange rates have a significant impact on MNCs' cash flows, financial managers of those companies must constantly watch the fluctuation of exchange rates. They must comprehend the impact of economic and other elements. so that they may foresee how exchange rates would alter in response to particular circumstances. This chapter lays the groundwork for comprehending how exchange rates are calculated. Demand and supply factors determine the equilibrium exchange rate between two currencies at any given time. The equilibrium exchange rate will be impacted by changes in the supply of a currency or the demand for a currency. Relative inflation rates, interest rates, income levels, and governmental regulations are the main economic variables that might affect exchange rate fluctuations through affecting the demand and supply conditions. The demand for a currency or the supply of currency available for sale, and consequently the equilibrium exchange rate, are both impacted when these factors modify international commerce or financial movements.

Keywords

Real interest rate: Nominal (or quoted) interest rate minus the inflation rate

Depreciation A fall in the currency value.

Appreciation A rise in currency value

Equilibrium exchange rate: The rate of exchange at which the supply and demand of a given currency are equal.

Self Assessment

1. Which of the following is wrong in regard to exchange rate?

A. an exchange rate (at a given time) represents the price of a currency,

B. It is the rate at which one currency can be exchanged for another

C. The exchange rate always involves one currency

D. the price of a currency is determined by the demand for that currency relative to its supply

2. Which of the following is wrong in regard to real interest rates?

A. Although a relatively high interest rate may attract foreign inflows (to invest in securities offering high yields), that high rate may reflect expectations of relatively high inflation

B. high inflation always place upward pressure on the local currency

C. some foreign investors may be discouraged from investing in securities denominated in that currency

D. The real interest rate is appropriate for international comparisons of exchange rate movements because it incorporates both the nominal interest rate and inflation, each of which influences exchange rates.

3. The governments of foreign countries can influence the equilibrium exchange rate in the following ways except:

A. imposing foreign exchange barriers;

B. imposing foreign trade barriers;

C. intervening (buying and selling currencies) in the foreign exchange markets; and

D. affecting mindset of the traders

4. Which of the following is wrong in regard to expectations?

A. Foreign exchange markets does not react to any news that may have a future effect.

B. Many institutional investors (such as commercial banks and insurance companies) take currency positions based on anticipated interest rate movements in various countries

C. Just as speculators can place upward pressure on a currency's value when they expect it to appreciate, they can place downward pressure on a currency when they expect it to depreciate.

D. foreign exchange markets react to any news that may have a future effect

5. Which of the following is wrong in regard to Impact of signals on currency speculation?

A. Day-to-day speculation on future exchange rate movements is typically driven by signals of future interest rate movements,

B. Signals of the future economic conditions that affect exchange rates never change quickly

C. Speculative positions in currencies may adjust quickly, which increases exchange rate volatility

D. It is not unusual for a currency to strengthen substantially on a given day, only to weaken substantially on the next day

6. Which of the following is wrong in regard to volume of international transactions?

A. The sensitivity of an exchange rate to these factors depends on the volume of international transactions between the two countries.

B. If the two countries engage in a large volume of international trade but a small volume of international capital flows, then the relative inflation rates will likely be more influential.

C. If the two countries engage in a large volume of capital flows, however, then interest rate fluctuations may be more influential

D. If the two countries engage in a large volume of international trade but a small volume of international capital flows, then the interest rate fluctuations will likely be more influential.

7. Which of the following is wrong in regard to Influence of factors across multiple currency markets?

A. Each exchange rate has its own market, meaning its own demand and supply conditions.

B. The value of the Malaysian ringgit in Australian dollars is influenced by the Australian demand for ringgit

C. the amount of ringgit supplied to the market (by Malaysian consumers and companies) in exchange for Australian dollars.

D. In some periods, most currencies move in the opposite direction against the Australian dollar because of a particular underlying factor in Australia that has a similar impact on demand and supply conditions across all currencies in that period.

8. Which of the following is wrong in regard toImpact of liquidity on exchange rate adjustment?

A. For all currencies, the equilibrium exchange rate is reached through transactions in the foreign exchange market; however, the adjustment process is more volatile for some currencies than for others

B. The liquidity of a currency affects the exchange rate's sensitivity to specific transactions.

C. If the currency's spot market is liquid, then its exchange rate will not be highly sensitive to a single large purchase or sale, so the change in the equilibrium exchange rate will be relatively small.

D. With many willing buyers and sellers of the currency, transactions can be accommodated with difficulty.

9. Which of the following is true in regard to Impact of liquidity on exchange rate adjustment?

A. if a currency's spot market is illiquid, then its exchange rate may be highly sensitive to a single large purchase or sale transaction.

B. In this case, there are not enough buyers or sellers to accommodate a large transaction, which means that the price of the currency must change in order to rebalance its supply and demand.

C. Illiquid currencies, such as those in emerging markets, tend to exhibit more volatile exchange rate movements because the equilibrium prices of their currencies adjust to even minor changes in supply and demand conditions

D. liquid currencies, such as those in emerging markets, tend to exhibit more volatile exchange rate movements because the equilibrium prices of their currencies adjust to even minor changes in supply and demand conditions

10. Which of the following is wrong in regard toMOVEMENTS IN CROSS EXCHANGE RATES?

A. Distinct international trade and financial flows between every pair of countries flows dictate the unique supply and demand conditions for these two countries' currencies, conditions that affect movements in the equilibrium exchange rate between them.

B. The value of the British pound in Swiss francs (from an Australian perspective, this is a cross exchange rate) is influenced by the Swiss demand for pounds and the supply of pounds to be exchanged (by British consumers and companies) for Swiss francs.

C. The movement in a cross exchange rate over a particular period cannot be measured as its percentage change in that period.

D. One can measure the percentage change in a cross exchange rate over some time period even when one lack cross exchange rate quotations.

11. Which of the following is wrong in regard to MOVEMENTS IN CROSS EXCHANGE RATES considering Australian dollar, British pound and Swiss franc?

A. If the British pound appreciates against the Australian dollar by a greater percentage than the Swiss franc appreciates against the Australian dollar, then the British pound appreciates against the Swiss franc.

B. If the British pound and Swiss franc move by the same percentage against the Australian dollar, then there is no change in the cross exchange rate.

C. If the British pound appreciates against the Australian dollar and the Swiss franc depreciates against the Australian dollar, then the British pound appreciates against the Swiss franc

D. If the British pound appreciates against the Australian dollar by a smaller percentage than the Swiss franc appreciates against the Australian dollar, then the British pound appreciates against the Swiss franc

12. Which of the following is wrong in regard to Institutional speculation based on expected appreciation/depreciation?

A. When financial institutions believe that a particular currency is presently valued lower than it should be in the foreign exchange market, they may consider investing in that currency now before it appreciates.

B. They would hope to liquidate their investment in that currency after it appreciates and so benefit from selling it for a higher price than they paid.

C. They would hope to hold their investment in that currency after it appreciates and so benefit from selling it for a higher price than they paid.

D. Some large financial institutions attempt to anticipate how the equilibrium exchange rate will change in the near future and may then take a position in the target currency in order to benefit from their expectations.

13. Which of the following is wrong in regard to Institutional speculation based on expectations?

A. If financial institutions believe that a particular currency is presently valued higher than it should be in the foreign exchange market, they may borrow funds in that currency now and convert it to their local currency now; that is, before the target currency's value declines to its 'proper' level.

B. The plan would be to repay the loan in that currency after it depreciates, so that the institutions could buy that currency for a lower price than the one at which it was initially converted to their own currency
C. The potential returns from foreign currency speculation are high for financial institutions that have a small borrowing capacity.
D. Because foreign exchange rates are volatile, a poor forecast could result in a large loss.

14. Which of the following is wrong in regard to Speculation by individuals?
A. There is speculation in foreign currencies even by individuals whose careers have nothing to do with foreign exchange markets
B. Individuals can take positions in the currency futures market or options market
C. Individuals can also establish a margin account on some websites; in this way, they can take positions in foreign currency while financing a portion of their investment with borrowed fund
D. they are not liable for any debt created from borrowing money to support the speculative position.

15. Which of the following is wrong in regard to the 'carry trade'?
A. One of the most common strategies used by institutional and individual investors to speculate in the foreign exchange market is the carry trade, whereby investors attempt to capitalize on the difference in interest rates between two countries.
B. Specifically, the strategy involves borrowing a currency with a high interest rate and investing the funds in a currency with a low interest rate.
C. The investor may execute a carry trade for only a day or for several months.
D. The term 'carry trade' is derived from the phrase 'cost of carry', which in financial markets represents the cost of holding (or carrying) a position in some asset.

Answers for Self Assessment

1.	C	2.	B	3.	D	4.	A	5.	B
6.	D	7.	D	8.	D	9.	D	10.	C
11.	D	12.	C	13.	C	14.	D	15.	B

Review Questions

1. Describe briefly how different economic variables can impact the equilibrium exchange rate.
2. India had significant inflation at times. Describe why the Indian rupee is under pressure as a result.
3. What sort of correlation is anticipated between the relative real interest rates of two nations and the rates at which respective currencies are traded?

4. What sort of correlation is anticipated between the relative real interest rates of two nations and the rates at which respective currencies are traded?
5. The numbers for Australia's trade deficit are released each month. Forex traders frequently respond to this announcement and even make an effort to predict the numbers before they are released. Why do you believe the declaration of the trade imbalance occasionally has such an effect on foreign exchange trading?

Further Readings

- International Financial Management 2ndEdition by Jeff Madura Ariful Hoque Chandrasekhar Krishnamurti, 2018
- International Accounting by Timothy S Doupnik_ Hector Perera, McGraw-Hill Education (2014).

Unit 08:Foreign Exchange Business

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand the FEMA Act
- explore the objectives and applicability of the FEMA Act
- understand the types of exchange rates
- apply methods of currency exchange

Introduction

In the world today, there are millions of transactions between citizens of different countries. Such transactions need to be settled in the respective country's home currency. If you are traveling to a foreign country, you need to pay in the local currency of that country instead of the Indian rupee. The expression of foreign exchange is popularly used to denote a foreign currency. The term also covers the method by which a currency of one country is exchanged for that of another. If a bank is said to buy or sells foreign exchange, it means it buys or sell foreign currencies. (Banks being the authorized person are the pivot point for money exchange) Therefore foreign exchange can be defined as- Foreign currency: Exchange of one currency into another. An exchange rate is the rate at which one currency can be exchanged for another between nations or economic zones. It is used to determine the value of various currencies in relation to each other and is important in determining trade and capital flow dynamics. Exchange rates are quoted between two currencies. For example – how many Canadian dollars (CAD) can be exchanged for one U.S. dollar (USD)? The exchange rate as of June 2022 is 1.40, which shows that CAD 1.40 is received if exchanging USD 1.00

8.1 Foreign Exchange Management Act (FEMA)

- The Foreign Exchange Management Act, 1999 (FEMA), is an Act of the Parliament of India "to consolidate and amend the law relating to foreign exchange to facilitate external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India.
- FEMA was formulated to fill all the loopholes and drawbacks of FERA (Foreign Exchange Regulation Act) and hence several economic reforms (major reforms) were introduced under the FEMA act.
- FEMA was basically introduced to de-regularize and have a liberal economy in India.

Objectives of FEMA

- The main objective for which FEMA was introduced in India was to facilitate external trade and payments.
- In addition to this, FEMA was also formulated to assist the orderly development and maintenance of the Indian forex market.
- FEMA outlines the formalities and procedures for the dealings of all foreign exchange transactions in India.
- These foreign exchange transactions have been classified into two Categories-Capital Account Transactions and Current Account Transactions.
- Under the FEMA Act, the balance of payment is the record of dealings among the citizens of different countries in goods, services, and assets.
- It is mainly divided into two categories, i.e. Capital Account and Current Account.

Capital Account

- Capital Account comprises all capital transactions whereas Current Account comprises trade of merchandise.
- Capital account recognizes the domestic investment in foreign assets and foreign investment in domestic.
- Current Account transactions are those transactions that involve inflow and outflow of money to and from the country/countries during a year due to the trading/rendering of commodity, service, and income.
- The capital account is a record of the inflows and outflows of capital that directly affect a nation's foreign assets and liabilities.
- It is concerned with all international trade transactions between citizens of one country and those in other countries.
- The components of the capital account include foreign investment and loans, banking, and other forms of capital, as well as monetary movements or changes in the foreign exchange reserve.
- The capital account flow reflects factors such as commercial borrowings, banking, investments, loans, and capital.

Current Account

- The current account is an indicator of an economy's status.

- The balance of payment comprises current and capital accounts, the remainder of the Balance of Payment is the Capital Account, which consists of the movement of capital in the economy due to capital receipts and expenditure.
- Transactions are recorded in the current account in the following ways:
  - Exports are noted as credits in the balance of payments
  - Imports are recorded as debits in the balance of payments
- The current account gives economists and other analysts an idea of how the country is faring economically.
- The difference between exports and imports, or the trade balance, will determine whether a country's current balance is positive or negative.
- When it is positive, the current account has a surplus, making the country a "net lender" to the rest of the world. A deficit means the current account balance is negative. In this case, that country is considered a net borrower.

Applicability of FEMA Act

- FEMA (Foreign Exchange Management Act) applies to the whole of India and is equally applicable to the agencies and offices located outside India (which are owned or managed by an Indian Citizen).
- The head office of FEMA is situated in New Delhi and is known as Enforcement Directorate.

FEMA is applicable to:

- Foreign exchange – includes all the receipts & payments
- Foreign securities – buy & sale of secirities
- Exportation of any commodity and/or service from India to a country outside India.
- Importation of any commodity and/or services from outside India.
- Securities as defined under The Public Debt Act 1994.
- Purchase, sale, and exchange of any kind (i.e. Transfer).
- Banking, financial, and insurance services.
- Any overseas company owned by an NRI (Non-Resident Indian) and the owner is 60% or more.
- Any citizen of India residing in the country or outside (NRI).

8.2 Main Features of Foreign Exchange Management Act, 1999

- It gives powers to the Central Government to regulate the flow of payments to and from a person / entity situated outside the country.
- All financial transactions concerning foreign securities or exchange cannot be carried out without the approval of FEMA. All transactions must be carried out through "Authorized Persons."
- In the general interest of the public, the Government of India can restrict an authorized individual from carrying out foreign exchange deals within the current account.
- Empowers RBI to place restrictions on transactions from capital Account even if it is carried out via an authorized individual.
- As per this act, Indians residing in India have the permission to conduct a foreign exchange, foreign security transactions, or the right to hold or own immovable property in a foreign

country in case security, property, or currency was acquired, or owned when the individual was based outside of the country, or when they inherit the property from individual staying outside the country.

8.3 Regulationandmanagementofforeign exchange Noperson shall

- transact in foreign exchange or transfer foreign securities to anyone who isn't an authorized person (AP);
- make any payment to or on behalf of any person residing outside of India in any manner; receive any payment by order or on that person's behalf in any fashion, other than through an authorized person.
- Explanation: For the purposes of this clause, any person in or resident of India who receives any payment by order of or on behalf of any person residing outside of India through any other person (including an authorized person) without a corresponding inward remittance from any location outside of India shall be deemed to have received such payment otherwise than through an authorized person;
- enter into any financial transaction in India in exchange for, or in connection with, the creation, transfer, or acquisition of a right to acquire, by any person, any asset outside of India.

Authorized Dealers

- Authorized dealers are the institutions that have the license from the RBI to sell and buy foreign currencies.
- Most of the authorized dealers are banks.
- As per the Foreign Exchange Management Act, 1999, the Reserve Bank, on an application, may authorize any person to be known as an authorized person to deal in foreign exchange as an Authorized Dealer.

Categories of Authorized Dealers

There are three types of authorized dealers, depending upon the type of institution. These three types are classified under the below-mentioned categories.

- Category I
- Category II
- Category III

Category	Authorized Dealer – Category I	Authorized Dealer Category – II	Authorized Dealer Category – III	Full Fledged Money Changers
Entities	1.Commercial Banks 2.State Co-operative Banks 3.Urban Co-operative Banks	1. Upgraded FFMC 2. Co-operative Banks 3. Regional Rural Banks (RRB's), others	1. Select Financial and other Institutions	1. Department of Post 2.Urban Co-operative Banks 3. Other FFMC
Activities Permitted	As per RBI guidelines, all current and capital account transactions	All activities permitted to FFMC and specified non-trade related current account transactions	Foreign exchange, transactions related	Purchase of foreign exchange and sale for private and business visits abroad

Authorized dealers list by RBI

LIST OF AUTHORISED DEALERS CATEGORY-I

Sl. No.	Name and address of the entity
1.	**The Royal Bank of Scotland N.V.** Level 3,4, North Avenue, Maker Maxity, Bandra-Kurla Complex, Bandra (E), Mumbai 400 051
2.	**Abu Dhabi Commercial Bank Ltd.** Foreign Exchange Department, 75 B, Rehmat Manzil, Veer Nariman Road, Mumbai- 400 020
3.	**Allahabad Bank**, Foreign Department, Head Office, Gillander House, Ground Floor, Block F, 8, N.S.Road, Kolkata-700001
4.	**Andhra Bank**, International Banking Division, 8F, Maker Towers, Cuffe Parade, Mumbai-400 005.
5.	**Antwerp Diamond Bank NV** Mumbai Branch, 2nd Floor, Engineering Centre, 9, Mathew Road, Opera House, Mumbai-400 004.

8.4 FEMA Act Violation Cases.

Mumbai: The Enforcement Directorate (ED) said it seized Rs 5,551.27 crore belonging to Xiaomi Technology India Pvt Ltd (Xiaomi India) on Saturday, nearly a fortnight after it questioned Manu Kumar Jain, the company's glob vice president. The company is being investigated for alleged violations of th Foreign Exchange Management Act (FEMA) since February pertaining to suspected illegal remittances made by it , the ED said in a statement.

Xiaomi India is a wholly owned subsidiary of the China-based Xiaomi Grou "This amount of Rs 5,551.27 crore lying in the bank accounts of the company has been seized by the ED," the agency said. Sources said the agency is investigating the company's foreign funding, shareholding, financial statements and related activities. Jain's statement had been recorded at the agency's Bengaluru office.

THE ECONOMIC TIMES | Industry

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Future Retail independent directors claim Amazon deal violates FEMA, FDI rules

Synopsis
The assertions of Amazon which it has claimed with success in the arbitral tribunal meant Amazon has significant strategic rights over FRL superior to all the shareholders, lenders and creditors of FRL, without holding even a single share in FRL.

Amazon's contractual rights to buy FRL shares come into force only after 2022.

Independent directors of Future Retail (FRL) said Amazon is in violation of foreign exchange rules since the Singapore arbitral tribunal has made FRL a party to the arbitration proceedings. In a letter to the stock exchange, independent directors said Amazon has also concealed facts, made misrepresentations and false representations to the Competition Commission of India to seek approval for its investment in Future Coupons, a promoter holding company.

The assertions of Amazon which it has claimed with success in the arbitral tribunal meant Amazon has significant strategic rights over FRL superior to all the shareholders, lenders and creditors of FRL, without holding even a single share in FRL.

8.5 Rate of Exchange

- Exchange rates are defined as the price that one nation or economic zone's currency can be exchanged for another currency.
- The rates are impacted by two factors:
    a. The domestic currency value
    b. The foreign currency value
- The main cause of fluctuations in the exchange rates are demand and supply of a currency, i.e. the amount generally offered for sale or purchase at a given moment.

- If the general demand for a currency at any moment exceeds the current supply, the exchange value of that currency appreciates, similarly if the demand falls, the currency value will depreciate.
- The factors affecting the demand and supply of a currency are numerous and varied.
- The supply and demand depend upon the balance of trade and balance of payment position of a country.
- The political outlook in a country is also a potent factor.
- Exchange rates are quoted –
  - For selling and buying transactions
  - In two methods – direct & indirect
  - For different periods – spot and forward

Bid-Ask Prices

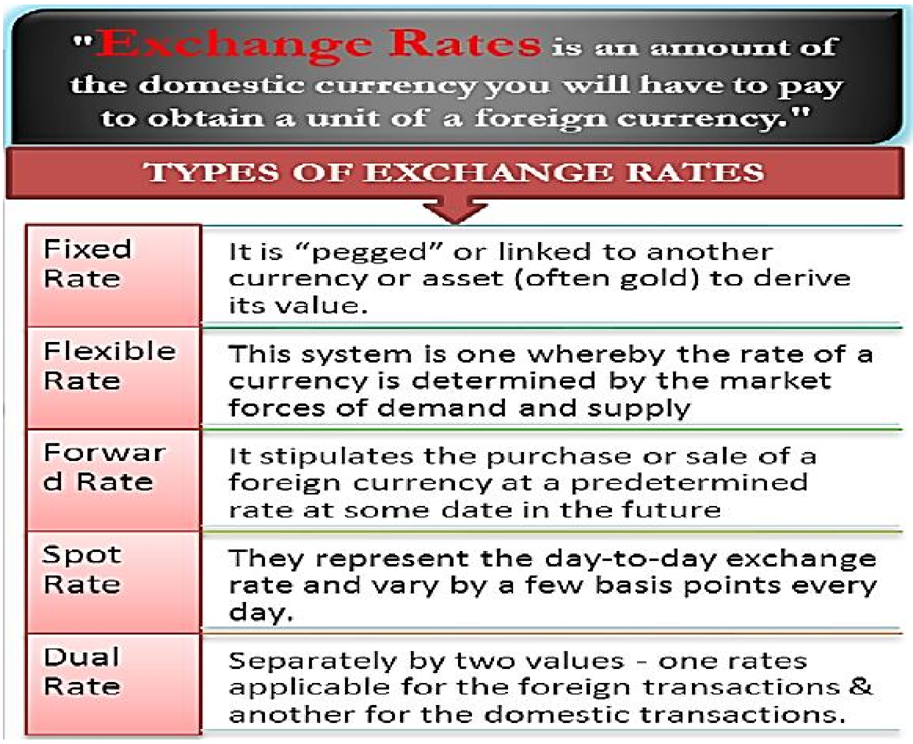
- The bid and ask prices are usually different from each other. For example, the EUR/JPY bid and ask prices can look like this: 119.21/119.23.
- The bid price is usually lower than the ask price.
- This difference in bid and ask prices (spread) is what Forex brokers use as a payout because often times, they don't have commission fees on trading or deposits/withdrawals. In this example, a spread would be 2 pips - 119.23-119.21=0.02.

Base Currency in a Forex Pair

- The base currency is the first element of the pair, and it represents one unit of that currency that buys the second currency.
- For example, in the EUR/USD currency pair, the euro is the base currency and it shows how much US dollars can one euro buy.

How to Read Currency Pairs?

- Currency pairs are the most important elements of Forex trading because they are used as assets for the actual trading process.
- People buy and sell base currency quote currency combinations to generate payouts.
- A currency pair consists of two elements, as we have already mentioned:
- The base and quote currencies.
- They are separated by a slash between them like this - EUR/USD.
- A currency pair represents the amount of the second currency (the quote) that is needed to buy the first one (the base).



8.6 Currency Exchange Quotes

Direct and Indirect Quote

- A direct currency quote uses the domestic or home currency as the base.
- For example, for an American national, the direct currency quote to obtain Euros will look like USD/EUR 1.17.

Indirect Quote

- An indirect currency quote denotes the domestic currency as the quoted currency.
- Or, in simpler terms, the value of our home currency is expressed in terms of the foreign currency sought to be acquired or sold.
- For example, EUR/USD 0.87. This means that a European Currency holder will have to give up 0.87 Euros to acquire 1 USD.

Bid & Ask Price

- In practical life, currency quotes are always quoted as USD/EUR 1.1681-1.1685
- The former part of the quote, USD/EUR 1.1681, is known as the bid rate. Bid Rate is the rate at which the bank will pay you should you go to it to buy Euros against USD. It is nothing but the buying rate for the bank.
- The latter part of the quote, USD/EUR 1.1685, is known as the ask rate.
- Ask Rate is a rate which the bank "asks" you to obtain a unit of Euro against the value in the dollar. It is nothing but the selling rate for the bank.
- It is important to know that the ask rate will always exceed the bid rate.
- The bank will always buy at a lower rate and sell at a higher rate.
- The simple reason is that the difference is the margin that the bank earns for facilitating such currency exchange.

Cross Currency Rate

- Reserve currency or an anchor currency is essentially the one in terms of which most other currencies are expressed.
- Such currency is held in large amounts by governments as Forex reserves.
- The US Dollar is currently the most widely held reserve currency, followed by the Euro.
- Consequently, a currency quote not expressed in terms of USD is known as a cross rate.
- All dominant and frequently traded currencies are translated in terms of USD.
- However, certain transactions may be such that they do not contain the dollar component at all.
- In such cases, the currency quotes are required to be expressed at a rate relative to one another to facilitate that exchange.

Example-A manufacturer in Germany wants to obtain certain automobile parts from a supplier in Australia. The supplier only accepts payment in Australian Dollars (AUD). Therefore, the German manufacturer will be compulsorily required to convert EUR to AUD to close the contract. The amount payable to the Australian Supplier is AUD 350,000.

The following quotes are quoted by the exchange.

- EUR/USD 1.1670-1.1674
- USD/AUD 1.3561-1.3570

The quote relevant to the German manufacturer is EUR/AUD

- The simple multiplication of (bid*bid)-(ask*ask) gives the required cross rate. (EUR/USD 1.1670-1.1674) (USD/AUD 1.3561-1.3570)
  = (1.1670*1.3561) --- (1.1674*1.3570)
  =1.5826-1.5841
- Therefore, the amount payable to the bank to obtain AUD 350,000 is (350,000/1.5841) EUR 220,945.

Spot Exchange Rates

- The spot exchange rate is the current market price for exchanging one currency for another.
- The rate one would have to pay in one currency to buy another at any moment in time.
- The forex market is the largest and most liquid market in the world, with trillions of dollars changing hands daily.
- The most actively traded currencies are the U.S. dollar, the euro, the British pound, the Japanese yen, and the Canadian dollar.
- The euro is used in many continental European countries including Germany, France, and Italy.
- Global forex trading takes place electronically between large, multinational banks, corporations, mutual funds, hedge funds, insurance companies, and government entities.
- Transactions are made for a wide range of purposes, including import and export payments, short- and long-term investments, loans, and speculation.
- Some currencies, especially in developing economies, are controlled by governments that set the spot exchange rate.
- For instance, the central government of China has a currency peg policy that sets the yuan and keeps it within a tight trading range against the U.S. dollar.

Forward Foreign Exchange

- A forward foreign exchange is a contract to purchase or sell a set amount of a foreign currency at a specified price for settlement at a predetermined future date (closed forward) or within a range of dates in the future (open forward).
- Contracts can be used to lock in a currency rate in anticipation of its increase at some point in the future. The contract is binding for both parties.
- For example, assume that Company A in the United States wants to contract for a future purchase of machine parts from Company B, which is located in France.
- Therefore, changes in the exchange rate between the US dollar and the euro may affect the actual price of the purchase – either up or down.
- The exporter in France and the importer in the US agree upon an exchange rate of 1.30 US dollars for 1 euro that will govern the transaction that is to take place six months from the date the currency forward contract is made between them.
- At the time of the agreement, the current exchange rate is 1.28 US dollars per 1 euro.
- If, in the interim and by the time of the actual transaction date, the market exchange rate is 1.33 US dollars per 1 euro, then the buyer will have benefited by locking in the rate of 1.3.
- On the other hand, if the prevailing currency exchange rate at that time is 1.22 US dollars for 1 euro, then the seller will benefit from the currency forward contract.
- However, both parties have benefited from locking down the purchase price so that the seller knows his cost in his currency, and the buyer knows exactly how much they will receive in their currency.

Summary

The Foreign Exchange Management Act of 1999 establishes the legal framework for managing foreign exchange transactions in India. All transactions involving foreign currency have been categorised as either capital or current account transactions under the Foreign Exchange Management Act, 1999 (FEMA), which went into effect on June 1, 2000. Current account transactions are all activities made by a resident outside of India that do not change his or her assets, liabilities, or contingent obligations. Under FEMA, capital account transactions are those that change a person's assets or liabilities, including contingent liabilities. Assets or liabilities owned outside India by an Indian resident or assets or liabilities held inside India by an Indian resident are changed. The primary idea of FEMA is transactions on the capital and current accounts. Both capital account and current account transactions involving residents and non-residents fall under this category. The basic idea is that as long as it's a current account transaction, it's okay unless FEMA forbids it or particularly regulates it. The general rule for capital account transactions is that they are forbidden by FEMA unless they are expressly authorized.

Keywords

"Capital Account Transaction" means a transaction, which alters the assets or liabilities, including contingent liabilities, outside India of person's resident in India or assets or liability in India of person's resident outside India, and includes transactions referred to in 1Section 6(3);

"Authorized person" means an authorized dealer, money changer, off-shore banking unit or any other person for the time being authorized under section 10(1) to deal in foreign exchange or foreign securities; [Section 2(c)]

"Adjudicating Authority" means an officer authorized under sub-section (1) of section 16(1);[Section 2(a)]

Self Assessment

1. RBI cannot do all transactions in the foreign exchange itself. Hence, RBI delegates its powers to the '…..' with suitable guidelines, to deal in foreign exchange and foreign securities.

A. Authorized Persons

B. Authorized workers
C. Authorized managers
D. Authorized directors

2. Commercial Banks, State Co-op Banks, Urban Co-op Banks fall under
A. Authorized Dealer –Category I
B. Authorized Dealer –Category II
C. Authorized Dealer –Category III
D. Full Fledged Money Changers (FFMC)

3. Upgraded FFMCs, Coop Banks, Regional Rural Banks (RRBs), others fall under
A. Authorized Dealer –Category I
B. Authorized Dealer –Category II
C. Authorized Dealer –Category III
D. Full Fledged Money Changers (FFMC)

4. Select Financial and other institutions fall under
A. Authorized Dealer –Category I
B. Authorized Dealer –Category II
C. Authorized Dealer –Category III
D. Full Fledged Money Changers (FFMC)

5. Department of Post, Urban Co-op Banks, Other FFMC fall under
A. Authorized Dealer –Category I
B. Authorized Dealer –Category II
C. Authorized Dealer –Category III
D. Full Fledged Money Changers (FFMC)

6. Full Fledged Money Changers (FFMC) has following Permitted Activities:
A. All current and capital account transactions as per RBI directions issued from time to time
B. Specified non-trade related current account transactions and all activities permitted to FFMC
C. Transactions incidental to the foreign exchange
D. Purchase of foreign exchange and sale for private and business visits abroad.

7. Authorized Dealer – Category III are **Permitted following Activities:**
A. All current and capital account transactions as per RBI directions issued from time to time
B. Specified non-trade related current account transactions and all activities permitted to FFMC
C. Transactions incidental to the foreign exchange
D. Purchase of foreign exchange and sale for private and business visits abroad.

8. Authorized Dealer – Category II are **Permitted following Activities**
A. All current and capital account transactions as per RBI directions issued from time to time
B. Specified non-trade related current account transactions and all activities permitted to FFMC

C. Transactions incidental to the foreign exchange

D. Purchase of foreign exchange and sale for private and business visits abroad.

9. Authorized Dealer – Category I are **Permitted following Activities**

A. All current and capital account transactions as per RBI directions issued from time to time

B. Specified non-trade related current account transactions and all activities permitted to FFMC

C. Transactions incidental to the foreign exchange

D. Purchase of foreign exchange and sale for private and business visits abroad.

10. Section 2(c) of the Foreign Exchange Management Act or FEMA states that 'authorized person' means an authorized dealer, money changer, off-shore banking unit, or any other person authorized under section …………to deal in foreign exchange and foreign securities.

A. 10 (1)

B. 11 (1)

C. 12 (1)

D. 13 (1)

11. …………deal in all other transactions in foreign exchange like bill of exchange, cheques, letters of credit, deposits, etc.

A. Authorized Dealer –Category I

B. Authorized Dealer –Category II

C. Authorized Dealer –Category III

D. Full Fledged Money Changers (FFMC)

12. Which of the following is wrong in regard to FEMA?

A. Though RBI exercises overall control over foreign exchange transactions, enforcement of FEMA has been entrusted to a separate 'Directorate of Enforcement' formed for this purpose.

B. FEMA, 1999 extends to the whole of India except J&K.

C. The scope of the Act has been extended to include branches, offices and agencies outside India.

D. The scope is thus wide enough because the emphasis is on the words "Owned or Controlled". Contravention of the FEMA committed outside India by a person to whom this Act applies will also be covered by FEMA.

13. The term'person resident in India'meansthefollowingentities:A person who resides in India for more than ……days during the preceding financial yea.

A. 182

B. 250

C. 365

D. 730

14. Section …..deals with current account transaction.

A. 5

B. 6
C. 7
D. 8

15. Section …..deals with capital account transaction.
A. 6
B. 7
C. 8
D. 9

Answers for Self Assessment

1.	A	2.	A	3.	B	4.	C	5.	D
6.	D	7.	C	8.	B	9.	A	10.	A
11.	A	12.	B	13.	A	14.	A	15.	A

Review Questions

1. What is the role of Authorized Persons under the Foreign Exchange Management Act, 1999?
2. What is the meaning of Current account Transactions and the Regulations and rules governing them?
3. Name certain important terms and definition under the Foreign Exchange Management Act, 1999.
4. What is the meaning of Capital account Transactions and the Regulations and rules governing them?
5. Explain the concept of Residential Status under the Foreign Exchange Management Act, 1999?

Further Readings

- ICAI: Paper 4: Corporate and economic laws
- International Financial Management 2ndEdition by Jeff Madura Ariful Hoque Chandrasekhar Krishnamurti, 2018
- International Accounting by Timothy S Doupnik_ Hector Perera, McGraw-Hill Education (2014).

Unit 09:Regulations

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand the various ways, policies, and regulations of forex management by Reserve Bank of India (RBI)
- understand the role of FEDAI in managing Forex
- understand the dealing room activities and its functions
- analyses the performance of a dealing room
- understand the different risks that affect the functioning of a dealing room
- take the corrective measures to avoid and mitigate the risks faced by the dealing room traders
- understand Correspondent Bank relationships

Introduction

India moved to a market-determined exchange rate system in March 1993. Under the new system, the rupee's exchange rate against other currencies is determined largely by market demand and supply. The Reserve Bank of India intervenes occasionally, only for maintaining orderly conditions in the market by curbing excessive volatility. Though large corporates continue to be active players in the Indian market, SMEs have also increased their presence. As one of the fastest-growing economies in the world, India's demand for crude oil has been growing significantly over the years. With limited proven reserves, the bulk of India's crude requirement is met through imports. Also, in recent years India's gold imports have increased significantly, putting pressure on its current account. Besides the software exports, remittances from the Indian diaspora have been quite robust and have helped contain the current account deficit (CAD) India, as structurally, a current account deficit economy, depends on capital flows to finance the CAD. During the last few years, India has witnessed a significant surge in capital flows in the form of Foreign Direct Investment (FDI), portfolio investments by FIIs, and External Commercial Borrowings (ECB). RBI is managing the Foreign exchange in Indian economy. The Foreign Exchange Dealers Association of India (FEDAI) is an association of commercial banks that specializes in the foreign exchange (forex) markets in India. These institutions are also called Authorized Dealers or ADs. Created in 1958 and incorporated under Indian law, Section 25 of The Companies Act of 1956, the Association regulates the rules that determine commissions, fees, and charges that are attached to the interbank foreign exchange business. The FEDAI determines many of the rules that oversee the day-to-day forex transactions in India. In addition to creating rules, FEDAI assists member banks by acting as an advisor, training personnel about Foreign Exchange Business, and accrediting foreign exchange brokers.

9.1 Liberalized Approach

The Reserve Bank issues licenses to banks and other institutions to act as Authorized Dealers in the foreign exchange market.

In keeping with the move towards liberalization, the Reserve Bank has undertaken substantial elimination of licensing, quantitative restrictions, and other regulatory and discretionary controls.

Apart from easing restrictions on foreign exchange transactions in terms of processes and procedure, the Reserve Bank has also provided the exchange facility for liberalized travel abroad for purposes such as:

- conducting business,
- attending international conferences,
- undertaking technical study tours,
- setting up joint ventures abroad,
- negotiating foreign collaboration,
- pursuing higher studies and training, and also for medical treatment.

Moreover, the Reserve Bank has permitted residents to hold a liberal amount of foreign currency.

Residents can now also open foreign currency accounts in India and credit specified foreign exchange receipts into it.

Foreign Investment

- Foreign investment comes into India in various forms.
- Following the reforms path, the Reserve Bank has liberalized the provisions relating to such investments.
- The Reserve Bank has permitted foreign investment in almost all sectors, with a few exceptions.
- In many sectors, no prior approval from the Government or the Reserve Bank is required for non-residents investing in India.
- Foreign institutional investors are allowed to invest in all equity securities traded in the primary and secondary markets.
- Foreign institutional investors have also been permitted to invest in Government of India treasury bills and dated securities, corporate debt instruments, and mutual funds.
- The NRIs have the flexibility of investing under the options of repatriation and non-repatriation.
- Similarly, Indian entities can also make an investment in an overseas joint venture or in a wholly-owned subsidiary abroad up to a certain limit.

External Commercial Borrowings

- Indian companies are allowed to raise external commercial borrowings including commercial-bank loans, buyers' credit, suppliers' credit, and securitized instruments.
- Foreign Currency Convertible Bonds (FCCBs) and Foreign Currency Exchangeable Bonds (FCEBs) are also governed by the ECB guidelines.

Liberalised Remittance Scheme

As a step towards further simplification and liberalization of the foreign exchange facilities available to the residents, the Reserve Bank has permitted resident individuals to freely remit abroad up to a liberal amount per financial year for any permissible purposes.

Currency Futures

- Exchange-traded currency futures are permitted in India. Such trading facilities are currently being offered by the National Stock Exchange, the Bombay Stock Exchange, and the MCX-Stock Exchange.
- As the product is an exchange-traded, the conduct of the currency futures trading facility is being regulated jointly by the Reserve Bank and the Securities and Exchange Board of India.

Exchange Rate Policy

- The Reserve Bank's exchange rate policy focuses on ensuring orderly conditions in the foreign exchange market.
- For the purpose, it closely monitors the developments in the financial markets at home and abroad.
- When necessary, it intervenes in the market by buying or selling foreign currencies.
- The market operations are undertaken either directly or through public sector banks.
- In addition to the traditional instruments like forward and swap contracts, the Reserve Bank has facilitated increased availability of derivative instruments in the foreign exchange market.
- It has allowed trading in Rupee-foreign currency swaps, foreign Currency-Rupee options, cross-currency options, interest rate swaps and currency swaps, forward rate agreements, and currency futures.

Foreign Exchange Reserves Management

The Reserve Bank of India, is the custodian of the country's foreign exchange reserves and is vested with the responsibility of managing their investment.

- The Reserve Bank's reserves management function has in recent years grown both in terms of importance and sophistication for two main reasons.
- First, the share of foreign currency assets in the balance sheet of the Reserve Bank has substantially increased.
- Second, with the increased volatility in exchange and interest rates in the global market, the task of preserving the value of reserves and obtaining a reasonable return on them has become challenging.
- The basic parameters of the Reserve Bank's policies for foreign exchange reserves management are safety, liquidity, and returns.
- The Reserve Bank of India Act permits the Reserve Bank to invest the reserves in the following types of instruments:

    1. Deposits with Bank for International Settlements and other central banks.

    2.Deposits with foreign commercial banks.

    3.Debt instruments representing sovereign or sovereign-guaranteed liability of not more than 10 years of residual maturity.

    4.Other instruments and institutions as approved by the Central Board of the Reserve Bank following the provisions of the Act.

    5.Certain types of derivatives.

- While safety and liquidity continue to be the twin pillars of reserves management, return optimization has become an embedded strategy within this framework.

- The Reserve Bank has framed policy guidelines stipulating stringent eligibility criteria for issuers, counterparties, and investments to be made with them to enhance the safety and liquidity of reserves.
- The Reserve Bank, in consultation with the Government, continuously reviews the reserves management strategies.

9.2 Legal Framework

- Reserve Bank of India Act, 1934
- Foreign Exchange Management Act, 1999

FEDAI's Core Functions

- Advising and supporting member banks with issues that arise in their dealings
- Representing member banks on the Reserve Bank of India (India's central bank)
- Announcement of daily and periodical interest rates to member banks
- Guidelines and Rules for Forex Business.
- Training of Bank Personnel in the areas of Foreign Exchange Business.
- Accreditation of Forex Brokers
- The FEDAI rules govern all Authorized Dealers of foreign exchange in India. Some of the important rules of FEDAI are as under…

Trading Hours of Authorized Dealers

- Exchange trading hours for interbank forex market in India is 9a.m to 5 p.m.
- As per the trading rule, ADs shall not take customer transactions after 4.30 pm on all working days.
- However, in the cases of cross-currency transactions cut-off time limit of 5 p.m. is not applicable, but the management of the concerned bank shall lay down the timings for extended dealing hours. Saturday will not be treated working day for foreign exchange dealings.
- The member banks are free to determine their charges for various types of forex transactions, keeping in view the advice of RBI that such charges are not to be out of line with the average cost of providing services.
- Banks should take care to ensure that customers with a low volume of activities are not penalized.
- Banks should prominently display their card rates for foreign currencies on their website and/or their B Category branches.
- Banks should also declare
  - Threshold amounts up to which they are committed to apply card rates.
  - Frequency and time of publishing the card rate.
- Authorized dealers may undertake customer (person resident in India and persons resident outside India) and inter-bank transactions on all working days beyond normal market hours.
- Transactions with person resident outside India, through their foreign branches and subsidiaries may also be undertaken on all working days beyond normal market hours.
- Transactions, including value cash transactions, for individual persons (including joint accounts or a proprietary firm) can be undertaken even on Saturdays, Sundays, and holidays as per the banks' internal policy.

Post Shipment Credit in Rupees

- Application of exchange rate Foreign Currency bills will be purchased/discounted/negotiated at the Authorized Dealer's current bill buying rate or contracted rate.
- Interest for the normal transit period and/or usance period shall be recovered upfront simultaneously.

Crystallization

- The process of converting the foreign currency liability of the exporter into Indian Rupee liability is called 'crystallization of foreign currency export bills'.
- The purpose of crystallization is to transfer the exchange risk involved in a belated receipt of export bill payment to the exporter.
- Authorized Dealers should formulate their own policy for crystallization of foreign currency liability into rupee liability, in case of non-payment of bills on the due date.
- The policy in this regard should be transparently available to the customers.

Realization of Bill After Crystallization

After receipt of advice of realization, the authorized dealer will apply the TT buying rate or contracted rate (if any) to convert foreign currency proceeds.

Dishonor of Bills

In case of dishonor of a bill before crystallization, the Bank shall recover;

1. Rupee equivalent amount of the bill and foreign currency charges at TT selling rate.
2. Appropriate interest and rupee- denominated charges.

Application of Interest

a) Rate of interest applicable to all export transactions shall be as per the guidelines of the Reserve Bank of India from time to time.

b) Overdue interest shall be recovered from the customer, if payment is not received within the normal transit period in case of demand bills and on/or before notional due date/actual due date in case of usance bills, as per RBI directive

c) In case of early realization, interest for the unexpired period shall be refunded to the customer.

Normal Transit Period

d) Concepts of normal transit period and notional due date are linked to the interest rate on export bills and to arrive at the due date of the bill/export credit.

e) Normal transit period comprises the average period normally involved from the date of negotiation/purchase/discount till the receipt of bill proceeds.

f) It is not to be confused with the time taken for the arrival of the goods at the destination.

g) Normal transit period for different categories of an export business are laid down as below.

Business Through Intermediaries

- Exchange brokers, Multi Bank Portals (MBP), and Electronic Order Matching Systems (EOMS) are some of the commonly used intermediaries in foreign exchange markets.
- While such intermediaries were earlier accredited by FEDAI, from 05 October 2018, FEDAI will continue to be the accrediting agency for Exchange Brokers (Voice) only.
- Electronic Trading Platforms viz. MBPs and EOMs will require to obtain authorization from RBI.
- Authorized Dealers shall use the services of intermediaries accredited by FEDAI/RBI.

- No brokerage, fees, charges, or any other form of remuneration shall be paid by the Authorized Dealers to other bank employees on any foreign exchange contracts.
- Accredited intermediaries will conform to the rules, conditions, and code of conduct laid down by FEDAI from time to time.

Interbank Settlement

- Issues of delays in payments of funds in any currency (including the Indian Rupee) in the settlement of foreign exchange contracts are dealt with in this rule.
- Considering the technological advances in processes of payments and reconciliation of accounts, it has become far speedier to detect nondelivered funds.
- Banks are expected to track delivery of funds, note discrepancies if any, and take corrective actions expeditiously and efficiently

Interest for Delayed Delivery

- In the event of late delivery of any currency (including Indian Rupee) in a foreign exchange contract, interest for the number of days of delay (regardless of the causes for delay) shall be payable by the seller-bank.
- The interest for the overdue period shall be payable at the rate of 2% over the benchmark rate of the currency concerned.
- The benchmark rates for the currencies are listed below: -

1. INR	- FBIL MIBOR overnight rate
2. STG	- Base rate of Barclays Bank
3. USD	- ~~Prime~~ Base rate of Citibank NA
4. EUR	- Marginal Lending Facility rate of European Central Bank
5. JPY	- Prime rate of Bank of Tokyo-Mitsubishi UFJ Ltd.
6. CHF	- 3 month rate of Swiss National Bank
7. CAD	- Prime rate of Bank of Nova Scotia

Deliberate Default

- In case the claim is not settled within 60 days from the date of lodgment of claim, the matter may be referred to FEDAI for the final decision, which shall be binding on both the banks concerned.
- The matter would be examined by the Managing Committee of FEDAI or any other Sub-Committee appointed for this purpose by the Managing Committee.
- The said committee of FEDAI will decide about the penalty on the defaulting bank.

Wrong Delivery of Funds

In case, a seller bank delivers funds to an account other than the notified account of the buyer bank, it shall compensate the buyer in terms of the above rules.

Use of incorrectly paid funds (undue enrichment)

A bank that has received funds, not intended for its accounts, shall be liable to compensate the bank which has been out of funds by either returning the funds with proper value, provided 1.charges for back valuation are borne by the original remitting bank.

2.returning the funds with interest that is earned, with fewer charges, if any.

9.3 Dealing Room

- The dealing room undertakes all the transactions relating to foreign exchange within the bank, an acts on behalf of the bank in the interbank market, in parallel markets or with the customers.
- Foreign exchange rates in simple terms mean the value of one currency in terms of another.
- The rates of exchange are guided basically by the demand and supply factors.
- Because of this one see fluctuations in exchange rates in foreign exchange markets.
- Dealing room to take advantage of such volatility in exchange rates will enter into trading positions – purely buying and selling – to maximize the profits.
- Therefore, a dealing room occupies an important role in the organization as a profit center.
- A dealing room is a centralized establishment, usually of a commercial bank, which is willing to offer a two way dealing price for different currencies (and asset classes instruments) at all times even when they may not wish to deal.
- It is staffed by technicians - popularly known as dealers – who have acquired a specialized skill and whose training has little to do with traditional banking.

Functions of a dealing room

- Basically a dealer is a service provider – to meet the requirements of his customers – to buy or sell currencies (and various other asset classes).
- He is also a part and parcel of the profit center – dealing room.
- Basically a dealer has to maintain two positions – funds position and currency (or asset) position.
- A Dealing-room gathers traders operating on financial markets.
- The dealing room is also often called the front office.
- The banks' capital market and money market (domestic and currencies) businesses, foreign exchange, long-term financing, bond market are gathered in today's dealing room operation.
- Foreign exchange dealing room operations comprise functions of a service branch to meet the needs of other branches / divisions to buy/sell foreign currency
- It acts a profit center for the banks / financial institution
- A dealer has to maintain two positions
  - funds position and
  - currency position
  - The funds position reflects inflows and outflows of funds i.e. receivables and payables.
- Currency position deals with overbought and oversold positions, arrived after taking various merchant or inter-bank transactions and the dealer is concerned with the overall net position.
- The overall net position exposes the dealer to exchange risks from market movements.
- A foreign exchange dealer, if he is a market maker, will quote a two-way price when asked for (bid & offer), the difference between the buying and selling rate is the dealers margin.
- Forex dealers work at a hectic pace and use slang to save time.

Working at a Dealing Room

- The activities of a foreign-exchange dealing room, where world currencies are bought and sold, has actually changed very little over time.
- Indeed, the foreign-exchange market is very different from other financial markets, such as the bond or equity markets.

Trading takes place on one floor, and for the most part over the telephone, or on electronic screens.

- In a foreign-exchange dealing room there are a large number of traders, each of them sitting at a desk.
- On these desks there are a number of computers with electronic screens.
- Each of the traders is trading, that is buying or selling, usually one foreign-exchange bilateral pair.
- By that I mean they are buying or selling pounds for dollars, or dollars for euros, or euros for yen, or dollars for yen.
- All the major currencies would be covered by the traders in the trading room, involving all the spot exchange rate and the forward and future exchange rates for the major currencies.
- In some cases there will be traders who deal with a number of smaller currencies, which are sometimes known as exotic currencies.
- That is when you are dealing in, for example, the Malaysian ringgit or the Thai baht or the Korean won.

9.4 Vehicle Currency and its Utility

- Assume that you have a customer who wants to sell Norwegian krone and buy South African rand.
- There is literally no market for doing that directly, as it would be extraordinarily illiquid.
- Each of the smaller currencies has quite a flourishing market with the US dollar, and in future will do so with the euro.
- If somebody wants to sell Norwegian krone to buy South African rand, he can sell the Norwegian krone for the dollar, and then use the dollar he has obtained to purchase the South African rand.
- So he sells the dollar and buys rand. In effect, he is going though the vehicle of the much more widely traded currency--i.e. the dollar or the euro--in going from one minor currency to another.

Performance measurement of a dealing room

- A dealing room has the dual role that quite often conflict with each other.
- While on one hand, it is expected to serve its clientele by offering extremely fine exchange rates that allows them to hedge their exposure in a most cost efficient way, on the other it is expected to function as an independent profit center generating handsome profits for the organization.
- As a profit center, the front office is expected to generate sufficient profit not only to cover the costs associated with its operations but also such profits as may be determined by the head of the Forex operations.
- Reserve bank of India has approved Foreign Exchange Dealers Association of India (FEDAI) guidelines on Uniform Standard Accounting procedures for the valuation of Forex profit & losses by the authorized dealers.

9.5 Risk Management at Dealing Room

- The forex market is among the most active and liquid in the world, with trillions of dollars changing hands between different currencies.

- Still, there are many risks that a trader must be aware of and how to minimize or mitigate those risks.
- Because forex trading operates with a relatively high degree of leverage, the potential risks are magnified compared to other markets.

Major Risk In Forex Dealing Operations

- Exchange Rate Risk
- Interest Rate Risk
- Credit Risk
- Country Risk
- Liquidity Risk
- Marginal or Leverage Risk
- Transactional Risk
- Risk of Ruin

Exchange Rate Risk

- Exchange rate risk is the risk caused by changes in the value of currency.
- It is based on the effect of continuous and usually volatile shifts in the worldwide supply and demand balance.
- This risk can be quite substantial and is based on the market's perception of which way the currencies will move based on all possible factors that happen (or could happen) at any given time, anywhere in the world.
- **The Position Limit -**A position limit is the maximum amount of any currency a trader is allowed to carry, at any single time.
- **The Loss Limit -**The loss limit is a measure designed to avoid unsustainable losses made by traders by means of setting stop loss levels. It is imperative that you have stop loss orders in place.
- **Risk / Reward Ratios -**A method traders use as a guideline when trying to control exchange rate risk is to measure their intended gains against their possible losses.
- The idea is that most traders will lose twice as many times as they profit, so a guide to trading is to keep your risk/reward ratio to 1:3.

Interest Rate Risk

- Interest rate risk refers to the profit and loss generated by fluctuations in the forward spreads, along with forward amount mismatches and maturity gaps among transactions in the foreign exchange book.
- This risk is pertinent to currency swaps; forward outright, futures, and options.
- To minimize interest rate risk, one sets limits on the total size of mismatches.
- A common approach is to separate the mismatches, based on their maturity dates, up to six months and past six months.
- All the transactions are entered in computerized systems in order to calculate the positions for all the dates of the delivery, gains and losses.
- Continuous analysis of the interest rate environment is necessary to forecast any changes that may impact on the outstanding gaps.

Credit Risk

- Credit risk refers to the possibility that an outstanding currency position may not be repaid as agreed, due to a voluntary or involuntary action by a counterparty.
- Credit risk is usually something that is a concern of corporations and banks.

Replacement Risk

Replacement risk occurs when counter-parties of a failed bank or Forex broker find they are at risk of not receiving their funds from the failed bank.

Settlement Risk

- Settlement risk occurs because of the difference of time zones on different continents.
- Consequently, currencies may be traded at different prices at different times during the trading day.
- Australian and New Zealand Dollars are credited first, then the Japanese Yen, followed by the European currencies and ending with the US Dollar.
- Therefore, payment may be made to a party that will declare insolvency or be declared insolvent, prior to that party executing its own payments.
- In assessing credit risk, the trader must consider not only the market value of their currency portfolios, but also the potential exposure of these portfolios.

Counter-party Default Risk

- Over-the-counter ("OTC") spot and forward contracts in currencies are not traded on exchanges; rather, banks typically act as principals in this market.
- The performance of spot and forward contracts on currencies is not guaranteed by any exchange or clearing house, the client is subject to counter-party risk -- the risk that the principals with a trader, the trader's bank or the counter-parties with which the bank trades, will be unable or will refuse to perform with respect to such contracts.
- Furthermore, principals in the spot and forward markets have no obligation to continue to make markets in the spot and forward contracts traded.
- A bank may decline to execute an order in a currency market which it believes to present a higher than acceptable level of risk to its operations.
- The financial failure of counter-parties could result in substantial losses. Again, when trading Foreign Currencies on an OTC basis, the trader/customer will be dealing with institutions as principals and institutions may be subject to losses or insolvency.

Country and Liquidity Risk

- Country risk refers to the uncertainty associated with investing in a particular country, and more specifically the degree to which that uncertainty could lead to losses for investors.
- This uncertainty can come from any number of factors including political, economic, exchange-rate, or technological influences.
- In particular, country risk denotes the risk that a foreign government will default on its bonds or other financial commitments increasing transfer risk.
- Several nations or groups of nations have in the past imposed trading limits or restrictions on the amount by which the price of certain Foreign Exchange rates may vary during a given time period, the volume which may be traded, or have imposed restrictions or penalties for carrying positions in certain foreign currencies over time.
- Such limits may prevent trades from being executed during a given trading period.
- Such restrictions or limits could prevent a trader from promptly liquidating unfavorable positions and, therefore could subject the trader's account to substantial losses.
- In addition, even in cases where Foreign Exchange prices have not become subject to governmental restrictions, the General Partner may be unable to execute trades at favorable prices if the liquidity of the market is not adequate.

- It is also possible for a nation or group of nations to restrict the transfer of currencies across national borders, suspend or restrict the exchange or trading of a particular currency, issue entirely new currencies to supplant old ones.

Leverage Risk

Due to use of leverage, a rrelatively small price movement in a contract may result in immediate and substantial losses in excess of the amount invested.

For example, if at the time of purchase, 10% of the price of a contract were deposited as margin, a 10% decrease in the price of the contract would, if the contract were then closed out, result in a total loss of the margin deposit before any deduction for brokerage commissions

- A decrease of more than 10% would result in a total loss of the margin deposit.
- Some traders may decide to commit up to 100% of their account assets for margin or collateral for Foreign Exchange trading.
- Traders should be aware that the aggressive use of leverage will increase losses during periods of unfavorable performance.

Transactional Risk

- Errors in the communication, handling and confirmation of a trader's orders (sometimes referred to as "out trades") may result in unforeseen losses.
- Often, even where an out trade is substantially the fault of the dealing counter-party institution, the trader/customer's recourse may be limited in seeking compensation for resulting losses in the account.

Risk of Ruin

Even where a trader/customer's medium to longer term view of the market may be ultimately correct, the trader may not be able to financially bear short-term unrealized losses, and may close out a position at a loss simply because he or she is unable to meet a margin call or otherwise sustain such positions.

Thus, even where a trader's view of the market is correct, and a currency position may ultimately turn around and become profitable had it been held, traders with insufficient capital may experience losses.

9.6 Correspondent Banking Relationships

Large commercial banks maintain demand deposit accounts—known as correspondent banking accounts—with one another as part of a network of correspondent banking partnerships that make up the interbank market.

International commercial banks can exchange instructions of this nature with one another thanks to the Association for Worldwide Interbank Financial Telecommunication (SWIFT). More than 11,000 financial institutions use the private, nonprofit SWIFT message transfer system, which is used in more than 200 nations and territories worldwide. Its international switching hubs are located in the Netherlands and Virginia, and its headquarters are in Brussels.

Almost 95% of U.S. dollar payments between foreign banks are settled interbank through The Clearing House (CHIPS), formerly known as the Clearing House Interbank Payments System, which works in conjunction with the U.S. Federal Reserve Bank System, known as Fedwire. Every day, CHIPS processes around $1.5 trillion in payments.

Consider U.S. Importer wishing to: As an example of how the network of correspondent bank accounts helps international foreign exchange transactions, to pay €750,000 to Netherlands Exporter to purchase goods with an invoiced price in euros. The American importer will speak with his American bank to find out the current $/€ conversion rate. Consider the price offered by U.S. Bank: $1.3092/€1.00. If U.S. Importer agrees to the price, U.S. Bank will debit U.S. Importer's demand deposit account with $981,900 (equivalent to €750,000 divided by 1.3092) to pay for the euros.

U.S. Bank will give EZ Bank instructions to debit €750,000 from its page 126 correspondent bank account and credit Dutch Exporter's bank account in the euro zone. In order to reflect the $981,900 debit to U.S. Importer's account and the $981,900 increase in the balance of its correspondent bank account with EZ Bank, U.S. Bank will subsequently credit $981,900 to its books.

Summary

The largest and busiest financial market in the world is the foreign exchange market. It is accessible around the clock, every day of the year. Foreign exchange spot and future transactions averaged $6.19 trillion daily in 2019. The FX market participants include international banks, bank customers, nonbank FX dealers, FX brokers, and central banks. Every hour of every working day, prices are changing and currencies are trading somewhere on the global foreign exchange (FX) market, which is open around-the-clock. It is the biggest and most significant market for both national and global economy. Monetary crises are frequently linked to large shifts in the 24-hour FX market, which show both growing risk awareness and modifications to the inherent risk of a particular currency investment. Hence, the increasing uncertainty over the security and market value of global financial assets had an impact on the FX market during the GFC. When there was a significant unwinding of the carry trade in August 2007, several currency market investors incurred significant losses, which confirmed the suspicions of FX market participants (Melvin & Taylor, 2009). Huge money movements across international borders as a result of the high demand for a globally liquid fund raised currency exposures. Currency derivatives are used by MNCs with significant FX exposures and economies of scale in hedging activities (Ge'czy, Minton & Schrand, 1997). For the past three decades, the currency options derivative has been utilized for financial risk management (for example, for hedging purposes). To lessen the variation in their cash flows or earnings against negative fluctuations in the FX rate, it is an effective financial risk management strategy for MNCs.

Keywords

Country risk: is frequently used to illustrate an MNC's exposure to various country factors, such as political acts like governmental conflict, government regulations (like tax laws), and economic circumstances within that country.

Foreign exchange (FX) market: The foreign exchange (FX) market includes currency exchanges, bank deposits of foreign currency, credit extensions denominated in foreign currencies, financing for international trade, trading in foreign currency options and futures contracts, and currency swaps.

Currency futures are an exchange-traded futures contract that specify the price in one currency at which another currency can be bought or sold at a future date.

Self Assessment

1. Which of the following statements is wrong about country risk?

A. Country risk represents the potentially adverse impact of a country’s environment on an MNC’s cash flows.

B. An MNC conducts country risk analysis when it applies capital budgeting to determine whether to implement a new project in a particular country or whether to continue conducting business in a particular country.

C. Financial managers must understand how to measure country risk and incorporate country risk within their capital budgeting analysis so that they can make investment decisions that maximize their MNC’s value.

D. Political risk viz. uncertain action by governments that affects the value of a company is not part of country risk.

2. Which of the following statements is wrong about Liberalized Approach by RBI?

A. The Reserve Bank issues licenses to banks and other institutions to act as Authorized Dealers in the foreign exchange market. In keeping with the move towards liberalization, the Reserve Bank has undertaken substantial elimination of licensing, quantitative restrictions and other regulatory and discretionary controls.

B. Apart from easing restrictions on foreign exchange transactions in terms of processes and procedure, the Reserve Bank has also provided the exchange facility for liberalized travel abroad for purposes, such as, conducting business, attending international conferences, undertaking technical study tours, setting up joint ventures abroad, negotiating foreign collaboration, pursuing higher studies and training, and also for medical treatment.

C. Moreover, the Reserve Bank has permitted non-residents to hold liberal amount of foreign currency.

D. Residents can now also open foreign currency accounts in India and credit specified foreign exchange receipts into it.

3. Which of the following statements is wrong about Foreign Investment by RBI?

A. In many sectors, no prior approval from the Government or the Reserve Bank is required for non-residents investing in India.

B. Foreign institutional investors are allowed to invest in all equity securities traded in the primary and secondary markets.

C. Foreign institutional investors have not been permitted to invest in Government of India treasury bills and dated securities, corporate debt instruments and mutual funds.

D. The NRIs have the flexibility of investing under the options of repatriation and non-repatriation.

4. Which of the following statements is wrong about exchange rate policy by RBI?

A. The Indian Rupee was pegged to the Pound Sterling on account of historic links with Britain. After the breakdown of Bretton Woods System in the early seventies, most of the countries moved towards a system of flexible/managed exchange rates.

B. With the decline in the share of Britain in India's trade, increased diversification of India's international transactions together with the weaknesses of pegging to a single currency, the Indian Rupee was de-linked from the Pound Sterling in September 1975.

C. A significant two-step downward adjustment in the exchange rate of the Rupee was made in 1991

D. The market operations are undertaken either directly or through private sector banks.

5. Which of the following statements is wrong about foreign exchange reserve management?

A. The Reserve Bank of India, is the custodian of the country's foreign exchange reserves and is vested with the responsibility of managing their investment.

B. The legal provisions governing management of foreign exchange reserves are laid down in the Reserve Bank of India Act, 1934.

C. The basic parameters of the Reserve Bank's policies for foreign exchange reserves management are safety, liquidity and returns.

D. The Reserve Bank, without consultation with the Government, continuously reviews the reserves management strategies.

6. The legal provisions governing management of foreign exchange reserves are laid down in the Reserve Bank of India Act….

A. 1934

B. 1935

C. 1936

D. 1937

7. he legal provisions governing management of foreign exchange reserves are laid down in the FEMA….

A. 1999

B. 2000

C. 2001

D. 2002

8. What is the limit of Liberalized remittance scheme 2022?

A. USD 250,000 per financial year

B. USD 350,000 per financial year

C. USD 450,000 per financial year

D. USD 550,000 per financial year

9. ……risk occurs because of the difference of time zones on different continents

A. Settlement Risk

B. Replacement Risk

C. Counter-party Default Risk

D. Interest Rate Risk

10. …….refers to the profit and loss generated by fluctuations in the forward spreads, along with forward amount mismatches and maturity gaps among transactions in the foreign exchange book.

A. Settlement Risk

B. Replacement Risk

C. Counter-party Default Risk

D. Interest Rate Risk

11. …..refers to the possibility that an outstanding currency position may not be repaid as agreed, due to a voluntary or involuntary action by a counterparty

A. Settlement Risk

B. Replacement Risk

C. Credit Risk

D. Interest Rate Risk

12. ….occurs when counter-parties of a failed bank or Forex broker find they are at risk of not receiving their funds from the failed bank.

A. Settlement Risk

B. Replacement Risk

C. Credit Risk

D. Interest Rate Risk

13. Where Foreign Exchange prices have not become subject to governmental restrictions, the General Partner may be unable to execute trades at favorable prices if the liquidity of the market is not adequate. This is …. risk

A. Settlement Risk
B. Replacement Risk
C. LiquidityRisk
D. Interest Rate Risk

14. Due to ……risk, a rrelatively small price movement in a contract may result in immediate and substantial losses in excess of the amount invested.
A. Leverage
B. Replacement Risk
C. Liquidity Risk
D. Interest Rate Risk

15. Errors in the communication, handling and confirmation of a trader's orders (sometimes referred to as "out trades") may result in unforeseen losses. This is …. risk
A. Leverage
B. Replacement Risk
C. Transactional Risk
D. Interest Rate Risk

Answers for Self Assessment

1.	A	2.	C	3.	C	4.	D	5.	D
6.	A	7.	A	8.	A	9.	A	10.	D
11.	C	12.	B	13.	C	14.	A	15.	C

Review Questions

1. Illustrate correspondent banking relationships.
2. A project to build a factory for making and selling consumer items in a developing nation is being considered by Reno Ltd. Suppose that the host nation's economy is highly reliant on oil prices, the local currency is highly unstable, and the risk to the nation is extremely high. Assume as well that Australia's economic situation has no bearing on that of the nation. Should the project's needed rate of return (and consequent risk premium) be higher or lower than that of comparable Australian ventures?
3. What are the Major Risk in Forex Dealing Operations?
4. Explain various ways, policies, and regulations of forex management by Reserve Bank of India (RBI).
5. Explain dealing room functioning.

Further Readings

- International Financial Management 2ndEdition by Jeff Madura Ariful Hoque Chandrasekhar Krishnamurti, 2018
- International Financial management by Eun,Resnick and Chuluun. Ninth edition. McGraw-Hill Education

- International Accounting by Timothy S Doupnik_ Hector Perera, McGraw-Hill Education (2014).

Web Links

- https://www.rbi.org.in/scripts/FS_Overview.aspx?fn=5
- https://www.investopedia.com/terms/c/currencyfuture.asp

Unit 10: Foreign Banking Products

CONTENTS

Objective

After studying this unit, you should be able to understand:

- Enlist the financial products available to NRIs under FEMA
- understand the remittance services by banks
- explore the provisions of RBIs 'Liberalized Remittance Scheme'

Introduction

For the past twenty years, India has experienced tremendous industrial growth. Thus, the nation is luring foreign direct investment (FDI). In comparison to many other nations where NRIs dwell, India has one of the fastest-growing global economies and is relatively stable. It's crucial to ensure that your money is invested in a nation that is sufficiently stable. Also, you contribute to increasing your nation's foreign exchange. This has led non-resident Indians (NRIs) to view India as a place where they may make profitable investments. Every day, the Indian government improves the business environment in the nation. NRIs are having trouble deciding which investments to make because there are so many possibilities available to them. After working a few years abroad, the vast majority of NRIs return to India and eventually use all of their investments there. It is one compelling argument in favour of investing a significant portion of your funds in India.

10.1 FEMA and NRI investments

- The Foreign Exchange Management Act (FEMA) is a law enacted by the Government of India in 1999 to control this flow of foreign currency across Indian borders.
- FEMA replaced the earlier Foreign Exchange Regulation Act or FERA, which was more stringent, in the wake of economic reforms introduced in the Indian economy in the early nineties.

- FEMA aims to facilitate external trade and their payments in India, a systematic improvement and continuation of foreign exchange in the Indian market. It outlines the procedures, formalities, businesses of all foreign exchange transactions in India.
- It's important for Indians working abroad to understand FEMA rules for NRIs very carefully since it can affect the way they can send and receive funds from India.
- A recent report suggests that India would be the second-largest economy in the world by 2050. At present, it ranks at 5th position across the globe as per the gross domestic product.
- So, this signifies that investing in India could be a great option for the NRIs. An economy with more than 130 billion population holds immense opportunity in terms of investment returns in most sectors.

1) Rapid economic growth

- India's GDP has grown dramatically over the years. It is now at the sixth position worldwide.
- It is expected that this economy would be within the world's top two economies in the next thirty years.
- The GDP forecast for the next five years suggests the economy would grow at a pace of around 6.5% to 7%.
- The stability in the economy reduces the risk of investment on the other hand.
- At present, India is having a stable government at the center as well. So, politically the economy is also in a stable state which, in turn, reduces the volatility in the financial market.

2) Diversification

- NRIs can diversify their investment well with multiple assets. They can invest in mutual funds, alternative investment funds, bonds, CFDs, and other investment assets.
- Diversification helps in reducing the risk factor and also optimize the returns. The minimum investment requirements in India for many asset classes is pretty lower. This is why it is easier for the NRIs to invest in India as well.

3) Higher Interest rates

- The prevailing interest rates are higher in India than in many other developing countries and far better than in developed countries.
- While it is around 4% to 7% in India, it is 0.25%- 1% in the US, and some other developed economies.
- You can see the huge difference in the interest rate in these countries. So, if you invest in India as an NRI, you can get great returns compared to the countries you are living in.

4) Growth in the mutual fund industry

- The mutual fund industry witnessed a sharp growth of around 4.5 times in just ten years.
- It was an industry of 7.31 trillion in May 2011, and now in the beginning of 2023 the AUM (assets under management) of the Indian mutual fund industry stood around Rs 40 trillion. So, investing in mutual funds in India can be fruitful for the NRIs if they are looking for wealth accumulation.

Let's look at FEMA Regulations for NRIs

- FEMA rules for NRIs do not allow holding a savings bank account. NRIs need to set up an NRO or NRE Account as stipulated by the Reserve Bank of India (RBI).
- An **NRO** is a Non-Resident Ordinary rupee account and can be held jointly by two or more NRIs.

- Legitimate dues in India of the account holder., Proceeds of remittances received in any permitted currency from outside India through normal banking channels or any permitted currency tendered by the account-holder during temporary visit to India or transfers from rupee accounts of nonresident banks can be credited to this account. Funds remitted, therefore, are non-repatriable to another country in a NRO account.

Comparison	NRE Account	NRO Account
Income can be Deposited	Foreign earnings and Indian Earnings	Only Indian Earnings
Meaning	Tax-Free	Taxable
Repatriability	Fully Repatriable	Partial (interest fully and principle within set limits)
Joint Account	Can be opened by 2 NRI's	Can be opened by an NRI along with another resident or NRI's
Deposits and Withdrawals	Can deposit in foreign currency, and withdraw in Indian currency	Can deposit in foreign as well as Indian currency, and withdraw in Indian currency

- An **NRE** is a Non-Resident (External) Rupee account. It permits for money transfer services from outside India, and the entire amount in the account is also repatriable back to the country where the NRI stays currently.
- Income earned in this account is exempt from taxation.
- FCNR is a Foreign Currency (Non-Resident) Account, and NRIs can deposit any foreign currency in it. It's a foreign currency fixed or term deposit available for one to five years.
- There is no tax implication on this type of account, and funds are completely repatriable on maturity.

10.2 Where can NRIs invest?

- NRIs are permitted an unlimited amount of investment options through repatriable and non- repatriable transactions.
- However, as per the FEMA rules for NRIs, they cannot make investments in small saving or Public Provident Fund (PPF) schemes of the government.
- NRIs can purchase residential or commercial property in India. However, purchasing agricultural property, plantations, farmhouse land, etc. isn't allowed. NRIs can also receive immovable property as gifts from relatives or through inheritance.

Investment Avenues

Lets look at some prominent investment options available to NRI and are permitted under FEMA

1) Real Estate

- Banking regulations in India are favorable towards NRIs wanting to invest in immovable property. Loans are available through leading financial institutions, subject to a few conditions.
- Finance is obtainable for buying of land, construction, renovation or purchase of a dwelling unit or commercial property.
- EMIs are payable by remittances from abroad. Investment in immovable properties now can serve as retirement homes when the NRIs wish to return to their base.
- Real estate in India is booming. The real estate prices in major Indian cities such as Delhi, Mumbai, Bengaluru, and Pune have skyrocketed over the past decade.
- Many NRIs are purchasing houses in India to let out on rent. There are a plethora of options to choose from such as developed plots, villas and apartments among others.

- One needs to analyze your requirements and risk profile before deciding to invest in Indian real estate.
- Investing in real estate in India is a good option as the country is expected to see massive development over the next decade. However, NRIs cannot invest in agricultural land and plantations in India.

2) Mutual Funds

- You may invest in mutual funds if it matches your investment objectives and risk profile.
- Mutual funds are capable of offering much higher tax-efficient returns than bank FDs. There are various mutual fund houses offering a plethora of mutual fund schemes.
- However, some AMCs have restrictions on NRI investments from the USA and Canada.
- NRIs can invest in mutual funds only through their NRO or NRE accounts. NRIs need to invest in Indian Rupees (INR) and not in foreign currency.
- The rate of return one get from mutual funds depends on the type of fund (debt, equity, and hybrid) and the investment horizon.
- One may invest in ELSS (Equity linked saving Scheme) a tax-saving mutual fund that qualifies for the Section 80C tax benefit if one is having income in India.

3) Portfolio Management Services (PMS)

- PMS is an advanced investment vehicle that provides medium to long term growth by picking and investing in undervalued or the growth stocks from a larger list of well researched stocks.
- The major benefit of this scheme is that investors can rely on the expert knowledge of fund managers.

4) Unit Linked Insurance Plans (ULIPs)

These plans come with the benefit of an insurance cover along with the returns of long term wealth creation. It is considered a very good option for investors with a moderate to high risk taking ability. The investments that you make in a ULIP are split into two parts:

- Premium for life insurance coverage
- Capital investment in debt and equity funds

5) Fixed Deposit

- Fixed Deposits (FDs) are not only popular among the resident Indians, but also among the non-resident Indians (NRIs).
- Bank FDs are considered the safest investment option as there are hardly any instances of banks defaulting on them. NRIs can start FD through their FCNR, NRO, or NRE accounts. The rate of interest depends on the bank, amount, and the tenure of the deposit.

Fixed deposits in the NRE account:

- One may consider opening an NRE account in Indian Rupees.
- The interest earned is tax-free, but the depositor will be taxed in the country of residence.
- The interest rate ranges from 5%-7% depending on the tenure of the deposit.

Fixed deposits in the NRO account:

- One may use the NRO account to control the Indian income. For instance, you may receive rental income or dividends from shares and mutual funds that can be paid into the NRO account. You can remit a maximum amount of $1 million from your NRO account after producing the relevant documents.

Fixed deposits in FCNR account:

- One can open the FCNR (Foreign-Currency Non-Resident Account) in any foreign currency.
- It may have a tenure of one to five years. The interest earned is tax-exempt. Moreover, foreign exchange fluctuations have no impact on the deposits in the FCNR account.

6) National Pension System

- An NRI between the age of 18 years to 60 years can open an NPS account with a POP (Point of Presence) in India.
- One may also open an eNPS account if you have a PAN card or an Aadhaar Card.
- One may consider using your NRO or NRE bank account to invest in the National Pension System.

7) Direct Equity

- One can consider investing in equity if you are an aggressive investor, and are ready to take some risk in the stock market.
- NRIs can invest in the Indian stock market directly under the Portfolio Investment Scheme (PINS) of RBI.
- NRIs are mandated to have an NRE/NRO bank account, a Demat account, and a trading account to invest in the Indian stock market.

8) Public Provident Fund

- You can continue with your PPF account which you opened when you were a resident Indian.
- However, you cannot extend the PPF account after the maturity period of 15 years. An NRI cannot open a PPF account in India.

10.3 Bank Remittance

- A bank remittance is a funds transfer from one bank account to another as a gift or payment.
- Remittances are used to pay bills or invoices and are sent via an electronic payment system, wire transfer, mail, draft, or check.
- When migrants send home part of their earnings in the form of either cash or goods to support their families, these transfers are known as workers' or migrant remittances.
- They have been growing rapidly in the past few years and now represent the largest source of foreign income for many developing economies.
- Remittances are typically transfers from one person to another person or household.
- They are targeted to the specific needs of the recipients and thus tend to reduce poverty.
- Cross-country analyses generally find that remittances have reduced the share of poor people in the population

A typical remittance transaction takes place in three steps:

- The migrant sender pays the remittance to the sending agent using cash, check, money order, credit card, debit card, or a debit instruction sent by e-mail, phone, or over the Internet.
- The sending agency instructs its agent in the recipient's country to deliver the remittance.
- The paying agent makes the payment to the beneficiary.
- As cross-border business increases, the need to send remittances grows.

- A bank remittance plays a massive role in today's financial ecosystem.

How Does a Bank Remittance Work?

- The amount of money being sent internationally has increased exponentially in recent years.
- This is in part due to the gig economy, but also the expansion of financial technology platforms that open new doors.
- In most cases, especially when the money involved is over a thousand dollars, the bank will apply a retail exchange rate.
- The drawback is that these rates are designed to deliver maximum profit to the receiving bank, not the customer.
- The costs of a remittance transaction include a fee charged by the sending agent, typically paid by the sender, and a currency-conversion fee for delivery of local currency to the beneficiary in another country.
- Some smaller operators charge the beneficiary a fee to collect remittances, presumably to account for unexpected exchange-rate movements.
- And remittance agents (especially banks) may earn an indirect fee in the form of interest (or "float") by investing funds before delivering them to the beneficiary.
- The float can be significant in countries where overnight interest rates are high.
- To provide adequate foreign exchange facilities and efficient customer services, the Reserve Bank has decided to grant licenses to certain entities by authorizing them as Authorized Dealers - Category II to undertake a range of non-trade current account transactions.
- Authorized Dealers category II are authorized to release/remit foreign exchange for the following non –trade current a/c transactions:

Private visits	Medical treatment abroad
Business travel	Fee for participation in global conferences
Film shooting	Medical treatment abroad
Overseas education	For overseas job applications
Visa fee	Credential assessment fee

NRIs (non-resident Indians) frequently find it difficult to manage their foreign interests in India. Given the variety of products available on the market, choosing the best account to keep one's money in can be very difficult. NRE and NRO accounts are two key resources on which NRIs can rely in this regard. Non-Resident External Account is abbreviated NRE, and Non-Resident Ordinary Account is abbreviated NRO.

10.4 NRE vs NRO Account

Purpose

After working a few years abroad, the vast majority of NRIs return to India and eventually use all of their investments there. It is one compelling argument in favour of investing a significant portion of your funds in India.

Repatriability

The interest accrued on any contributions made to an NRE account is also completely refundable. Limits on repatriation apply to NRO accounts. After paying all necessary taxes, you can repatriate up to USD 1 million from an NRO account per fiscal year.

Taxability

Income tax is not applied to any deposits made to an NRE account. This covers both the principal sum and any accrued interest.

Nonetheless, tax deductible at source (TDS) regulations apply to the interest earned on an NRO account (TDS).

Account holding

Two NRIs or an NRI and an Indian resident can jointly hold an NRE account.

Together with an Indian citizen or other NRIs, an NRI can open an NRO account.

Fund transfer

A transfer of money between NRE accounts is possible. They may be transferred from both an NRO account and an NRE account to a resident.
Only NRO accounts and resident accounts—not NRE accounts—can accept transfers of money from NRO accounts.

Exchange rate risk

An NRE account is affected by exchange rate risks like as fluctuations and conversion losses/gains.

An NRO account is not prone to daily exchange rate swings. (This needs to be clarified. Moreover, foreign revenue can be deposited into an NRO account. Hence it wouldn't always be free from the risk of exchange rates.)NRE vs NRO: Which one should you choose?

There is no single, correct or incorrect account. You should make a choice as an NRI depending on your particular needs and sources of income.

While an NRO account is used to hold both overseas revenue and money generated in India, an NRE bank account can be used to store foreign currency that has been converted to Indian rupees. NRE accounts do not have a repatriation cap, while NRO accounts have, up to USD 1 million each fiscal year.

10.5 The Liberalized Remittance Scheme – LRS

- Under the Liberalized Remittance Scheme (LRS), all resident individuals are allowed to freely remit up to USD 2,50,000 or its equivalent per financial year to another country for investment and expenditure.
- They can also open and maintain foreign currency accounts abroad for executing transactions.
- As a part of the Foreign Exchange Management Act (FEMA) 1999, LRS was introduced with an outward remittance limit of USD 25,000 during a financial year.

Prohibited items under the Scheme

- Remittance for any purpose specifically prohibited under Schedule-I (like the purchase of lottery tickets/sweep stakes, proscribed magazines, etc.) or any item restricted under Schedule II of Foreign Exchange Management (Current Account Transactions) Rules, 2000.
- Remittance from India for margins or margin calls to overseas exchanges / overseas counterparty.
- Remittances for purchase of FCCBs issued by Indian companies in the overseas secondary market.
- Remittance for trading in foreign exchange abroad.
- Capital account remittances, directly or indirectly, to countries identified by the Financial Action Task Force (FATF) as "non-cooperative countries and territories."
- Remittances directly or indirectly to those individuals and entities identified as posing a significant risk of committing acts of terrorism as advised separately by the Reserve Bank to the banks.

Key features of the scheme

- The facility is available to all resident individuals including minors
- Remittances under the facility can be consolidative in respect of family members subject to individual family members complying with the terms and conditions of the scheme.
- Remittances under the scheme are allowed only in respect of permissible current or capital account transactions or a combination of both
- Resident individuals are free to acquire and hold immovable property or shares of listed companies or debt instruments, or any other asset outside India without prior approval of The Reserve Bank
- The limit of $250,000 under the scheme also include remittances towards gift and donation by a resident individual
- Remittances under the scheme can be used for purchasing objects of art subject to the provisions of other applicable laws such as the extent foreign trade policy of the Government of India.
- The scheme can be used for the remittance of funds for the acquisition of ESOPs and qualification shares and is also linked to ADR/GDR.

Summary

Financial planning is of utmost importance in today's time, be it for an Indian Resident or an NRI (Non-Indian Resident). India's growing economy in the past two decades has attracted many Foreign Direct Investments (FDIs), and hence, NRIs have also started considering investing in India as one of the most viable options. There are several NRI investment options that can be considered while planning to invest. The Indian Government is opening more doors for NRIs (Non-Resident Indians) to invest in their home country and hence is coming up with vital options so that NRIs can diversify their global portfolio. But still, countries like the USA and Canada have some restrictions regarding NRIs investing their money. In this chapter, one is able to understand different NRI investment options that can be considered while planning to Invest in India.

Keywords

NRE account: It is a bank account opened in India in the name of an NRI, to park his foreign earnings;

NRO account: It is a bank account opened in India in the name of an NRI, to manage the income earned by him in India. These incomes include rent, dividend, pension, interest, etc.

'Non-resident Indian': is an individual who is a citizen of India or a person of Indian origin and who is not a resident of India. Thus, in order to determine whether an Individual is a non-resident

Indian or not, his residential status is required to be determined under Section 6 of Income tax Act 1961.

Review Questions

1. How we can determine that an Individual is NRI?
2. What are the key features of liberalized remittance scheme?
3. Elaborate different investment plans for NRIs ?
4. How would you differentiate NRI and NRO accounts ?
5. What are different remittance facilities offer to NRIs?

Self Assessment

1. The legal framework for administration of foreign exchange transactions in India is provided by the …… Act, 1999.

A. FEMA
B. FERA
C. FIFA
D. FSA

2. Under the Foreign Exchange Management Act, 1999 (FEMA), which came into force with effect from June 1, 2000, all transactions involving foreign exchange have been classified as

A. capital transactions only
B. current transaction only
C. either as capital or current account
D. neither as capital or current account

3. The remittance facility under the Scheme is not available for the following except:

A. Remittance for any purpose specifically prohibited under Schedule-I (like purchase of lottery tickets/sweep stakes, proscribed magazines, etc.) or any item restricted under Schedule II of Foreign Exchange Management (Current Account Transactions) Rules, 2000.
B. Remittance from India for margins or margin calls to overseas exchanges / overseas counterparty.
C. Remittances for purchase of FCCBs issued by Indian companies in the overseas secondary market.
D. buy or sell foreign exchange for any current account transaction except for those transactions for which drawal of foreign exchange has been prohibited by Central Government

4. Which of the following is wrong in regard to repatriation of the accrued interest/dividend on deposits/investments abroad by resident individuals under LRS?

A. The investor can retain and reinvest the income earned from portfolio investments made under the Scheme.
B. The investor can-not retain and reinvest the income earned from portfolio investments made under the Scheme.

C. However, a resident individual who has made overseas direct investment in the equity shares and compulsorily convertible preference shares of a Joint Venture or Wholly Owned Subsidiary outside India, within the LRS limit, then he/she shall have to comply with the terms and conditions as prescribed under [Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations 2004 as amended from time to time] Notification No. 263/ RB-2013 dated August 5, 2013.
D. None of the above

5. Which of the following is not a condition to permit a resident individual make a rupee loan to a NRI/PIO who is a close relative of resident individual, by of crossed cheque/ electronic transfer?
A. The loan is free of interest and the maximum maturity of the loan is one year.
B. The loan amount should be within the overall LRS limit of USD 2,50,000, per financial year, available to the resident individual. It would be the responsibility of the lender to ensure that the amount of loan is within the LRS limit of USD 2,50,000 during the financial year.
C. The loan shall be utilised for meeting the borrower's personal requirements or for his own business purposes in India.
D. The loan shall not be utilised, either singly or in association with other person, for any of the activities in which investment by persons resident outside India is prohibited.

6. Which of the following is wrong in regard to a resident individual making a rupee gift to a NRI/PIO who is a close relative of resident individual, by of crossed cheque/ electronic transfer?
A. A resident individual can make a rupee gift to a NRI/PIO who is a close relative of the resident individual [relative' as defined in Section 2(77) of the Companies Act, 2013] by way of crossed cheque /electronic transfer.
B. The amount should be credited to the Non-Resident (Ordinary) Rupee Account (NRO) a/c of the NRI / PIO and credit of such gift amount may be treated as an eligible credit to NRO a/c.
C. The gift amount would be within the overall limit of USD 5,50,000 per financial year as permitted under the LRS for a resident individual.
D. It would be the responsibility of the resident donor to ensure that the gift amount being remitted is under the LRS and all the remittances made by the donor during the financial year including the gift amount have not exceeded the limit prescribed under the LRS.

7. NRO Account stands for
A. Non-Resident (Ordinary) Rupee Account
B. Non-Resident (Extra-Ordinary) Rupee Account
C. Non-Resident (Not-Ordinary) Rupee Account
D. Non-Resident (External) Rupee Account

8. NRE Account stands for
A. Non-Resident (Ordinary) Rupee Account
B. Non-Resident (Extra-Ordinary) Rupee Account

C. Non-Resident (Not-Ordinary) Rupee Account
D. Non-Resident (External) Rupee Account

9. FCNR (B) Account stands for:
A. Foreign Currency Non Resident (Bank) Account
B. Foreign Currency Resident (Bank) Account
C. Foreign Currency Ordinary Resident (Bank) Account
D. Foreign Currency Not ordinary Resident (Bank) Account

10. Authorised Dealers can allow remittance/s upto USD… million, of balances in NRO accounts/of sale proceeds of assets on production of an undertaking by the remitter togetherwith a certificate issued by a Chartered Accountant in Annexure A and B as prescribed by the Central Board of Direct axes (CBDT).
A. 1
B. 2
C. 3
D. 4

11. In the case of repatriation of sale proceeds of immovable property by NRIs/PIOs, ADs can allow repatriation thereof even if the immovable property was held by the NRIs/PIOs for less than …. years
A. 10
B. 15
C. 20
D. 25

12. Joint account of two or more NRIs is permitted in
A. FCNR (B) Account only
B. NRE Account only
C. NRO Account only
D. In all accounts viz. FCNR (B) Account ,NRE Account, NRO Account

13. In which of the following accounts Repatriability of the Principal is not permitted?
A. FCNR (B) Account only
B. NRE Account only
C. NRO Account only
D. In all accounts viz. FCNR (B) Account ,NRE Account, NRO Account

14. In which of the following accounts Repatriability of the interest is permitted?
A. FCNR (B) Account only
B. NRE Account only
C. NRO Account only
D. In all accounts viz. FCNR (B) Account ,NRE Account, NRO Account

15. In which of the following accounts Rupee Loans in India against Security of the funds held in the account to:Account holder, Third Party is permitted?

A. FCNR (B) Account only
B. NRE Account only
C. NRO Account only
D. In all accounts viz. FCNR (B) Account ,NRE Account, NRO Account

Answers for Self Assessment

1.	A	2.	C	3.	D	4.	B	5.	A
6.	C	7.	A	8.	D	9.	A	10.	A
11.	A	12.	D	13.	C	14.	D	15.	D

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Unit 11: International Trade

CONTENTS

Objectives

After studying this unit, you should be able to understand:

- Understand the factors affecting international trade
- understand the basic government policies affecting international trade
- understand the role of International organisations in international trade

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Introduction

A country producing some goods apart from selling in the domestic market try to send them to another country.This may be due to the surplus of availability of the goods for the domestic market and deficit in the other country, or otherwise, the country which is in need of foreign exchange will try to sell it out to the other country. If every country is self-sufficient in all respect, then there may not be a need for any international trade.But even if a country is efficient in producing goods and services, it will still be advantageous to import goods from another country.India is the best example from where some other countries try to import the manufactured/produced goods since it is cheaper to import the goods than to manufacture or produce the goods in countries like USA or UK. Any country’s external receipts and payments are classified under two categories:Current account and Capital account. The current account is further classified as visible and invisible trade. The visible trade comprise of receipt and payment towards goods, i.e. merchandise. The Invisible trade comprises dividend payments etc.The trade balance is the difference between exports and imports. The surplus of exports over imports makes a trade surplus, and the imports over exports make the trade deficit

11.1 International Trade

Companies can use international commerce as a somewhat conservative strategy to enter new markets (by exporting) or to get goods at a discount (by importing). The corporation takes no capital risks with this strategy, thus there is very little risk involved. If a company's exporting or importing decreases, it can typically cut or end that aspect of its business at a cheap cost. Australia's top 25 exports of products and services totaled $475.24 billion in 2019–20, an increase of 0.94

percent from 2018–19. Large Australian MNCs like BHP, Rio Tinto, and Alcoa help boost Australia's exports of goods and services.

How the Internet facilitates international trade

Several businesses include the things they sell on their websites along with the cost of each item. Because of this, they can easily market their goods to potential importers anywhere in the world without having to send out brochures to other nations. Also, by simply updating its website, a business can expand its product offering or alter its pricing. As a result, importers just need to sometimes visit an exporter's website to stay up to date on the company's product information.

Also, businesses can use their websites to take online orders. Certain goods, such software, can be sent to the importer straight via the Internet as a file to be installed on the importer's machine. Even when there are other things that need to be transported, using the Internet makes it simpler to monitor the delivery process. An email order for goods can be sent by an importer to the exporter, and the warehouse can notify the importer and the exporter's headquarters by email when the goods have been shipped.

The warehouse may also utilise technology to keep track of its product inventory, alerting suppliers to send more supplies when the stock drops below a predetermined level. The Internet enables many warehouses owned by the exporter to function as a network, so if one warehouse is unable to fill an order, another warehouse will.

11.2 Factors Affecting International Trade Flows

The economy of a nation can be strongly impacted by international trade, therefore it's critical to recognise and keep an eye on the variables that affect it. The following are the deciding elements:

- cost of labour
- inflation
- national income
- credit conditions
- government policies
- exchange rates.

Cost of labour

The cost of labour varies widely between nations. It is not unexpected that China's corporations frequently produce things that require physical labour at a significantly cheaper cost than other nations in Europe, North America, and Australasia because many Chinese employees earn less than US$300 per month. Eastern European countries often have substantially lower incomes than Western European nations do within the continent of Europe. Businesses from nations with low labour costs often have an advantage in global competition, particularly in labor-intensive industries.

Currently, the propensity to outsource services is driven by cheaper technical labour. Functions like IT, human resources, finance, real estate, facilities management, and procurement are all outsourced, according to Deloitte's 2020 Global Outsourcing Study. Executives from outsourcing companies cite flexibility, speed to market, access to tools and procedures, and agility as important aspects in addition to cost reduction.

Top 10 global outsourcing companies

Rank	Company name	Headquarters	Activities
1	Accenture	Dublin, Ireland	Application, infrastructure, BPO and bundled outsourcing
2	Tata Consultancy Services	Mumbai, India	Banking and global financial markets
3	Cognizant	Teaneck, New Jersey, USA	End-to-end learning solutions
4	Wipro Technologies	Bangalore, India	IT infrastructure solutions
5	HCL Technologies	Noida, India	Global technology solutions and innovation labs
6	Capgemini	Paris, France	Application life-cycle services, business services, cloud choice and cybersecurity
7	IBM	Armonk, New York, USA	Supply chain, productivity improvement and BPO
8	ScienceSoft	McKinney, Texas, USA	IT consulting services
9	Infosys Technologies	Bangalore, India	Technology-enabled business solutions
10	DXC Technologies	Tysons, Virginia, USA	IT hosting, network and communication support

Jeff Madura ,Ariful Hoque, and Chandrasekhar Krishnamurti, 2018

Inflation

Assuming all else is equal, a country's current account should grow if its inflation rate rises relative to the nations it trades with. Due to the high local inflation rate, it is most likely that individuals and businesses in that nation will increase their abroad purchases while decreasing their exports to other nations. The impact of inflation on the trade balance between some nations, however, may be restricted, as in cases when the average wage in one nation is more than ten times higher than the average wage in another.

National income

If a country's income level (national income) increases by a higher percentage than those of other countries, then its current account should decrease, other things being equal. As the real income level (adjusted for inflation) rises, so does consumption of goods. A percentage of that increase in consumption will most likely reflect an increased demand for foreign goods.

Credit conditions

Because businesses are less able to pay back debt when economic conditions are bad, credit terms tend to get tighter. In that situation, banks are less inclined to finance MNCs, which might restrict corporate expenditure and erode the economy even more. MNCs decrease their spending, which also decreases their need for imported goods. As a result, there is a reduction in global trade flows.

Unfavorable credit conditions can also have a negative impact on commerce by making it difficult for some MNCs to raise the money required to make import purchases. A lot of MNCs that buy imports rely on letters of credit, which are promises to pay for the imports when they are delivered and are issued by commercial banks on behalf of the importers. Banks may refuse to grant credit if they believe that a multinational corporation (MNC) will not be able to pay back its loan due to a sluggish economy, in which case the MNC would not be able to purchase imports.

Government policies

Free trade theories are frequently discussed in depth in classrooms, but these theories lose favour when the nation's unemployment rate rises in reaction to a significant balance of trade deficit. As a result of the possibility that a job generated in one country could be lost in another, nations compete for a larger proportion of global exports.

Which companies within an industry gain the most market share globally can be significantly influenced by government policy. These laws have an impact on the nation that they are passed in terms of unemployment, income, and economic expansion. The goal of every government is to expand exports because doing so will raise output, revenue, and perhaps even employment.

Also, a nation's government typically prefers that its people and businesses buy goods and services locally (rather than importing them) because doing so generates local jobs.

Asking students (or professors) what they believe their nation's international trade policy should be is a simple way to start a discussion. Individuals who believe that trade has a big impact on their employment opportunities frequently hold strong views on this issue.

Governments of nations with struggling economies often become more innovative and aggressive with their attempts to increase exports or decrease imports. Several different sorts of policies are frequently employed to enhance the trade balance and consequently generate employment inside a nation:

1. Restrictions on imports
2. Subsidies for exporters
3. Restrictions on piracy
4. Environmental restrictions
5. Labour laws
6. Business laws
7. Tax breaks
8. Country trade requirements
9. Government ownership or subsidies
10. Country security laws
11. Policies to punish country governments

Restrictions on imports

Some governments impose trade restrictions to restrict or discourage imports from other nations. The most often applied of these are tariffs and quotas.

Consumers must pay extra to buy imported goods when a nation's government levies a tax, commonly referred to as a tariff, on them. To encourage exporters to form local subsidiaries that will produce the cars, many governments levy tariffs on imported cars (and create local jobs). In comparison to other countries, the US government imposes lesser tariffs on a regular basis. Nonetheless, certain US businesses are more protected by tariffs than others. With high taxes on relevant imports, American agricultural and apparel products have historically received additional protection against international competition.

In addition to imposing tariffs, a government may also set import quotas, or upper limits on what can be brought into the country. Quotas have frequently been imposed on a range of products that some nations, like the United States, import. In fact, declining economic conditions between 2008 and 2012 prompted some nations to erect barriers meant to safeguard parts of their businesses.

In order to prevent hazardous pests and diseases from entering the country, Australia places limits on the importation of food goods. The following products are prohibited

- eggs and egg products
- dairy products
- uncanned meat
- seeds and nuts
- fresh fruit and vegetables.

Example:

Argentina's government placed limitations on local businesses that import cars in 2011 by requiring them to export goods worth a comparable amount to other nations. Hence, in order to import more vehicles for sale in Argentina, these importers started exporting wine, olives, and other goods.

Such a government programme raises concerns since increased exporting might displace local businesses whose main line of business is exporting.

Further trade limitations on imports were also implemented by Argentina. Argentina later had better trade balance, but a variety of products, including some medical supplies, were short-handed.

The Indian government's 2014 mandate that at least 10% of the modules used in Indian solar facilities be manufactured locally is a recent illustration of local content criteria. These requirements' clear objectives are to improve local capability and generate local employment.

As was previously said, fewer overt trade barriers have emerged as a result of international trade accords. But, there are still a lot of additional national features that can favour one country's businesses in world trade.

Subsidies for Exporters

In order for domestic firms to make goods cheaper than their international rivals, a government may provide subsidies to those firms. These incentives increase the demand for the exports made by those businesses.

Example

The federal government provides subsidies to a number of Australian businesses, particularly in the manufacturing industry. Prior to a few years ago, the projected Australian subsidy for producing vehicles was US$1885 per vehicle, which was far greater than the subsidies provided by other First World nations like Sweden ($297), Germany ($206), and the United States ($166). (Sloan, 2014). Despite these substantial incentives, Australian automakers left the nation in 2017.

Government subsidies are given to businesses in various nations provided that the manufactured goods are then exported. Dumping is the term used to describe the export of goods that were made possible by government subsidies. These businesses could be able to sell their goods for less than any of their rivals in other nations. Although it may be claimed that every government gives subsidies in some capacity, some are more evident than others.

Restrictions on piracy

Government anti-piracy measures differ from country to country. A government's absence of anti-piracy measures can have an impact on how trade flows internationally. If a government does not take action to curb piracy, it may indirectly lower imports and potentially deter multinational corporations from exporting to that market.

Example

Piracy is a major issue in China. People (known as pirates) create CDs and DVDs that resemble the actual products made in the US and other nations almost perfectly.

They even sell the CDs and DVDs to retail outlets, but they sell them on the street for less money than the original product's price. As a result, local customers receive replicas of imports as opposed to genuine imports. Around 90% of DVDs bought in China that are the property of US firms may be pirated, according to the US film industry. According to estimates, Chinese piracy costs US creators of film, music, and software $2 billion in lost sales annually. The Chinese government makes repeated vows to take action, yet there is still a lot of piracy there.

China's need for imports has decreased as a result of piracy. One factor contributing to the United States' significant trade deficit with China is piracy. But even if piracy were completely eliminated, this loss would remain sizable.

Environmental restrictions

Local businesses incur greater manufacturing costs when a government enacts environmental regulations. Because of those expenses, local businesses may be at a disadvantage to those operating outside nations without the same regulations. To ensure that local businesses can compete globally, some governments have thought about easing or abolishing environmental rules. Naturally, such a strategy will be directly at odds with the goals of the environmental organisations in that nation. Whether local jobs or a clean environment are viewed as the most significant factor frequently influences how someone feels about the best course of action.

Labour laws

Many countries have different labour regulations, which can allow for noticeable disparities in the labour costs that businesses suffer in other nations. Some nations have stricter legislation in place to safeguard employees' rights. Additionally, some nations have stricter rules governing underage labour.

The cost of labour will be higher for businesses situated in nations with stricter rules, all other things being equal. As a result, while competing with businesses established in other nations, their companies might be at a disadvantage.

Example

Due to a history of child labour in state-owned cotton fields, 23 Australian businesses have decided to boycott cotton from Uzbekistan, one of the biggest cotton producers in the world (Donelly, 2015).

Business laws

Several nations have different levels of bribery legislation. In some circumstances, such as when government representatives of an agency seeking particular services from MNCs anticipate receiving bribes from the MNCs hoping to gain that contract, companies situated in these nations may not be able to compete globally.

Tax Breaks

Governments in various nations may offer tax advantages to businesses that work in particular sectors. This practise is a type of government financial support, even if it need not be a subsidy, that may be advantageous to businesses who export goods. For instance, US-based MNCs may qualify for tax benefits when spending money on both equipment and machinery purchases as well as on research and development.

Country Trade Requirements

Before multinational corporations (MNCs) can export goods to a country, the government may require that they fill out different paperwork or acquire licences. Simply because the government is ineffective at validating the forms or licences, such regulations frequently cause delays. The procedure may even be deliberately ineffective in order to deter exporters and therefore, subtly, safeguard domestic employment.

International or domestic bureaucracy is a significant commercial impediment. Furthermore, it can be challenging to establish that a government intentionally tries to obstruct trade and is doing so in contravention of free trade agreements.

Government Ownership or Subsidies

Even with the advancements in technology currently accessible (such the possibility of online forms), many governments still react slowly to requests from exporters of goods from other countries to export to their country. When some governments take their time, it stands to reason that other countries might also take their time as a kind of revenge, which could impede commerce and thereby save local jobs. Some MNCs are deterred from doing business abroad by bureaucratic delays.

Country security laws

Several Australian politicians have claimed that when Australian security is threatened, restrictions on foreign ownership and international trade should be put in place. Although this viewpoint is broadly shared, there is dispute over which particular Australian businesses and transactions should be shielded from international competition.

The Collins-class submarines owned by the Australian government are currently being replaced since they must be phased out by the middle of the next decade. Think about the following inquiries, for instance:

1. Should Australia produce the new submarines domestically even if it costs twice as much as buying them from a foreign supplier? The trade-off is between greater security and a wider budget deficit. With Australian-built submarines, is Australia actually safer? Are technological trade secrets more secure when produced by an Australian company?
2. Should there be limitations on foreign ownership of the Australian firm that manufactures submarines alone? The majority of Australia's large publicly traded corporations are owned in part by foreign investors.
3. Should investors from certain nations be subject to limitations on foreign ownership but not from investors from other countries, or should owners from any foreign country be prohibited from business dealings that would jeopardies Australia's security? Is there a risk that the owners of the production business would sell technology secrets to Australia's adversaries? Is a business with just Australian shareholders safe from that risk? Which nations are deemed acceptable if certain foreign owners are acceptable?
4. What items pose the greatest security risk to Australia? Imagine, for example, that only Australian businesses are allowed to manufacture submarines. What about every component that is employed in the manufacture of submarines? The submarine makers import some of the parts used in Australian submarines that are made in China.

11.3 Policies to Punish Country Governments

Since people have come to expect that trade policies will be used to punish national governments for a variety of behaviours, international trade policy concerns have grown even more divisive over time. A lot of people anticipate that nations will impose import restrictions on goods from nations that don't uphold their environmental or child labour regulations, declare war on another nation, or refuse to support an illegally installed ruler in another nation. Today, there are many protesters with various agendas at every international trade convention. Even though international commerce isn't the main topic of every rally, some demonstrators nonetheless want to see it eliminated (or at least reduced).

Although the majority of demonstrators are undoubtedly against current trade policies, there is no agreement on what those policies should change to. These divergent points of view are comparable to the conflicts that arise between government officials when they attempt to negotiate international trade policies.

These problems in international trade strategy cannot be resolved by the managers of each MNC. Yet, businesses should at least be aware of how a specific foreign trade policy affects their ability to compete in the market and how future policy changes might effect that ability.

Exchange rates

Exchange rates are used to determine the worth of one nation's currency in relation to other currencies.

Then, exchanges of currencies can help with cross-border transactions. Because of market and governmental pressures (which are covered in greater detail in Chapter 5), the values of most currencies change over time. Assuming everything else is equal, a country's current account balance should decline if its currency starts to appreciate against other currencies. The demand for commodities exported by that country will decline as its currency appreciates since the importing nations would have to pay more for those goods.

11.4 International Trade Regulations

Historically, bilateral agreements between two countries governed trade. Multilateral agreements like those of the GATT and World Trade Organization (WTO) were the main system for governing international trade after World War II as free trade emerged as the prevailing concept.

An international body tasked with regulating and arbitrating international commerce is the World Trade Organization (WTO), which was established in 1995 to replace the General Agreement on Tariffs and Trade (GATT). The WTO is in charge of policing member countries' adherence to all WTO agreements, signed by the majority of the world's trading nations and ratified in their parliaments, and deals with the rules of trade between nations on a nearly global scale. The WTO is also responsible for negotiating and implementing new trade agreements.

The WTO also has a responsibility to examine national trade policies and guarantee the consistency and openness of trade policies through oversight of the formulation of global economic policy.

The WTO, which maintains its main office in Geneva, Switzerland, has more than 150 members, accounting for more than 95% of all international trade. A general council, which executes the ministerial conference's policy decisions and is in charge of day-to-day administration, a director-general, who is chosen by the ministerial conference, and a ministerial conference that meets every two years manage it.

The WTO's role in regulating the world trading system is guided by five fundamental principles:

Nondiscrimination. The most favoured nation (MFN) rule and the national treatment policy, which are incorporated into the primary WTO rules on commodities, services, and intellectual property, were both influenced by this notion. A WTO member must provide all other WTO members the most favourable circumstances under which it permits trade in a particular product category in accordance with the MFN rule, which mandates that all commerce with other WTO members be subject to the same conditions. The national treatment policy mandates that imported and locally produced goods should be treated equally in order to overcome nontariff trade obstacles (such as technical requirements and security standards) (at least after the foreign goods have entered the market).

Reciprocity. This idea reflects the need for better access to international markets as well as a desire to reduce the potential for free riding that could result from the MFN norm.

binding agreements that are enforceable. A list of concessions lists the tariff pledges made by WTO members during a multilateral trade negotiation and upon membership. Only after negotiations with its economic partners, which may entail paying them for lost commerce, can a nation alter its promises. The complaining country may use the WTO dispute settlement processes if satisfaction is not attained.

Transparency. WTO members are obligated to make their trade regulations public, to keep institutions in place that are tasked with reviewing administrative decisions that influence trade, to respond to information requests from other members, and to notify the WTO of changes in their trade policies.

safety switches. Governments have the right (within certain bounds) to impose trade restrictions in order to pursue non-economic goals, uphold "fair competition," and in unique economic situations.

Although the WTO uses the "one country, one vote" principle, no actual votes have ever been cast. Decisions are purportedly reached by consensus, with relative market size serving as the main source of negotiating leverage. In reality, informal negotiations between small groups of countries are how the majority of WTO decisions are actually decided. These negotiations are frequently referred to as "green room" negotiations (after the colour of the WTO director-office general's in Geneva) or "miniministerials" when they take place in other nations. Many of the WTO's developing-country members, who are frequently excluded from these negotiations, have frequently criticised these methods. The WTO is in charge of around 60 agreements that qualify as international legal documents. All WTO accords are subject to ratification and signature by member nations. A few of the most significant accords relate to services, intellectual property, and agriculture.

A second aspect of the international trade regulation structure is regional agreements like Mercosur in South America, the North American Free Trade Agreement (NAFTA) between the United States, Canada, and Mexico, ASEAN in Southeast Asia, and the European Union (EU) between 27 autonomous states.

The EU is a 27-member political and economic union. The European Union (EU), committed to regional integration, was founded on the preceding European Economic Community by the Treaty of Maastricht on November 1, 1993. With a combined population of approximately 500 million, the EU accounts for 30% of the nominal gross world product.

By a uniform set of regulations that are applicable in each member state, the EU has created a single market that permits the free flow of capital, products, services, and people. It continues to adhere to shared trade, agricultural, fisheries, and regional development policies. The Eurozone, which consists of 20 members, has accepted the euro as its standard currency. With representation at the UN, G8 meetings, and the WTO, the EU has grown to play a relatively minor role in foreign policy. It passes laws pertaining to justice and domestic issues, such as the elimination of passport restrictions between various member states. Twenty-one EU nations are also NATO members, with Austria, Cyprus, Finland, Ireland, Malta, and Sweden being the only non-NATO members.

The Treaty of Asunción, which established the Mercosur trade pact between Argentina, Brazil, Paraguay, and Uruguay in 1991, was then updated and revised by the Treaty of Ouro Preto in 1994. Its goal is to encourage open trade and the smooth movement of people, products, and money.

Currently, Bolivia, Chile, Colombia, Ecuador, and Peru are considered associate members. Venezuela signed a membership agreement on June 17, 2006, however before it can join as a full member, the Paraguayan and Brazilian parliaments must ratify it.

The North American Free Trade Agreement (NAFTA) is a pact that the governments of the United States, Canada, and Mexico signed to establish a trilateral trading bloc. The deal became effective on January 1st, 1994. The United States-Canada Free Trade Agreement was replaced by it. As of 2007, the trade block was the largest in the world in terms of total purchasing power parity GDP and second largest in terms of nominal GDP. The North American Agreement on Environmental Cooperation (NAAEC) and the North American Agreement on Labor Cooperation are two supplements to NAFTA (NAALC).

The Association of Southeast Asian Countries, or ASEAN, was established on August 8, 1967, by Indonesia, Malaysia, the Philippines, Singapore, and Thailand. It is a geopolitical and economic alliance of ten Southeast Asian nations. Since then, Cambodia, Laos, Vietnam, Burma (Myanmar), and Brunei have all joined. Its objectives include fostering social advancement, accelerating economic growth, fostering cultural exchange among its citizens, and preserving regional peace and stability.

Summary

Every government implements some policies that may give its local companies an advantage in the battle for global market share, so the playing field is probably not level across all countries. However, no formula can ensure a completely fair contest for market share. Notwithstanding the progress of international trade treaties, most governments will be pressured by their constituents and companies to implement policies that give their local companies an exporting advantage. Such actions are typically initiated without considering the ultimate consequences when other countries are adversely affected and then implement their own trade policy in retaliation. Any government can find an argument for restricting imports if it wants to increase domestic employment. Some arguments might be justified; others, less so. Naturally, countries that are adversely affected by a trade policy may retaliate in order to offset the effects on employment. This means that the plan to create jobs by restricting imports may not be successful. It is noteworthy that, even when the overall employment situation for both countries is unchanged, employment within particular industries may be changed by government actions on trade. Any government can find an argument for restricting imports if it wants to increase domestic employment. Some arguments might be justified; others, less so. Naturally, countries that are adversely affected by a trade policy may retaliate in order to offset the effects on employment. This means that the plan to create jobs by restricting imports may not be successful. It is noteworthy that, even when the overall employment situation for both countries is unchanged, employment within particular industries may be changed by government actions on trade.

Keywords

Tariff: Government-imposed tax on imported goods.

Quota The maximum limit of a good that can be imported

Dumping The export of products to other countries at a cheaper price due to government subsidies.

J-curve effect The initial worsening of a trade deficit due to higher prices of imports dominating the lower volume of imports in the short run.

Self Assessment

1. Which of the following is not a principle of WTO ?

A. Reciprocity.
B. Binding and enforceable commitments
C. Discrimination
D. Transparency

2. MFN stands for

A. Most favored nation
B. Meager favored nation
C. Marginal favored nation
D. Malaysian favored nation

3. …. rule requires that a WTO member must apply the same conditions on all trade with other WTO members, that is, a WTO member has to grant the most favorable conditions under which it allows trade in a certain product type to all other WTO members.

A. MFN
B. LFN
C. SFN
D. GFN

4. This principle reflects both a desire to limit the scope of free riding that that may arise because of the MFN rule and a desire to obtain better access to foreign markets…

A. Reciprocity.
B. Binding and enforceable commitments
C. Discrimination
D. Transparency

5. The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a list of concessions…

A. Reciprocity.
B. Binding and enforceable commitments
C. Discrimination
D. Transparency

6. WTO members are required to publish their trade regulations…

A. Reciprocity.

B. Binding and enforceable commitments

C. Discrimination

D. Transparency

7. Under specific circumstances, governments can (within limits) restrict trade to attain noneconomic objectives…

A. Reciprocity.

B. Binding and enforceable commitments

C. Discrimination

D. Safety valves

8. ASEAN covers:

A. United States, Canada, and Mexico

B. Southeast Asia

C. European countires

D. American nations

9. The *EU* is an economic and political union of … member states

A. 27

B. 30

C. 40

D. 50

10. EU was established by the Treaty of Maastricht on November 1, 1993

A. 1993

B. 1994

C. 1995

D. 1996

11. euro, has been adopted by …member states known as the Eurozone

A. 20

B. 17

C. 18

D. 19

12. *Mercosur* is a regional trade agreement among…., Brazil, Paraguay, and Uruguay

A. *Japan*

B. Argentina

C. India

D. Russia

13. *NAFTA* is an agreement creating a trilateral trade bloc in …

A. North America

B. South America

C. Europe

D. Russia

14. NAFTA came into force on January 1, ….
A. 1994
B. 1995
C. 1996
D. 1997

15. ASEAN was formed on August 8, 1967, by Indonesia, Malaysia, the Philippines, Singapore, and…..
A. Thailand
B. India
C. Malawi
D. Namibia

Answers for Self Assessment

1.	C	2.	A	3.	A	4.	A	5.	B
6.	D	7.	D	8.	B	9.	A	10.	A
11.	A	12.	B	13.	A	14.	A	15.	A

Review Questions

1. How World Trade Organization regulates international trade ?
2. How NAFTA regulates international trade ?
3. What is the role of ASEAN in regulating international trade ?
4. What are the five basic principlesguide the WTO's role in overseeing the global trading system?
5. How government policies of a country regulate international trade ?

Further Readings

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Unit 12: International Banking

CONTENTS

Objective

After studying this unit, you should be able

- understand the trade policies of Directorate General of Foreign Trade (DGFT)
- analyse the role of WTO in current context
- interpret the WTO actions to improve the global trade

Introduction

Directorate General of Foreign Trade (DGFT) Organization is an attached office of the Ministry of Commerce and Industry headed by the Director-General of Foreign Trade.Right from its inception in 1991, when liberalization in the government's economic policies took place, this organization has been essentially involved in regulating and promoting foreign trade through regulation. Keeping in line with liberalization and globalization and the overall objective of increasing exports, DGFT has since been assigned the role of "facilitator". The shift was from prohibition and control of imports/exports to promotion and facilitation of exports/imports, keeping in view the interests of the country. World Trade Organization (WTO) is the only international organization dealing with the global rules of trade. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.By lowering trade barriers through negotiations among member governments, the WTO's system also breaks down other barriers between peoples and trading economies.

12.1 Organisational Set-up

- This Directorate, with headquarters in New Delhi, is headed by the Director-General of Foreign Trade.
- It is responsible for implementing the Foreign Trade Policy to promote India's exports.

- The DGFT also issues licenses to exporters and monitors their corresponding obligations through a network of 25 Regional Offices and an extension counter at Indore.
- All regional offices provide facilitation to exporters concerning developments in International Trade, i.e. WTO agreements, Rules of Origin and anti-dumping issues, etc., to help exporters in their import and export decisions in a dynamic international environment.

12.2 Functions of DGFT

Some of the major functions of DGFT and its regional offices throughout the country are as follows

- To implement the exam policy or foreign trade policy of India by introducing various schemes and guidelines through its network of DGFT regional offices throughout the country
- DGFT performs its functions in coordination with state governments and all the other departments of the Ministry of Commerce and industry Government of India
- To grant exporter importer code number to Indian exporters and importers.
- IEC number is a unique 10-digit code required by the traders or manufacturers for the purpose of import and export in India.
- DGFT IEC codes are mandatory for carrying out import- export trade operations and enable companies to acquire benefits on their imports/exports, Indian customs and export promotion council etc., in India.
- DGFT permit or regulate the transit of goods from India or to countries adjacent to India in accordance with the bilateral treaty between India and other countries
- To promote trade with neighboring countries
- To grant the permission for free export in export policy schedule 2
- DGFT also plays an important role in controlling DEPB rates (Duty Entitlement Passbook)
- DEPB (Duty Entitlement Pass Book) is an export incentive scheme of the Indian Government provided to Exporters in India.
- The DGFT also controls setting standard input-output norms
- Apart from the above, DGFT also acts as a trade facilitator
- It also deals with the quality complaints of foreign buyers.
- Officials at DGFT work in close coordination with other related economic offices like the customs Commissionerate, Central Excise authorities, DRI authorities and enforcement directorate

12.3 DGFT Recent Developments

The revised rules for calculating the composition fee for the extension of the export requirement period under the Advance Authorization Scheme were published by the Directorate General of Foreign Trade (DGFT).

The Advance Authorization System makes it easier to import duty-free components that must be utilised in goods that must be exported within a certain time frame. They are not allowed to sell goods in local markets.

The process was complicated and challenging for exporters due to the prior composition charge formula's complexity. The updated composition fee formula, on the other hand, is clear, simpler to figure out, and based on a precise rate for various levels of the CIF value of permission. By making the computation for the composition charge simpler and more straightforward, automation and quicker service delivery are facilitated.

It will assist in automating the export obligation extension procedure with the least amount of human involvement, hence removing misunderstandings and the possibility of mistakes. Automation will speed up service delivery by reducing paperwork and laborious calculations. Exporters will profit since the procedure of extending their export obligations will take less time and effort.

The DGFT is implementing the automation process as part of its IT overhaul project, and will separately announce the automation process. The DGFT is aiming to simplify the calculation by making it simpler for exporters to grasp. It will result in easier corporate operations and trade facilitation.

12.4 Global trade rules

- Global rules of trade provide assurance and stability.
- Consumers and producers know they can enjoy secure supplies and greater choice of the finished products, components, raw materials and services they use.
- Producers and exporters know foreign markets will remain open to them.
- This leads to a more prosperous, peaceful and accountable economic world.
- Decisions in the WTO are typically taken by consensus among all members and they are ratified by members' parliaments.
- Trade frictions are channeled into the WTO's dispute settlement process, where the focus is on interpreting agreements and commitments and how to ensure that members' trade policies conform with them.
- That way, the risk of disputes spilling over into political or military conflict is reduced.
- By lowering trade barriers through negotiations among member governments, the WTO's system also breaks down other barriers between peoples and trading economies.
- At the heart of the system – known as the multilateral trading system – are the WTO's agreements, negotiated and signed by a large majority of the world's trading economies, and ratified in their parliaments.
- These agreements are the legal foundations for global trade. Essentially, they are contracts, guaranteeing WTO members important trade rights.
- They also bind governments to keep their trade policies transparent and predictable which is to everybody's benefit.
- The agreements provide a stable and transparent framework to help producers of goods and services, exporters and importers conduct their business.
- The goal is to improve the welfare of the peoples of the WTO's members.
- The past 70 years have seen an exceptional growth in world trade.
- Merchandise exports have grown on average by 6% annually.
- Total exports in 2019 were 250 times the level of 1948.
- The GATT and the WTO have helped to create a strong and prosperous trading system contributing to unprecedented growth.

12.5 Trade Negotiations

- The system was developed through a series of trade negotiations, or rounds, held under the GATT.
- The first rounds dealt mainly with tariff reductions but later negotiations included other areas such as anti-dumping and non-tariff measures.
- The 1986-94 round – the Uruguay Round – led to the WTO's creation.
- The negotiations did not end there. In 1997, an agreement was reached on telecommunications services, with 69 governments agreeing to wide-ranging liberalization measures that went beyond those agreed in the Uruguay Round.
- In the same year, 40 governments successfully concluded negotiations for tariff-free trade in information technology products, and 70 members concluded a financial services deal covering more than 95% of trade in banking, insurance, securities and financial information.

- In 2000, new talks started on agriculture and services.
- These were incorporated into a broader work program, the Doha Development Agenda, launched at the fourth WTO Ministerial Conference in Doha, Qatar, in November 2001.
- A revised Government Procurement Agreement – adopted at the WTO's 8th Ministerial Conference in 2011 – expanded the coverage of the original agreement by an estimated US$ 100 billion a year.
- At the 9th Ministerial Conference in Bali in 2013, WTO members struck the Agreement on Trade Facilitation, which aims to reduce border delays by slashing red tape.
- When fully implemented, this Agreement – the first multilateral accord reached at the WTO – will cut trade costs by more than 14% and will lift global exports by as much as US$ 1 trillion per year.
- The expansion of the Information Technology Agreement – concluded at the 10th Ministerial Conference in Nairobi in 2015 – eliminated tariffs on an additional 200 IT products valued at over US$ 1.3 trillion per year.
- Another outcome of the Conference was a decision to abolish agricultural export subsidies, fulfilling one of the key targets of the UN Sustainable Development Goal on "Zero hunger".
- Most recently, an amendment to the WTO's Intellectual Property Agreement entered into force in 2017, easing poor economies' access to affordable medicines.
- The same year saw the Trade Facilitation Agreement enter into force.

12.6 WTO Agreements

- How can you ensure that trade is as fair as possible, and as open as is practical?
- By negotiating rules and abiding by them.
- Through these agreements, WTO members operate a non- discriminatory trading system that spells out their rights and their obligations.
- Each member receives guarantees that its exports will be treated fairly and consistently in other members' markets.
- Each promises to do the same for imports into its own market.
- The system also gives developing economies some flexibility in implementing their commitments.

12.7 How the WTO is organized

The WTO's overriding objective is to help trade flow smoothly, freely and predictably.

It does this by:

functions

Structure

WTO Functions

- Administering trade agreements
- Acting as a forum for trade negotiations
- Settling trade disputes
- Reviewing national trade policies
- Building the trade capacity of developing economies
- Cooperating with other international organizations

WTO Structure

- The WTO has 164 members, accounting for 98% of world trade.
- A total of 25 countries are negotiating membership.
- Decisions are made by the entire membership. This is typically by consensus.
- The WTO's top level decision- making body is the Ministerial Conference, which meets usually every two years.
- The General Council also meets as the Trade Policy Review Body and the Dispute Settlement Body.
- Below this is the General Council (normally ambassadors and heads of delegation based in Geneva but sometimes officials sent from members' capitals) which meets several times a year in the Geneva headquarters.
- At the next level, the Goods Council, Services Council and Intellectual Property (TRIPS) Council report to the General Council.

10 things the WTO can do

- Cut living costs and raise living standards
- Settle disputes and reduce trade tensions
- Stimulate economic growth and employment
- Cut the cost of doing business internationally
- Encourage good governance
- Help countries develop
- Give the weak a stronger voice
- Give the weak a stronger voice
- Support the environment and health
- Contribute to peace and stability
- Be effective without hitting the headlines

Keywords

General Agreement on Tariffs and Trade: General Agreement on Tariffs and Trade, which the WTO has supplanted as a global institution. The WTO's current accord covering trade in goods is an updated General Agreement. The old GATT (pre-1994) is referred to as GATT 1947 in the law. GATT 1994: The WTO's official name for the General Agreement's updated version, which also includes GATT 1947

Uruguay Round: International trade talks began in Punta del Este, Uruguay, in September 1986 and ended in Geneva, Switzerland, in December 1993. Ministers in Marrakesh, Morocco, signed the document in April 1994.
Special treatment: :A clause in the Agricultural Agreement allowed members to postpone tariffication (see "tariffication") on a restricted number of items.

Summary

Trade has played a significant role in fostering economic development and fostering friendly relations between nations from the early days of the Silk Road through the establishment of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO).The largest change to global trade since the end of World War II was brought about by the establishment of the WTO on January 1, 1995. The WTO and its agreements also deal with trade in services and intellectual property, whereas the GATT primarily focused on trade in goods. New methods for resolving disputes were also developed with the establishment of the WTO.

Review Questions

1. Explain the role of WTO in Globalisation.
2. Interpret the WTO actions to improve the global trade
3. Explain Trade negotiations under the regime of WTO
4. Explain organisational structure of WTO.
5. Explain the role of WTO in Globalisation

Self Assessment

1. Expand WTO
A. World Trade Organization
B. world tariff organization
C. world treatment organization
D. world terrification organization

2. The ……. has helped to create a strong and prosperous trading system contributing to unprecedented growth.
A. World Bnak
B. WTO
C. IMF
D. IBRD

3. The…… Round – led to the WTO's creation.
A. Uruguay Round
B. Paris Round
C. Geneva Round
D. Singapore Round

4. In ….., an agreement was reached on telecommunications services, with 69 governments agreeing to wide-ranging liberalization measures
A. 1997
B. 1998
C. 1999
D. 2000

5. In …….., new talks started on agriculture and services
A. 2000
B. 2001
C. 2002
D. 2003

6. Doha Development Agenda, launched at the fourth WTO Ministerial Conference in Doha, Qatar, in November …...
A. 2001
B. 2002

C. 2003

D. 2004

7. A revised Government Procurement Agreement – adopted at the WTO's 8th Ministerial Conference in …..

A. 2010

B. 2011

C. 2012

D. 2013

8. At the 9th Ministerial Conference in Bali in ….., WTO members struck the Agreement on Trade Facilitation, which aims to reduce border delays by slashing red tape.

A. 2012

B. 2013

C. 2014

D. 2015

9. The expansion of the Information Technology Agreement – concluded at the 10th Ministerial Conference in Nairobi in 2015 – eliminated tariffs on an additional 200 IT products valued at over US$ 1.3 trillion per year.

A. 2012

B. 2013

C. 2014

D. 2015

10. Most recently, an amendment to the WTO's Intellectual Property Agreement entered into force in ….., easing poor economies' access to affordable medicines

A. 2012

B. 2013

C. 2014

D. 2017

11. DGFT stands for

A. Directorate General of Foreign Trade (DGFT) and their policies

B. Directorate General of Free Trade (DGFT) and their policies

C. Directorate General of Factoring Trade (DGFT) and their policies

D. Directorate General of Forfaiting Trade (DGFT) and their policies

12. The WTO has ….members

A. 164

B. 180

C. 200

D. 250

13. The WTO's top level decision- making body is the Ministerial Conference, which meets usually every ….years.

A. 2

B. 3

C. 4

D. 5

14. General Council meets …times a year in the Geneva headquarters.

A. Two

B. Three

C. Four

D. Several

15. TRIPS stands for

A. Trade Related Aspects of Intellectual Property Right

B. Tourism Related Aspects of Intellectual Property Right

C. Transport Related Aspects of Intellectual Property Right

D. Tariff Related Aspects of Intellectual Property Right

Answers for Self Assessment

1.	A	2.	A	3.	B	4.	D	5.	A
6.	B	7.	A	8.	B	9.	A	10.	D
11.	A	12.	A	13.	D	14.	A	15.	A

Further Readings

https://www.wto.org/english/thewto_e/history_e/history_e.htm

https://www.dgft.gov.in/CP/

Unit 13: International Banking

CONTENTS

Objectives

After studying this unit, you should be able

- explore the components of balance of payments.
- differentiate between factor payment and transfer payments.
- explore the components of balance of trade.
- differentiate between balance of trade and balance of payments.

- analysing current and capital account convertibility.
- evaluating pros and cons of convertibility and managing risks to an economy.
- summarize and explain various trade-related documents.
- dissect the financing functions of banks involved in international trade.
- classify the various categories of financing the global trade.

Introduction

Banks do finance domestic commercial transactions, but because there are greater challenges in financing international trade, their role is more comprehensive. The exporter may first doubt the importer's capacity for payment. Second, even if an importer has a good credit rating, the government of that country may apply exchange controls that block payment to the exporter. Third, the importer could not have confidence in the exporter to deliver the ordered goods. Fourth, even if the exporter does send the products, there is a chance that the arrival date will be delayed by trade restrictions or delays in international transit.In order for their businesses to export or import in a way that maximises the value of the MNC, financial managers must be aware of the many techniques they might employ to finance international trade. Credit is given in any international commerce transaction by the exporter (supply), the importer (buyer), one or more financial institutions, or any combination of these parties. The supplier may have enough cash flow to cover the entire cost of the transaction, from the product's production to the buyer's eventual payment. Supplier credit is the name given to this type of credit. The exporter may occasionally need bank borrowing to increase its cash flow.On the other side, the supplier might not want to offer financing, in which case the purchaser would have to fund the deal on their own either internally, externally, or through their bank. In trade finance, banks on both sides of the transaction are essential.

13.1 Balance of Payments

- The Balance of Payments is a statement that contains the transactions made by residents of a particular country with the rest of the world over a specific time period.
- It is also known as the balance of international payments and is often abbreviated as BoP.
- It summarizes all payments and receipts by firms, individuals, and the government.
- The transactions can be both factor payments and transfer payments.
- There are two accounts in the BOP statement: the Current Account and Capital Account.
- The Current account records all transactions involving goods, services, investment income, and current transfer payments.
- The Capital account shows the net change in ownership of foreign assets and transactions in financial instruments (securities etc.)
- The balance of payments account follows a double-entry system.
- All receipts are entered on the credit side, whereas all payments are entered on the debit side.
- Theoretically, a balance of payments accounts is always zero, with the total on the debit side equaling the total on the credit side.
- Practically, however, there might be an error of some degree due to the different sources of data and fluctuation of currency exchange rates.
- The BOP of a country reveals its financial and economic status.
- A BOP statement can be used to determine whether the country’s currency value is appreciating or depreciating.
- The BOP statement helps the government to decide on fiscal and trade policies.
- It provides important information to analyze and understand the economic dealings with other countries.

13.2 Factor Payments

- Payment made to a factor of production in return for rendering productive (or factor) service is called factor payment (or factor income)
- This is reward or compensation to factors of production for productive services rendered by them in the production process, and for them, these are factor income.
- Examples are rent, wages, interest and profit. Income of land is rent, of labor wages, of capital interest and of enterprise is profit. This also means that in order to earn income, one has to contribute in the production process.
- Remember, without production, we cannot conceive of factor income.
- All factor payments (or factor incomes) are included in the national income.
- Factor incomes earned by factors of production and factor payments made by an enterprise to factors for rendering productive services are, in fact, the same.
- The former is viewed from the side of factors of production and the latter from the side of an enterprise.

13.3 Transfer Payment

- Payment received without any good or service provided in return is called transfer payment (or transfer income)
- Transfer income is a receipt concept as compared to factor income which is an earning concept.
- There are certain types of payments which are received without making any corresponding contribution to the flow of goods and services, i.e., they are not earned but received only.
- Such payments for which no productive services are rendered are known as transfer payments.
- Thus, all unilateral (or one-directional) payments are transfer payments.
- For the recipient, a transfer payment is an unearned income.
- Examples of transfer payments are old- age pension, scholarships to students, unemployment allowance for unemployed people, flood relief pocket money, etc.
- These payments are received without making a contribution to production.
- It may be noted that such payments may be personal incomes of the recipients since they get purchasing power equal to the value of the amount received, but these cannot be termed as factor incomes or factor payments since they have not been earned.
- They are, therefore, called transfer payments or transfer incomes, for they are merely transferred by the government or other agencies without getting in return any productive services from the recipients.
- Hence, they are not included in the national income of a country.
- There are two accounts in the BOP statement: the Current Account and Capital Account.
- The Current account records all transactions involving goods, services, investment income, and current transfer payments.
- The Capital account shows the net change in ownership of foreign assets and transactions in financial instruments (securities etc.)
- The balance of payments account follows a double-entry system.
- All receipts are entered on the credit side, whereas all payments are entered on the debit side.

13.4 Components of BOP

- The BOP comprises two accounts:
- Current and Capital.

Components of the Current account

The four major components are as follows:

1) Visible trade – This is the net of export and imports of goods (visible items). The balance of this visible trade is known as the trade balance.
2) There is a trade deficit when imports are higher than exports and a trade surplus when exports are higher than imports.
3) Invisible trade – This is the net of exports and imports of services (invisible items). Transactions mainly consist of shipping, IT, banking, and insurance services.
4) Unilateral transfers to and from abroad – These refer to payments that are not factor payments – for example, gifts or donations sent to the resident of a country by a non-resident relative.
5) Income receipts and payments – These include factor payments and receipts.
6) These are generally rent on the property, interest on capital, and profits on investments.

Components of the capital account

The capital account is used to finance the deficit in the current account or absorb the surplus in the current account.

1) Loans to and borrowings from abroad – These consist of all loans and borrowings given to or received from abroad.
   - It includes both private sector loans as well as public sector loans.
2) Investments to/from abroad – These are investments made by nonresidents in shares in the home country or investments in real estate in any other country.
3) Changes in foreign exchange reserves – Foreign exchange reserves are maintained by the central bank to control the exchange rate and ultimately balance the BOP.

- A Current account deficit is financed by a surplus in the Capital account and vice versa. This can be done by borrowing more money from abroad or lending more money to non-residents.

13.5 Significance of Balance of Payments

- The balance of payments data is important to a lot of users.
- Investment managers, government policymakers, the central bank, businessmen, etc., all use the BOP data to make important decisions.
- The BOP data is affected by vital macroeconomic variables such as exchange rate, price levels, interest rates, employment, and GDP.
- Monetary and fiscal policies are formed in a way to achieve very specific objectives, which generally exert a significant impact on the balance of payments.
- Policies can be formed with the objective of inducing or curbing foreign inflows or outflows.
- Businesses use BOP to analyze the market potential of a country, especially in the short term.
- A country with a large trade deficit is not as likely to import as much as a country with a trade surplus.

- If there is a large trade deficit, the government may adopt a policy of trade restrictions, such as quotas or tariffs.

13.6 Balance of Trade

- The balance of trade (BOT), also known as the trade balance, refers to the difference between the monetary value of a country's imports and exports over a given time .
- A positive trade balance indicates a trade surplus, while a negative trade balance indicates a trade deficit.
- The BOT is an important component in determining a country's current account.

Balance of Trade = Value of Exports – Value of Imports v

- The formula for calculating trade balance is as above:

  Where:

  Value of Exports is the value of goods and services that are sold to buyers in other countries.

  Value of Imports is the value of goods and services that are bought from sellers in other countries.

- Exports are goods or services made domestically and sold to a foreigner.
- That includes a pair of jeans you mail to a friend overseas.
- It could also be signage a corporate headquarter transfers to its foreign office. If the foreigner pays for it, then it's an export.
- Imports are goods and services bought by a country's residents but made in a foreign country.
- It includes souvenirs purchased by tourists traveling abroad.
- Services provided while traveling, such as transportation, hotels, and meals, are also imports.
- It doesn't matter whether the company that makes the goods or services is domestic or foreign. If it was purchased or made in a foreign country, it's an import.
- The trade balance is also the biggest part of the current account.
- It measures a country's net income earned on international assets.
- It's the trade balance plus any other payments across borders.

Interpretation of BOT for an Economy

- To the misconception of many, a positive or negative trade balance does not necessarily indicate a healthy or weak economy.
- Whether a positive or negative BOT is beneficial for an economy depends on -
  - the countries involved,
  - the trade policy decisions,
  - the duration of the positive or negative BOT, and
  - the size of the trade imbalance, among other things.
- In short, the BOT figure alone does not provide much of an indication regarding how well an economy is doing.
- Economists generally agree that neither trade surpluses nor trade deficits are inherently "bad" or "good" for the economy.

- A positive balance occurs when exports > imports and is referred to as a trade surplus.
- A negative trade balance occurs when exports < imports and is referred to as a trade deficit.

Favorable Trade Balance

- Many countries implement trade policies that encourage a trade surplus.
- These nations prefer to sell more products and receive more capital for their residents, believing this translates into a higher standard of living and a competitive advantage for domestic companies.
- For some, this holds true, especially over the short term.
- Unfortunately, some nations resort to trade protectionism to maintain a trade surplus.
- They defend domestic industries by levying tariffs, quotas, or import subsidies.
- Soon, other countries react with retaliatory, protectionist measures, and a trade war ensues.
- Inevitably, this results in higher costs for consumers, reduced international commerce, and diminished economic conditions for all nations.

Unfavorable Trade Balance

- Sometimes, a trade deficit can be unfavorable for a nation, especially one whose economy relies heavily on the export of raw materials.
- Generally, this type of nation imports a lot of consumer products.
- As a result, its domestic businesses don't gain the experience needed to make value-added products.
- Rather, its economy becomes increasingly dependent on global commodity prices, which can be highly volatile.
- Mercantilism advocates protectionist measures, such as tariffs and import quotas.
- While these measures can prove effective in increasing the balance of trade, they typically lead to retaliatory acts of protectionism, which result in higher costs for consumers, reduced international trade, and diminished economic growth.

Difference Between Trade Balance and Balance of Payments

- The balance of trade is the most significant component of the balance of payments.
- The balance of payments adds international investments plus net income made on those investments to the trade balance.
- A country can run a trade deficit but still have a surplus in its balance of payments.
- A large surplus in investments could offset a trade deficit.
- That can only occur if the financial account runs a huge surplus.
- For example, foreigners could invest heavily in a country's assets. They could buy real estate, own oil drilling operations, or invest in local businesses.
- The balance of trade is part of a larger economic unit, the BALANCE OF PAYMENTS (the total of all economic transactions between one country and its trading partners around the world), which includes capital movements (money flowing to a country paying high-interest rates of return), loan repayment, expenditures by tourists, freight and insurance charges, and other payments
- If the exports of a country exceed its imports, the country is said to have a favorable balance of trade or a trade surplus.
- Conversely, if the imports exceed exports, an unfavourable balance of trade, or a trade deficit, exists.

- According to the economic theory of mercantilism, which prevailed in Europe from the 16th to the 18th century, a favorable balance of trade was a necessary means of financing a country's purchase of foreign goods and maintaining its export trade.
- This was to be achieved by establishing colonies that would buy the products of the mother country and would export raw materials (particularly precious metals), which were considered an indispensable source of a country's wealth and power
- The assumptions of mercantilism were challenged by the classical economic theory of the late 18th century, when philosophers and economists such as Adam Smith argued that free trade is more beneficial than the protectionist tendencies of mercantilism and that a country need not maintain an even exchange or, for that matter, build a surplus in its balance of trade (or in its balance of payments).

13.7 Capital Account Convertibility

- Capital Account convertibilityin its entirety would mean that any individual, be it Indian or Foreigner will be allowed to bring in any amount of foreign currency into the country.
- Full capital account convertibility also known as Floating rupee means the removal of all controls on the cross-border movement of capital, out of India to anywhere else or vice versa.
- Capital account convertibility refers to the freedom to convert local financial assets into foreign financial assets or vice versa at market-determined rates of interest.
- If capital account convertibility is introduced along with current account convertibility it would mean full convertibility.
- Complete convertibility would mean no restrictions and no questions.
- In general, restrictions on foreign currency movements are placed by developing countries which have faced foreign exchange problems in the past to avoid sudden erosion of their foreign exchange reserves which are essential to maintain stability of trade balance and stability in their economy.
- With India's Forex reserves increasing steadily, it has slowly and steadily removed restrictions on movement of capital on many counts.
- Capital account convertibility means that an investor is allowed to move freely from the local currency to a foreign currency.
- India has limited capital account convertibility to prevent shocks to the capital account and maintain a stable exchange rate, by stipulating sectoral norms that ensure a lock-in period for investments.
- The balance of payments account, which a statement of all transactions made between a country and the outside world, consists of two accounts — current and capital account.
- While the current account deals mainly with import and export of goods and services, the capital account is made up of cross-border movement of capital by way of investments and loans.
- Capital account convertibility means the freedom to conduct investment transactions without any constraints.
- India has come a long way in liberating the capital account transactions in the last three decades and currently has partial capital account convertibility.
- Typically, it would mean no restrictions on the amount of rupees you can convert into foreign currency to enable you, an Indian resident, to acquire any foreign asset.
- Similarly, there should be no restraints on your NRI cousin bringing in any amount of dollars or dirhams to acquire an asset in India.
- Typically, it would mean no restrictions on the amount of rupees you can convert into foreign currency to enable you, an Indian resident, to acquire any foreign asset.
- Some of the recent moves include increasing the foreign portfolio investment limits in the Indian debt markets, introducing the Fully Accessible Route (FAR) — through which non-

residents can invest in specified government securities without any restrictions and the easing of the external commercial borrowing framework by relaxing end-user restrictions.

- Inward FDI is allowed in most sectors, and outbound FDI by Indian incorporated entities is allowed as a multiple of their net worth.

13.8 Current Account Convertibility

- Current account convertibility refers to the freedom to convert your rupees into other internationally accepted currencies and vice versa without any restrictions whenever payments are made.
- The current account covers exports and imports of goods and services, factor income and unilateral transfers.

Why convertibility is important?

- Free capital mobility, or internationalization of capital markets, is commonly recognized as an engine of global growth. Specifically, benefits of internationalization of capital markets are well accepted, in terms of broadening the investor base for recipient country financial assets, improved liquidity in financial markets and positive pressures for market infrastructure and market practices.
- International capital markets, by enabling access to a global savings pool and to different currencies, can potentially reduce borrowing costs, facilitate better risk allocation and enhance global liquidity
- Developing countries are usually cautious in opening up their capital account.
- This is because inflows and outflows of the foreign and domestic capital, which are prone to volatility, can lead to excessive appreciation/depreciation of their currency and impact the monetary and financial stability.
- India's prudence in opening up its capital account was lauded after the currency crisis in East Asian countries in 1997 exposed the problems arising from the potent combination of high current account imbalances, dependence on short-term capital flows and the whimsical nature of these flows.
- The SS Tarapore committee's report on fuller capital account convertibility released in 2006 argued that even countries that had apparently comfortable fiscal positions have experienced currency crises and rapid deterioration of the exchange rate, when the tide turns.
- The report further points that most currency crises arise out of prolonged overvaluation in exchange rates leading to unsustainable current account deficits.
- An excessive appreciation of the exchange rate causes exporting industries to become unviable, and imports to become much more competitive, causing the current account deficit to worsen.
- Thus, it suggests transparent fiscal consolidation is necessary to reduce the chances of a currency crisis.
- If you are an investor looking to park money overseas or an NRI wanting to invest in Indian assets, full convertibility on capital account may give you a greater opportunity to diversify investments and reduce geographical risk.
- Note that cross-border investments are allowed even now under RBI's Liberalized Remittance Scheme but within the overall limit of $250000 annually.

13.9 Objectives of Full Capital Account Convertibility

Economic Growth: The introduction of FCAC will help in the economic development of the country through capital investment in the country. This lead to employment generation in the country, infrastructure development, global competition etc.

- Improvement in Financial Sector: There would be improvement in the financial sector as huge capital flow into the system, which will help the companies to perform better. It will boost liquidity into the system.

- Diversification of Investment: It will also help in the diversification of investments by ordinary people, wherein they can invest abroad without any restriction and diversify their portfolio.

Risks involved in Full Capital Account Convertibility

- Market risks such as interest rate and foreign exchange risks become more complex as financial institutions and corporates gain access to new securities and markets, and foreign participation changes the dynamics of domestic markets. For instance, banks will have to quote rates and take unhedged open positions in new and possibly more volatile currencies.
- Similarly, changes in foreign interest rates will affect banks' interest sensitive assets and liabilities. Foreign participation can also be a channel through which volatility can spill-over from foreign to domestic markets.
- Credit risk will include new dimensions with cross-border transactions. For instance, transfer risk will arise when the currency of obligation becomes unavailable to borrowers.
- Settlement risk is typical in foreign exchange operations because several hours can elapse between payments in different currencies due to time zone differences.
- Cross-border transactions also introduce domestic market participants to country risk, the risk associated with the economic, social, and political environment of the borrower's country, including sovereign risk.
- With full capital account convertibility, liquidity risk will include the risk from positions in foreign currency denominated assets and liabilities.
- Potentially large and uneven flows of funds, in different currencies, will expose the banks to greater fluctuations in their liquidity position and complicate their asset-liability management as banks can find it difficult to fund an increase in assets or accommodate decreases in liabilities at a reasonable price and in a timely fashion.

Managing Risks of Free Capital Mobility

- The various currency and banking crises experienced over the last few decades have simultaneously highlighted the costs and risks of internationalization such as exposure to global shocks, credit and asset bubbles, exchange rate volatility associated with sudden exit of capital and higher refinancing risk.
- Increased globalization has brought to the fore the vulnerability to contagion effects.
- While it was argued that such risks are the short-term pains needed to reap long term, there is now a wider acceptance that benefits of internationalization are not an unmixed blessing and that there is a nuanced trade off between growth and crisis risk.
- Such awareness has led to policy focus on three fronts……
- First, that benefits of internationalization presupposes sound macroeconomic fundamentals, a well developed financial system and a sound market infrastructure, including efficient markets for funding and risk transfer.
- Second, that countries need to develop appropriate tools to deal with the risks of internationalization, in particular, tools to manage the volume and composition of capital inflows and macro prudential tools.
- Third, that different types of capital flows carry different risks – some are riskier than others.
- The agreed hierarchy of capital flows is that foreign direct investment is the least risky, followed by equity investment, followed by debt capital.
- While FDI is seen to contribute to long-run growth, portfolio equity gives a shorter run boost.
- Debt flows, while necessary, are susceptible to be volatile.
- Understandably, the focus of capital flow regulations, and macro-prudential regulations, has been debt flows.

- Not all emerging economies, however, may have this choice, and may be constrained to depend on capital flows, either to meet their investment needs or to develop financial markets.
- For many of these countries, the required development of policy and markets has to happen simultaneously with dependence on foreign capital.
- Often, there is only a limited choice on the type of capital that flows in, leading to dependence on risky debt capital.
- Managing these flows with a not-so-efficient domestic institutional base requires policy flexibility.
- Building up reserves has been an acceptable course, especially after the Asian crisis. Having some control on the amount of debt capital as well as on its nature is another defense.
- Long-term debt flows could be preferred to short-term flows, stable investors (pension or insurance funds, reserve portfolios) could be preferred to flighty investors such as carry traders, arbitrage traders etc. In a sense capital flow measures may really be used to compensate for lack of strong macro-fundamentals and adjustment mechanism.

Indian Perspective

- India has come a long way in achieving increasing levels of convertibility on the capital account.
- It has broadly achieved the desired outcome for the policy choices it has made, in terms of achieving a stable composition of foreign capital inflow.
- At the same time, India is on the cusp of some fundamental shifts in this space with increased market integration in the offing and freer non-resident access to debt on the table.
- The rate of change in capital convertibility will only increase with each of these and similar measures.
- With that comes the responsibility to ensure that such flows are managed effectively with the right combination of capital flow measures, macro-prudential measures and market intervention.
- Market participants, particularly banks, will have to prepare themselves to manage the business process changes and the global risks associated with capital convertibility. The regulator's job is somewhat different.
- As someone once said, the job of a regulator is like the gas regulator in the kitchen - it cannot ensure the quality of the dish, but it can prevent the kitchen from blowing up.
- The quality of the dish – that is, the efficiency with which investment needs of the country are met - is up to how well Authorized Dealers and other intermediaries adjust to the increasingly fuller capital account convertibility.

13.10 Liberalised Remittance Scheme (LRS)

- Under the Liberalized Remittance Scheme, all resident individuals, including minors, are allowed to freely remit up to USD 2,50,000 per financial year (April – March) for any permissible current or capital account transaction or a combination of both.
- Further, resident individuals can avail of foreign exchange facility within the limit of USD 2,50,000 only.

13.11 Trade Documents

- International market involves various types of trade documents that need to be produced while making transactions.

- Each trade document differs from others and presents the various aspects of the trade like description, quality, number, transportation medium, indemnity, inspection and so on.
- So, it becomes important for the importers and exporters to make sure that their documents support the guidelines as per international trade transactions.
- A small mistake could prove costly for any of the parties.
- For example, a trade document about the bill of lading is proof that goods have been shipped on board, while Inspection Certificate, certifies that the goods have been inspected and meet quality standards.
- So, depending on these necessary documents, a seller can assure a buyer that he has fulfilled his responsibility whilst the buyer is assured of his request being carried out by the seller.
- The following is a list of documents often used in international trade:
    - Air Waybill
    - Bill of Lading
    - Certificate of Origin
    - Combined Transport Document
    - Draft (or Bill of Exchange)
    - Insurance Policy (or Certificate)
    - Packing List/Specification
    - Inspection Certificate

Air Waybill

- Air Waybills make sure that goods have been received for shipment by air.
- A typical air waybill sample consists of three originals and nine copies.
- The first original is for the carrier and is signed by an export agent; the second original, the consignee's copy, is signed by an export agent; the third original is signed by the carrier and is handed to the export agent as a receipt for the goods.
- Air Waybills serves as:
    - Proof of receipt of the goods for shipment.
    - An invoice for the freight.
    - A certificate of insurance.
    - A guide to airline staff for the handling, dispatch and delivery of the consignment.
- The principal requirement for an air waybill is:
    - The proper shipper and consignee must be mentioned.
    - The airport of departure and destination must be mentioned.
    - The goods description must be consistent with that shown on other documents.
    - Any weight, measure or shipping marks must agree with those shown on other documents.
    - It must be signed and dated by the actual carrier or by the named agent of a named carrier.
    - It must mention whether freight has been paid or will be paid at the destination point.

13.12 Bill of Lading (B/L)

- Bill of Lading is a document given by the shipping agency for the goods shipped for transportation form one destination to another and is signed by the representatives of the carrying vessel.
- Only one original is sufficient to take possession of goods at the port of discharge so, a bank which finances a trade transaction will need to control the complete set.
- The bill of lading must be signed by the shipping company or its agent and must show how many signed originals were issued.
- Bill of landing is issued in the set of two, three or more.
- The number in the set will be indicated on each bill of lading and all must be accounted for.
- This is done due to the safety reasons which ensure that the document never comes into the hands of an unauthorized person.
- Only one original is sufficient to take possession of goods at the port of discharge so, a bank which finances a trade transaction will need to control the complete set.
- The bill of lading must be signed by the shipping company or its agent and must show how many signed originals were issued.

It will indicate whether the cost of freight/ carriage has been paid or not :

- "Freight Prepaid": Paid by shipper
- "Freight collect": To be paid by the buyer at the port of discharge

The bill of lading also forms the contract of carriage.

The main parties involved in a bill of lading are:

- Shipper
    - The person who sends the goods.
- Consignee
    - The person who takes delivery of the goods.
    - Notify Party
    - The person, usually the importer, to whom the shipping company or its agent gives notice of the arrival of the goods.
- Carrier
    - The person or company who has concluded a contract with the shipper for the conveyance of goods

The bill of lading must meet all the requirements of the credit as well as comply with UCP 500. These are as follows :

- The correct shipper, consignee and notifying party must be shown.
- The carrying vessel and ports of the loading and discharge must be stated.
- The place of receipt and place of delivery must be stated, if different from port of loading or port of discharge.
- UCP - Uniform Customs and Practice for Documentary Credits
- The goods description must be consistent with that shown on other documents.
- Any weight or measures must agree with those shown on other documents.
- Shipping marks and numbers and /or container numbers must agree with those shown on other documents.
- It must state whether freight has been paid or is payable at destination.
- It must be dated on or before the latest date for shipment specified in the credit.

- It must state the actual name of the carrier or be signed as agent for a named carrier.

13.13 Certificate of Origin

- The Certificate of Origin is required by the custom authority of the importing country for the purpose of imposing import duty.
- It is usually issued by the Chamber of Commerce and contains information like seal of the chamber, details of the good to be transported and so on.

The certificate must provide that the information required by the credit and be consistent with all other document, It would normally include :

- The name of the company and address as exporter.
- The name of the importer.
- Package numbers, shipping marks and description of goods to agree with that on other documents.
- Any weight or measurements must agree with those shown on other documents.
- It should be signed and stamped by the Chamber of Commerce.

13.14 Combined Transport Document

- Combined Transport Document is also known as Multimodal Transport Document and is used when goods are transported using more than one mode of transportation.
- In the case of the multimodal transport document, the contract of carriage is meant for a combined transport from the place of shipping to the place of delivery. It also evidences receipt of goods, but it does not evidence on board shipment.
- The liability of the combined transport operator starts from the place of shipment and ends at the place of delivery.
- These documents need to be signed with the appropriate number of originals in the full set and proper evidence which indicates that transport charges have been paid or will be paid at the destination port.

Multimodal transport document would normally show :

- That the consignee and notify parties are as the credit.
- The place goods are received, or taken in charges, and place of final destination.
- Whether freight is prepaid or to be collected.

Multimodal transport document would normally show :

- The date of dispatch or taking in charge, and the "On Board" notation, if any must be dated and signed.
- Total number of originals.
- Signature of the carrier, multimodal transport operator or their agents.

13.15 Commercial Invoice

- Commercial Invoice document is provided by the seller to the buyer.
- Also known as an export invoice or import invoice, the commercial invoice is finally used by the customs authorities of the importer's country to evaluate the good for the purpose of taxation.

The commercial invoice must :

- Be issued by the beneficiary named in the credit (the seller).

- Be address to the applicant of the credit (the buyer).
- Be signed by the beneficiary (if required).
- Include the description of the goods exactly as detailed in the credit.

The commercial invoice must :

- Be issued by the beneficiary's name
- Be issued in the stated number of originals (which must be marked "Original) and copies.
- Include the price and unit prices if appropriate.
- State the price amount payable which must not exceed that stated in the credit
- include the shipping terms.

13.16 Bill of Exchange

- A Bill of Exchange is a special type of written document under which an exporter ask the importer a certain amount of money in future and the importer also agrees to pay the importer that amount of money on or before the future date.
- This document has special importance in wholesale trade where a large amount of money is involved.

The following persons are involved in a bill of exchange:

- Drawer: The person who writes or prepares the bill.
- Drawee: The person who pays the bill.
- Payee: The person to whom the payment is to be made.
- Holder of the Bill: The person who is in possession of the bill.

On the basis of the due date there are two types of bill of exchange:

- Bill of Exchange after Date: In this case, the due date is counted from the date of drawing and is also called bill after the date.
- Bill of Exchange after Sight: In this case, the due date is counted from the date of acceptance of the bill and is also called a bill of exchange after sight.

13.17 Insurance Certificate

- Also known as Insurance Policy, it certifies that goods transported have been insured under an open policy and is not actionable with little details about the risk covered.
- It is necessary that the date on which the insurance becomes effective is same or earlier than the date of issuance of the transport documents.
- Also, if submitted under a LC, the insured amount must be in the same currency as the credit and usually for the bill amount plus 10 per cent.

The requirements for completion of an insurance policy are as follows:

- The name of the party in the favour which the documents have been issued.
- The name of the vessel or flight details.
- The place from where insurance is to commerce is typically the seller’s warehouse or the port of loading and the place where insurance cases are usually the buyer's warehouse or the port of destination.
- Insurance value that is specified in the credit.
- Marks and numbers to agree with those on other documents.
- The description of the goods, which must be consistent with that in the credit and on the invoice.
- The name and address of the claims settling agent together with the place where claims are payable.

13.18 Packing List

Also known as packing specification, it contains details about the packing materials used in the shipping of goods. It also includes details like measurement and weight of goods.

The packing List must :

- Have a description of the goods ("A") consistent with the other documents.
- Have details of shipping marks ("B") and numbers consistent with other documents

13.19 Inspection Certificate

- Certificate of Inspection is a document prepared at the request of the seller when he wants the consignment to be checked by a third party at the port of shipment before the goods are sealed for final transportation.
- In this process seller submit a valid Inspection Certificate along with the other trade documents like invoice, packing list, shipping bill, bill of lading etc. to the bank for negotiation.
- On demand, an inspection can be done by various world-renowned inspection agencies on nominal charges.

13.20 Banks – A Key Link to Global Trade

- Banks play a critical role in international trade by providing trade finance products that reduce the risk of exporting.
- Banks help manage international trade transactions by providing services that ensure the smooth exchange of goods and services across borders.

Banks are helping the global traders in the following ways:

- Banks help build trust between partners
- Financing projects
- Foreign Exchange Services
- Providing resources and information

1) Banks Help Build Trust Between Partners

- The establishment of bank branches in different countries provides an invaluable route through which merchants can trade with the bank's country of origin and other countries that the bank has branches in.
- This helps businesses trade comfortably in their local currencies while benefiting from transactions carried out abroad.
- Banks also provide credit cards in foreign currencies, making it easier and cheaper to buy or receive payments.
- Banks do a lot of business with money transfer agencies and online payment systems across the world to facilitate trade.
- They also help collect recurring payments through credit cards, direct payments, or lockboxes.

2) Financing Projects

- Many of the major innovations in the industry would not have happened if banks did not help multinationals establish projects across borders.

- Loans to finance acquisitions and mergers, pay workers, purchase inventory, and fund energy projects, along with providing liquidity, all go towards facilitating international trade.
- However, only experienced banks should advise businesses to avoid any unforeseen circumstances.
- Railroads, trade hubs, and large-scale industrial projects are also possible thanks to the willingness of banks to invest in ideas that promote trade.

3) Foreign Exchange Services

- The establishment of bank branches in different countries provides an invaluable route through which merchants can trade with the bank's country of origin and other countries that the bank has branches in.
- This helps businesses trade comfortably in their local currencies while benefiting from transactions carried out abroad.
- Banks also provide credit cards in foreign currencies, making it easier and cheaper to buy or receive payments.
- Banks do a lot of business with money transfer agencies and online payment systems across the world to facilitate trade.
- They also help collect recurring payments through credit cards, direct payments, or lockboxes.

4) Providing Resources and Information

- Banks know what is happening with the economy because they know where the money flows.
- Thus, the information they provide helps traders make smart decisions about their future.
- Many banks have mastered how to utilize their knowledge to best guide importers and exporters towards good investment and minimal risk.
- Bankers can also introduce them to services like insurance, accounting, new markets, or lawyers who can help with contracts, shipping agencies, and raising financial capital.

13.21 Banking Services Enabling Global Trade

- Non-Fund Based
- Guarantees & Standby Letter of Credits
- Letter of Credit
- Fund Based
- Trade Credits: Suppliers Credit / Buyers Credit
- Export Credit Agencies/ Multilateral Agency (ECA/MLA) backed
- Factoring: Receivable & Payable Financing
- Collection of Import / Export Documents
- UPAS: Usance LC Payable at Sight
- Secondary Market Risk Participation
- Bankers' Acceptance

(1) Guarantees & Standby Letter of Credits

- A standby letter of credit (SLOC) is a legal document that guarantees a bank's commitment of payment to a seller in the event that the buyer–or the bank's client–defaults on the agreement.

- A standby letter of credit helps facilitate international trade between companies that don't know each other and have different laws and regulations.
- Although the buyer is certain to receive the goods and the seller certain to receive payment.

How a Standby Letter of Credit Works

- A SLOC is most often sought by a business to help it obtain a contract.
- The contract is a "standby" agreement because the bank will have to pay only in a worst-case scenario.
- Although an SBLC guarantees payment to a seller, the agreement must be followed exactly.
- For example, a delay in shipping or a misspelling a company's name can lead to the bank refusing to make the payment.

Types of Standby Letters of Credit

There are two main types of standby letters of credit:

- A financial SLOC guarantees payment for goods or services as specified by an agreement. An oil refining company, for example, might arrange for such a letter to reassure a seller of crude oil that it can pay for a huge delivery of crude oil.
- The performance SLOC, which is less common, guarantees that the client will complete the project outlined in a contract. The bank agrees to reimburse the third party in the event that its client fails to complete the project.

How to get a SLOC?

- The procedure for obtaining a SLOC is similar to an application for a loan. The bank issues it only after appraising the creditworthiness of the applicant.

Advantages of a Standby Letter of Credit

- The SLOC is often seen in contracts involving international trade, which tend to involve a large commitment of money and have added risks.
- For the business that is presented with a SLOC, the greatest advantage is the potential ease of getting out of that worst-case scenario.
- If an agreement calls for payment within 30 days of delivery and the payment is not made, the seller can present the SLOC to the buyer's bank for payment.
- Thus, the seller is guaranteed to be paid. Another advantage for the seller is that the SBLC reduces the risk of the production order being changed or canceled by the buyer.
- An SBLC helps ensure that the buyer will receive the goods or service that's outlined in the document.
- For example, if a contract calls for the construction of a building and the builder fails to deliver, the client presents the SLOC to the bank to be made whole.
- Another advantage when involved in global trade, a buyer has an increased certainty that the goods will be delivered from the seller.
- Also, small businesses can have difficulty competing against bigger and better-known rivals. An SBLC can add credibility to its bid for a project and can oftentimes help avoid an upfront payment to the seller.

(2) Letter of Credit

- A letter of credit, or "credit letter," is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount.

- In the event that the buyer is unable to make a payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase.
- It may be offered as a facility.
- Due to the nature of international dealings, including factors such as distance, differing laws in each country, and difficulty in knowing each party personally, the use of letters of credit has become a very important aspect of international trade.
- Banks also collect a fee for service, typically a percentage of the size of the letter of credit. The International Chamber of Commerce Uniform Customs and Practice for Documentary Credits oversees letters of credit used in international transactions.

(3) Trade Credit

- A trade credit is an agreement or understanding between agents engaged in business with each other that allows the exchange of goods and services without any immediate exchange of money.
- When the seller of goods or services allows the buyer to pay for the goods or services later, the seller is said to extend credit to the buyer.
- Trade credit is usually offered for 7, 30, 60, 90, or 120 days, but a few businesses, such as goldsmiths and jewellers may extend credit for a longer period.
- The terms of the sale mention the period for which credit is granted, along with any cash discount and the type of credit instrument being used.

- For example, a customer is granted credit with terms of 4/10, net 30.
- This means that the customer has 30 days from the invoice date within which to pay the seller.
- In addition, a cash discount of 4% from the stated sales price is to be given to the customer if payment is made within 10 days of invoicing. If instead, the terms of sale were net 7, then the customer would have 7 days from the invoice date to pay, with no discount offered for early payment.
- Trade credit extended to a customer by a firm appears as accounts receivable and trade credit extended to a firm by its suppliers appears as accounts payable.
- Trade credit can also be thought of as a form of short-term debt that doesn’t have any interest associated with it.

(4) Export Credit Agencies

- An export credit agency (ECA) is an institution that works to support companies with their international trade.
- Export credit agencies can be private, quasi-governmental, or entirely run by the government.
- They offer financing solutions and risk insurance (guarantees) for companies trying to export and import products.
- Export credit agencies originally came to fruition through the government trying to support local companies and increase their product/service export business.
- Their respective services were offered to minimize the risk of participating in international markets and decrease the barriers to entry for domestic businesses.
- It is more common for export credit agencies to assist companies and banks from their own country; however, it is becoming more usual to see ECAs work with international businesses or affiliate companies on the other end of trade deals.
- Banks can also come into play during such deals. One example would be a bank supporting a domestic company’s export and an export credit agency helping the international organization on the receiving end.

- Export credits or insurance can be supplied for short-term (up to 2 years), medium-term (2 to 5 years), and long-term (over 5 years).
- An export credit agency will be chosen over a bank or insurance company due to their specialization in their practice and in foreign markets.

(5) Factoring

- International factoring is based on the idea of selling (and/or assigning) a business's outstanding receivables for a buyer in another country (=sales invoices) to the Factor in your country and receiving a set of trade-related services which include:
- The role of the factor is to collect money owed to exporters by approaching buyers in their own country, in their own language and in the locally accepted manner.
- A factor can also provide the seller with 100% protection in the case of the buyer's inability to pay.

(6)Collection of Import / Export Documents

- Documentary collection is a form of trade finance in which an exporter is paid for its goods by an importer after the two parties' banks exchange the required documents.
- The exporter's bank collects funds from the importer's bank in exchange for documents releasing title to the shipped merchandise, usually after the goods arrive at the importer's location.
- Documentary collection is so-called because the exporter receives payment from the importer in exchange for the shipping documents.
- Shipping documents are required for the buyer to clear the goods through customs and take delivery.
- They include a commercial invoice, certificate of origin, insurance certificate, and packing list.
- A key document in a documentary collection is the bill of exchange or draft, which is a formal demand for payment from the exporter to importer.
- Documentary collection is less common than other forms of trade finance, such as letters of credit and advance payment.
- It is less expensive than some methods but also somewhat riskier, so is generally limited to transactions between parties who have developed trust or are located in countries with strong legal systems and contract enforcement.

(7)Documents Required for Export of Goods

It requires the following documents for the export of goods from India:

- Bill of Lading / Air Waybill
- Commercial invoice-cum-packing list
- Shipping Bill or Bill of Export

(8) Documents Required for Import of Goods

It requires the following documents for import of goods into India:

- Bill of Lading / Air Waybill
- Commercial invoice-cum-packing list
- Bill of Entry

In addition to the above documents, Import Export Code (IE Code) would always be required to undertake an import or export transaction.

(8)UPAS: Usance LC Payable at Sight

- A usance letter of credit is a specific type of letter of credit that allows a predetermined credit period to the buyer, i.e., the importer.
- In common business usage, a usance letter of credit is also known as a deferred letter of credit.
- A usance letter of credit provides a deferred payment option to the buyer.
- The tenor of payment is pre-decided by the buyer and the seller.
- The usance letter of credit can be classified into two based on their tenor. The usual tenors can be as follows:
    - Payment within 90 days after the bill of lading (B/L)
    - Payment within 30 days after sight
- Payment within 90 days after the bill of lading (B/L)
- This means that after the B/L is issued, the buyer has a time of 90 days from the date of B/L to make the payment for the goods.
- Payment within 30 days after sight
- This means that on the date that the issuing bank receives the documents, from that date, the buyer has 30 days to make the payment for the goods.

Summary

Prepayment (before products are shipped), letters of credit, draughts, consignment, and open accounts are the typical payment methods for international trade. Accounts receivable financing, factoring, letters of credit, banker's acceptances, working capital financing, medium-term capital goods financing (forfaiting), countertrade, and working capital financing are the most common ways to finance international trade. The Export-Import Bank, Private Export Financing Corporation, and Overseas Private Investment Corporation are the three main organisations that support foreign trade through export insurance and/or credit programmes.

Keywords

Balance of payments: A summary of transactions between domestic and foreign residents of a country.

Balance of trade The difference between the value of merchandise exports and merchandise imports.

Bank for International Settlements (BIS): International financial institution which facilitates monetary and financial cooperation and serves as a bank for central banks.

Banker’s acceptance: A time draft drawn on and accepted by a bank and representing the exporter’s formal demand for payment when presented under a letter of credit

Factoring: Selling a company’s receivables at a discount to a third party (factor)

Factor income: The income received by a country resident on foreign investments in financial securities

Self Assessment

1. Credit provided by the supplier to the buyer is called:

A. Supplier credit
B. Buyer credit
C. Banking finance
D. Credit provided by the supplier to the buyer.

2. …….is an instrument issued by a bank on behalf of the importer (buyer) promising to pay the exporter (beneficiary) upon presentation of shipping documents in compliance with the terms stipulated therein

A. Letter of credit
B. Letter of debit
C. Bill of lading
D. Commercial invoice

3. ….. An unconditional promise drawn by one party, usually the exporter, instructing the buyer to pay the face amount of the draft upon presentation.

A. Letter of credit
B. Letter of debit
C. Bill of lading
D. Commercial invoice

4. If shipment is made under a sight draft, the exporter is paid once shipment has been made and the draft is presented to the buyer for payment. It is called…

A. documents against payment.
B. documents against acceptance
C. trade acceptance
D. consignment

5. ….is a company specializing in collection on accounts receivable.

A. Factor
B. BIS
C. Federal Bank
D. Correspondent bank

6. Closing a transaction by using a network of factors across borders is called

A. Within border factoring
B. Cross border factoring
C. Inter-bank factoring
D. Countertrade

7. Which of the following statements is wrong in regard to letter of credit?

A. A revocable letter of credit can be cancelled or revoked at any time without prior notification to the beneficiary, but it is no longer used.
B. The bank issuing the L/C is known as the issuing bank.
C. An irrevocable letter of credit can be cancelled or amended without the beneficiary's consent
D. The correspondent bank in the beneficiary's country to which the issuing bank sends the L/C is referred to as the advising bank

8. Which of the following statements is wrong in regard to letter of credit?

A. The bank issuing the L/C makes payment as soon as the required documentation has been presented in accordance with the payment terms

B. The importer must pay the issuing bank the amount of the L/C plus accrued fees associated with obtaining the L/C
C. The importer usually has not established an account at the issuing bank to be drawn upon for payment so that the issuing bank does not tie up its own funds
D. If the importer does not have sufficient funds in its account, the issuing bank is still obligated to honour all valid drawings against the L/C.

9. Which of the following is wrong in regard to bill of lading?
A. It serves as a receipt for shipment and a summary of freight charges;
B. It does not convey title to the merchandise
C. If the merchandise is to be shipped by boat, the carrier will issue what is known as an ocean bill of lading
D. When the merchandise is shipped by air, the carrier will issue an airway bill

10. The exporter's (seller's) description of the merchandise being sold to the buyer is the …
A. commercial invoice
B. standby letter of credit
C. transferable letter of credit
D. Bill of lading

11. … can be used to guarantee invoice payments to a supplier: it promises to pay the beneficiary if the buyer fails to pay as agreed.
A. commercial invoice
B. standby letter of credit
C. transferable letter of credit
D. Bill of lading

12. ……..is a variation of the standard commercial L/C that allows the first beneficiary to transfer all or a part of the original L/C to a third party.
A. commercial invoice
B. standby letter of credit
C. transferable letter of credit
D. Bill of lading

13. In this case, the original beneficiary of the L/C pledges (or assigns) the proceeds under an L/C to the end supplier
A. commercial invoice
B. standby letter of credit
C. transferable letter of credit
D. assignment of proceeds
14. It is the accepting bank's obligation to pay the holder of the draft at maturity
A. commercial invoice
B. Bill of lading
C. Banker's acceptances
D. Airway bill

15. A form of medium-term trade financing in which the exporter sells promissory notes to a bank at a discount.

A. Factoring

B. Forfaiting

C. L/C

D. Bankers acceptance

Answers for Self Assessment

1.	A	2.	A	3.	C	4.	A	5.	D
6.	A	7.	A	8.	C	9.	B	10.	C
11.	C	12.	B	13.	B	14.	C	15.	B

Review Questions

1) How is a time draft accepted by a banker?
2) Just why would an exporter finance an importer?
3) What part does a factor play in transactions involving international trade?
4) How do bills of lading facilitate international commerce transactions?
5) Describe how an irreversible L/C would typically help the business transaction between Pacific West and the Russian importer (the Australian exporter)

Further Readings

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Unit 14: Foreign Exchange

CONTENTS

Learning Outcome:

After studying this unit, you should be able

- elaborate the objectives of exchange control.
- analyze the ways of foreign exchange control.
- elaborate the export and import financing.
- analyse the ways of funding exports and imports.
- elaborate the various services offered by the Exim bank
- decide the appropriate financing schemes for different categories ofbuyers
- Identify risks associated with trade finance,
- Control and mitigate the risks posing threat to the trade financers.

Introduction

Exchange controls are government-imposed controls and restrictions on private transactions conducted in foreign currency. The government's major aim of exchange control is to manage or prevent an adverse balance of payments position on national accounts. Exchange controls are government-imposed limitations on the purchase and/or sale of currencies. These controls allow countries to better stabilize their economies by limiting in-flows and out-flows of currency, which can create exchange rate volatility. Not every nation may employ such measures. It involves ordering all or part of foreign exchange received by a country into a common pool controlled by authorities, typically the central bank.The foreign exchange pool is rationed to cater for "essential" or priority payments abroad. It involves controlling the trading of foreign currency and transfers across national borders. The government will determine how foreign exchange earned by individuals and businesses is spent. It will be mandatory for all earned foreign exchange to be sold at the central bank at a predetermined rate.Limits on foreign currency amount that individuals and businesses can purchase from the central bank will also be put in place. Exchange control is also used to restrict non-essential imports, encourage the importation of priority goods, control the outflow of capital, and manage the country's exchange rate.Generally, countries use foreign exchange control to manage the value of the local currency.Like every other business entity, exporters depend heavily on capital to maintain their production and every day operational activities. However, exporters may sometimes find it challenging to sustain their business activities due to the lack of working capital. In such a situation, they may often find export financing as a suitable financing solution.This quick guide will give you a breakdown of everything you need to know about import and export financing and why Comerical Bank can be your trade financing facilitator.

14.1 Enforcement of Government Control

- Exchange controls can be enforced in a few common ways.
- A government may ban the use of a particular foreign currency and prohibit locals from possessing it.
- Alternatively, they can impose fixed exchange rates to discourage speculation, restrict any or all foreign exchange to a government-approved exchanger, or limit the amount of currency that can be imported to or exported from the country.
- The justification and motivation for the imposition of foreign exchange controls vary from country to country and their respective economic situations. Below are some of the justifications:
- Capital flight at unprecedented levels, mainly due to speculative pressure on the local currency, fear, and extremely low confidence levels.
- A marked decline in exports resulting in a Balance of Payments (BOP) deficit
- Adverse shifts in terms of trade
- War/conflict budgeting. The BOP may be in disequilibrium due to war, drought, etc.
- Economic development and reconstruction.

14.2 Objectives of Foreign Exchange Control

- Restore the balance of payments equilibrium
- Protect the value of the national currency
- Prevent capital flight
- Protect local industry
- Build foreign exchange reserves

14.3 Restore the Balance of Payments Equilibrium

- The main objective of introducing exchange control regulations is to correct the balance of payments equilibrium.
- The BOP needs realignment when it is sliding to the deficit side due to greater imports than exports.
- Hence, controls are put in place to manage the dwindling foreign exchange reserves by limiting imports to essentials items and encouraging exports through currency devaluation.

2) Protect the Value of the National Currency

- Governments may defend their currency's value at a certain desired level through participating in the foreign exchange market.
- The control of foreign exchange trading is the government's way to manage the exchange rate at the desired level, which can be at an overvalued or undervalued rate.
- The government can create a fund to defend currency volatility to stay in the desired range or get it fixed at a certain rate to meet its objectives.
- An example is an import-dependent country that may choose to maintain an overvalued exchange rate to make imports cheaper and ensure price stability.

3) Prevent Capital Flight

- The government may observe increased trends of capital flight as residents and non-residents start making amplified foreign currency transfers out of the country.
- It can be due to changes in economic and political policies in the country, such as high taxes, low interest rates, increased political risk, pandemics, and so on.
- The government may resort to an exchange control regime where restrictions on outside payments are introduced to mitigate capital flight.

4) **Protect Local Industry**

- The government may resort to exchange control to protect the domestic industry from competition by foreign players that may be more efficient in terms of cost and production.
- It is usually done by encouraging exports from the local industry, import substitution, and restricting imports from foreign companies through import quotas and tariff duties.

5) Build Foreign Exchange Reserves

- The government may intend to increase foreign exchange reserves to meet several objectives, such as stabilize local currency whenever needed, paying off foreign liabilities, and providing import cover.

6) Effective Economic Planning

- For successful economic planning, foreign trade has to be coordinated with planned programs and the outflow of capital should be restricted in order to make it available to domestic industries.
- Thus, for mitigating the economic repercussions of foreign trade endangering economic plans, exchange control becomes inevitable.

7) Maintaining Over-value of Home Currency

- Sometimes exchange control is used in order to maintain the external value of the country's currency at an overvalued level.

- For this purpose, the available foreign exchange resources are rationed for use of specific and important purposes only and the government thereby, seeks to adjust total demand with total supply of foreign currencies.

8) To prevent Spread of Depression

- Depression in a big country may spread from country to country via international economic relations.
- Exchange control may work as a preventive against such spread of depression by controlling the main doors – imports and exports.

14.4 Typical Currency Control Measures

- Restriction or prohibition of certain remittance categories such as dividends or royalties.
- Ceilings on direct foreign investment outflows.
- Controls on overseas portfolio investments.
- Import restrictions.
- Required surrender of hard-currency export receipts to central bank.
- Limitations on prepayments for imports.
- Requirements to deposit in interest-free accounts with central bank, for a specified time, some percentages of the value of imports and/or remittances.
- Foreign borrowings restricted to a minimum or maximum maturity.
- Ceilings on granting of credit to foreign firms.
- Imposition of taxes and limitations on foreign-owned bank deposits.
- Multiple exchange rates for buying and selling foreign currencies, depending on category of goods or services each transaction falls into.

14.5 Consequences of Exchange Controls

- Exchange controls can be effective in some instances, but they can also come with negative consequences.
- Often, they lead to the emergence of black markets or parallel markets in currencies.
- The black markets develop due to higher demand for foreign currencies that is greater than the supply in the official market.
- It leads to an ongoing debate about whether exchange controls are effective or not.

14.6 Foreign Exchange Regulation Concerning Exports

- Export of goods is the most important foreign exchange earner for the country and the law provides that foreign exchange in payment of exported goods must be realized in full and with utmost promptness.
- Exporters are required to give a declaration for almost all exports to realize export proceeds within the prescribed period
- Exchange control procedures envisage to ensure that no foreign exchange arising out of exports from India is lost.
- The important provisions include declaration of exports on prescribed forms, realization of export proceeds in permitted methods, permitted currencies prescribed period and prescribed manner.

- Let us discuss them id detail….

Prohibition of Export

- Export of all goods cither directly or indirectly to any place outside India other than Nepal and Bhutan is prohibited unless the exporter furnishes to the prescribed authority a declaration in the prescribed form.
- It should be supported by such evidences as may be prescribed or so specified and true in all material particulars.

The Prohibition Shall not Apply to the Export of

- Trade samples supplied free of payment.
- Personal effects of travelers, whether accompanied or unaccompanied.
- Ship's store, transshipment cargo and goods shipped under the orders of the Central Government in this behalf of or the military, naval or air force authorities in India for military, naval or air force requirements.
- Goods dispatched by air freight and accompanied by a declaration by the sender that they are not more than ten thousand rupees in value
- Goods export of which in the opinion of Reserve Bank does not involve any transaction in foreign exchange.
- Goods dispatched by air freight and covered by a certificate issued by an authorized dealer that their export does not involve any transaction in foreign exchange.

Export Declaration

- Every exporter must make a true declaration in the prescribed form. The declaration is mandatory and include:
- the full export value of the goods; or
- If the full export value of the goods is not ascertainable at the time of export, the value which the exporter, having regard to the prevailing market conditions, expects to receive on the sale of goods in the overseas market.

14.7 Import and Export Trade Financing

- Import and export financing, as their titles imply, pay for the accompanying expenses associated with receiving and shipping goods to and from companies in other parts of the world.
- From tariffs to freight rates, duties and fees, capital requirements are huge for the global trades.
- Import and export financing provide the funding advances so the exchanging of goods can transpire.

How does it Work?

- There are at least three parties involved in the trade flow process: the customer receiving the goods (importer); the company selling (exporter); and the lending institution that's financing the operation.
- Once a sales agreement is reached between the two parties that are buying and selling, the financial institution makes the funds available for the transaction to proceed.
- Where the funds go - and how they're delivered - depends upon the nature of the loan.

- For export financing, where the exporter's bank is involved, the lender sends the appropriate funds to use as a deferred payment.
- For import financing, it's the importer's bank that pays the exporter, and the importer repays the lending institution the principal amount plus interest.
- Import and export financing fund the transaction itself, but financing can also be made available before it transpires.
- With pre-import financing, the lender provides the importer with a working capital loan, and approval is based on the borrower's credit history.
- With pre-export financing, it's the seller that's seeking an advance, so it can produce goods to sell, although the money may be used for other purposes, such as the transportation of goods and warehousing.
- Approval of the loan is measured both on credit history and a solid track record of buyers.

Export Financing/Advances

- As the name suggests, this particular type of financing pertains to export.
- The primary aim of export financing is to provide financial support to businesses that deal in the international market.
- In international trade, a significant gap exists between exporting goods and receiving payment from buyers that often strains the exporter’s cash flow.
- Banking and non-banking institutions and foreign-trade based lending institutions can provide export finance to exporters.
- For example, in India institutions like Export-Import bank, developmental banks like ICICI, IDBI, etc., National Small Industries Corporation, Export Credit Guarantee Corporation and State Finance Corporations serve as sources of export financing.
- This is a credit operation in which the bank advances a specific amount, in any officially traded currency, to an exporter so that it can collect the value of deferred-payment sales made to a foreign importer.

This process involves three parties:

- Financial institution
- Exporter
- Foreign importer

The financing must always be linked to an export operation.

Why Should One Choose Export Financing?

- Typically, exporters can opt for export financing in India at various stages of their business cycle to meet the requirements.
- Most businesses resort to this financing option during the pre-shipment and post-shipment phases.
- Also, this funding option proves useful in case of suspension of export subsidies and collection of invoices throughout the working capital cycle.

In general, businesses opt for export finance for these following reasons –

- To start a new export-based business
- For business expansion
- To meet the working capital requirement
- To keep production undisturbed

Process of Export Financing/Advances

1. A sales agreement is struck between the Spanish exporter and the foreign importer.
2. The exporter delivers the goods to the foreign importer, who agrees to pay for them on a future date.
3. The financial institution advances the value of the operation to the exporter in local currency, or any other currency.
4. On the agreed expiry date, the importer pays for the purchase.
5. The exporter repays the advance using the importer's payment.

14.8 Types of Export Financing

Major types of export financing –

Pre-Shipment Export Finance: This type of finance is accessed when an exporter requires funds before goods are shipped. Typically, the fund availed is used to purchase and process raw materials, packaging finished product, etc. The best sources of pre-shipment export finance include -

- Packaging credit
- Business loan

Post-Shipment Export Finance: Once the products are shipped, and an invoice is raised, sellers have to wait until the products reach the buyers to receive payment. Typically, the gap between shipment and receipt of payment ranges between 1 month and 3 months. Sellers can cater to their working capital needs through post-shipment finance via these sources –

- Invoice discounting
- Invoice factoring

Forfaiting: Financing & Credit insurance

- Financial institutions use forfaiting, a non-recourse financial product, to offer their exporter-customers the option to sell, without recourse, the commercial credits arising from their exports.
- In those cases where the importer is declared insolvent, the banking institution cannot reclaim the money from the exporter.

Forfaiting enables the banking institution to offer its exporter-customers the following:

- Collection of payment is guaranteed.
- The exchange and interest rate risk disappear, as the funds are advanced.
- The political and commercial risk of the operation is eradicated.
- It furnishes liquidity.

Forfaiting enables the banking institution to offer its exporter-customers the following:

- It enables the transaction to be removed from the balance sheet.
- It enables more to be sold, or more expensively, by enabling longer credit terms to be offered.

14.9 Imports Financing

With this credit operation, an importer receive payment for an imported product. As a result, the importer requests financing owing to:

- Insufficient funds to pay on delivery.
- The availability of better purchase prices.

Although similar to a domestic loan, this operation differs in that the payments are used only to pay for imports. This process requires the involvement of three players:

- Financial institution
- Spanish importer
- Foreign exporter

The financing operation must always be linked to the payment of imports.

Import Financing Process

1. A sales agreement is struck between the importer (customer of the bank) and the foreign exporter.
2. The foreign exporter delivers the goods to the importer.
3. The importer (the bank's customer) requests financing from their bank so that it can pay the foreign exporter.
4. The importer's bank pays the foreign exporter.
5. When it expires, the importer (bank customer) repays the financing with the proceeds of the sales.

14.10 Export-Import Bank of India (India Exim Bank)

- Export-Import Bank of India (India Exim Bank) was set up in 1982 by an Act of Parliament and is fully owned by the Government of India (GOI).
- The Bank is the principal financial institution for coordinating the working of institutions engaged in financing exports and imports.
- India Exim Bank has, over the years, played a catalytic role in facilitating India's integration with the global economy by promoting, financing, and facilitating India's international trade and investment.
- The Bank's range of programs has helped Indian enterprises become competitive and develop a global footprint.
- Assistance is given to export-oriented companies by way of term loans for setting up production facilities, expansion / modernization / upgradation of existing facilities, and for the acquisition of production equipment or technology.
- Exim Bank of India represents a rare case of an institution where the concept and need for such an institution had been debated for a long period-more than two decades – before it was finally set up in 1982.
- The two decades prior to the establishment of Exim Bank witnessed significant changes in the industrial and trade scenario.
- Indian exports during the fifties and the early sixties consisted of primary commodities and traditional manufacturers like jute and cotton textiles.
- The dominant viewpoint was that in India's case, expansion in domestic demand alone could realistically serve as the engine for economic growth since export expansion opportunities were limited and there were fundamental constraints (like inadequate infrastructure) to export growth.
- The ideology relating to the manufacturing sector was to promote industrialization through import substitution.
- As a result, the export sector remained neglected with a small share in India's GDP.

14.11 Exim Bank Key functions

- The first and core function of EXIM bank of India is to address India's Import and Export Industry requirements.
- The institution finances the various types of export-import machinery for lease and hires purposes as well.
- Financing the goods and services imported from other countries than India.
- With the purpose of foreign trade, EXIM refinances financial transactions of the banks and other financial institutions.
- Besides the financial assistance, EXIM banks also offer professional technical guidance on the administrative matters connected to the import-export community.
- In addition to financial institutions and banks also assist the newbie business and joint venture businesses in foreign countries that want to grow in this particular industry.

Key Financial Products of Exim Bank

- Corporate Banking
- Buyers credit
- Finance to the Overseas Investments
- Lines of credit

14.12 Key Risks in Trade Finance

- Counterparty risks
- Country risks
- FX risks
- Dilution risks
- Insolvency risks
- Fraud risks
- Compliance risks

Lets try to understand these risks…

14.13 Mitigation Methods

Mitigation methods for counterparty risk include credit enhancement and collateral. Examples of credit enhancement are:

  - Corporate guarantee (e.g. from the customer's parent company) where the guarantor is a stronger risk counterparty;
  - Trade credit insurance for receivables purchased or financed;
  - Guarantee from a multilateral development bank for confirmation of, and/or financing under, a letter of credit;
  - Risk participation to distribute the risk of a trade finance transaction or program to participants (typically financial institutions).

- COVID-19 has had adverse effects on the revenues, cash flows, debt levels and access to financing of many businesses, which has resulted in increased counterparty risks in certain trade finance transactions.

Some ways in which this risk may be mitigated are:

- Credit insurance that covers political risk, where available or feasible.

- Guarantee of a multilateral development bank ("MDB", for example, Asian Development Bank, International Finance Corporation) under the relevant Trade Finance Program ("TFP", variously named) offered by the MDB.
- For documentary trade financing, the confirmation or irrevocable reimbursement undertaking from a bank in a lower risk location.
- Risk distribution to other financial institutions.
- Recent Russia – Ukraine conflict has exacerbated the causes of political risk, and thus increased it.
- Tensions brought about by the global spread of inflation have resulted in imposition of certain protectionist policies, trade embargoes and trade sanctions by nation states.
- It has also increased the risk of sovereign defaults.
- The usual way of mitigating FX risk is by way of hedging techniques, such as FX forward contracts with banks (to fix the FX rate over a period of time), and FX options.
- The counterparty may also have exports and imports in the same currency, which could provide a natural hedge for its foreign currency requirements.
- COVID-19 has triggered some sharp swings in FX markets, particularly in the currencies of some emerging market economies as a result of a flight to 'safe-haven' currencies.
- For dilution risk Due diligence on the receivables to be performed prior to financing, to assess the dilution percentage and to set the appropriate advance ratio for the financing.
- The dilution rate may be monitored on ongoing basis, and adjustments to advance ratios made accordingly on periodic basis.
- Use of unconditional payment instruments such as bills of exchange and promissory notes, to create a payment obligation separate from the commercial transaction that gave rise to it.
- Dilution to be included as a recourse event, in the financing agreement with the exporter; i.e. the exporter is to make good to the finance provider any shortfall due to dilution in the collection of the receivables.

Mitigation for Insolvency Risks Includes:

- Assessment and continuous monitoring of the credit quality of the relevant counterparties
- Uncommitted financing arrangements
- Availability of collateral
- Perfection of security arrangements
- Trade credit insurance where feasible

Mitigation for compliance Risks Includes:

- Education and training of the finance provider's staff on compliance requirements and to instill a compliance culture, based on guidelines or guidance from its regulators.Transaction screening, reviewing and monitoring, to verify that the underlying trade transactions are genuine and do not violate applicable regulation.
- Effective management of compliance ought to have the benefit of reducing friction for customers and helping governments with their objective of financial inclusion.
- Effective Know-Your-Customer ("KYC") practice to verify the customer and its owners prior to onboarding (and periodic reviews subsequent to onboarding) and Customer Due Diligence ("CDD") to assess their level of AML/CFT risk.

Summary

It's not every nation that can legitimately introduce exchange control measures. According to the articles of agreement by the International Monetary Fund (IMF), only countries with transitional

economies can apply exchange controls. Several western nations employed exchange control measures soon after World War II but gradually phased them out before the 1980s as their economies strengthened overtime.The phasing out of exchange controls was also necessitated by trends towards globalization, free trade, and economic liberalization in the 1990s, which does not co-exist with the application of exchange controls. Presently, exchange controls are mostly utilized by developing countries with weak economies, low exports, are import-dependent, and with low foreign currency reserves.The world's economy is connected through global trade accords like the North American Free Trade Agreement, the Transatlantic Trade and Investment Partnership and many other agreements with foreign countries. Growth is made possible through the open exchange of international commerce, taking full advantage of human ingenuity to benefit societies.While the cooperation of governments has allowed for access in the near and far reaches of the globe, actually tapping into these international markets requires importing and exporting services. That's where import and export financing comes into play. Given the inherent risks of international trade, government institutions and the private sector offer various forms of export credit, export finance and guarantee programs to reduce risk and stimulate foreign trade.The prominent agency providing these services in the INDIA is EXIM bank.

Key words

Lines of Credit (LOC): is a unique Programme offered by Exim Bank which offers a risk-free financing option to Indian exporting companies which helps them penetrate new markets and enhance their export volumes in overseas markets.

Buyers Credit: Basically, with this facility, any international buyer can open a letter of credit in favor of any Indian exporter. Under deferred payment, they can import any goods or services from Indian exporters without any hurdles or complications.

Corporate Banking: To increase the competitiveness of home-grown companies, the Export -Import bank in India offers numerous financial programs in order to provide financial support through its corporate banking facilities.It offers a variety of financing programs to augment the export competitiveness of Indian companies.

Review questions

1. Elaborate the significance of EXIM bank for Indian economy.
2. Explain the difference in the risk to the exporter between accounts receivable financing and factoring
3. Explain how EXIM bank can encourage Indian companies to export to less developed countries where there is political risk.
4. Explain the advantages and disadvantages of the forfaiting forms of export financing.
5. Recently, Never Never Distilling (NND) started selling abroad. There are now 40 open overseas orders, with an average order value of $3000. To reduce its credit risk on international sales, NND is investigating the following options:
    a. Demand a letter of credit from every client. The customer would be responsible for paying $100 plus 0.25 percent of the invoice total. NND has consented to cover the cost of the letter of credit in order to remain competitive.
    b. Factor the accounts payable. The factor would impose a 2% non-recourse fee.
    c. Purchase insurance from Export Finance Australia, which carries a 1.5% insurance cost.

Which of these substitutes would you suggest NND use? Why?

Objective Questions

1. This type of finance is accessed when an exporter requires funds before goods are shipped.

A. Pre-Shipment Export Finance
B. Post-Shipment Export Finance
C. During shipment advance
D. No shipment advance

2. Sellers can cater to their working capital needs through post-shipment finance but not via these sources
A. Invoice discounting
B. Invoice factoring
C. Packaging credit
D. None of These

3. Which of the following is wrong in regard to export financing process ?
A. A sales agreement is struck between the Spanish exporter and the foreign importer.
B. The exporter delivers the goods to the foreign importer, who agrees to pay for them on a future date.
C. The financial institution advances the value of the operation to the exporter in local currency, or any other currency.
D. On the agreed expiry date, the exporter pays for the purchase.

4. Which of the following is wrong in regard to import financing process ?
A. A sales agreement is struck between the importer (customer of the bank) and the foreign exporter.
B. The foreign exporter delivers the goods to the importer.
C. The importer (the bank's customer) requests financing from their bank so that it can pay the foreign exporter.
D. The exporter's bank pays the foreign importer.

5. Which of the following is not the characteristic of import financing ?
A. The contract length will coincide with the period needed to sell and collect payment for the imported product
B. The currency used in import financing can be any officially traded currency
C. Repayment must comply with the deadline set in the import financing.
D. The rate of interest used will depend on the currency in which the import financing is not denominated.

6. When the currencies of the import financing and the proceeds earned by the importer from selling the goods differ, ….. risk is created
A. Exchange
B. Political
C. Default
D. Dilution

7. …….refers to risk that the amount that may be payable by the debtor on a trade receivable will be less than the invoiced amount(s Exchange
A. Political
B. Counterparty

C. Dilution

D. Exchange

8. ……..may arise due to a variety of reasons including return of goods, short-shipment, damaged goods, warranty claims, billing error, rebates and commercial dispute

A. Political

B. Default

C. Dilution

D. Exchange

9. EXIM bank was established in India in….

A. 1982

B. 1993

C. 2000

D. 2012

10. EXIM Bank is solely owned by

A. RBI

B. Government of India

C. IBRD

D. IMF

11. EXIM bank is headquartered at…

A. Mumbai

B. Delhi

C. Chennai

D. Chnadigarh

12. Which of the following is wrong in regard to EXIM bank?

A. It is created by an Act of Parliament.

B. The bank works under the finance ministry.

C. Bank's primary objective is to help export-related companies.

D. It is headquartered at Mumbai

13. The issuing bank's obligations under an acceptance letter of credit are to

A. only accept the bill,

B. pay against the bill.

C. Accepting the bill right away and paying the whole amount by the due date.

D. To have the importer's approval on the bill.

14. A member of the Working Group for Project Export Approval is not

A. the Reserve Bank of India.

B. The financing bank.

C. The Exim Bank

D. DGFT.

Answers

1.	A	4.	D	7.	C	10.	A	13.	B
2.	C	5.	D	8.	C	11.	A	14.	C
3.	D	6.	A	9.	A	12.	A	15.	D

Further readings

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Unit 15: International Capital Markets

CONTENTS

Objectives

After studying this unit, you should be able

- explore the global capital markets
- identify the reasons for growth behind capital markets
- distinguish between debt and equity instruments
- deal in various type of capital market products
- explore the reasons behind global capital market flows,
- analyse the pros and cons of global flows.
- analysing the problems associated with global capital flows

Introduction

- A capital market is basically a system in which people, companies, and governments with an excess of funds transfer those funds to people, companies, and governments that have a shortage of funds. This transfer mechanism provides an efficient way for those who wish to borrow or invest money to do so. For example, every time someone takes out a loan to buy a car or a house, they are accessing the capital markets. Capital markets carry out the desirable economic function of directing capital to productive uses.There are two main ways that someone accesses the capital markets—either as debt or equity. While there are many forms of each, very simply, debt is money that's borrowed and must be repaid, and equity is money that is invested in return for a percentage of ownership but is not guaranteed in terms of repayment.In essence, governments, businesses, and people that save some portion of their income invest their money in capital markets such as stocks and bonds. The borrowers (governments, businesses, and people who spend more than their income) borrow the savers' investments through the capital markets. When savers make investments, they convert risk-free assets such as cash or savings into risky assets with the hopes of receiving a future benefit. Since all investments are risky, the only reason a saver would put cash at risk is if returns on the investment are greater than returns on holding risk-free assets. Basically, a higher rate of return means a higher risk.Financial intermediaries are very important in the capital marketplace. Banks lend money to many people, and in so doing create economies of scale. This is one of the primary purposes of the capital markets.

15.1 Role of Capital Markets

- Capital markets promote economic efficiency. In the example, the beverage company wants to invest its $100,000 productively.
- There might be a number of firms around the world eager to borrow funds by issuing debt security or equity security so that they can implement a great business idea. Without issuing the security, the borrowing firm has no funds to implement its plans.
- By shifting the funds from the beverage company to other firms through the capital markets, the funds are employed to their maximum extent.
- If there were no capital markets, the beverage company might have kept its $100,000 in cash or in a low-yield savings account. The other firms would also have had to put off or cancel their business plans.
- International capital markets are the same mechanism but in the global sphere, in which governments, companies, and people borrow and invest across national boundaries.
- In addition to the benefits and purposes of a domestic capital market, international capital markets provide the following benefits:

15.2 Benefits of International Capital Markets

Higher returns and cheaper borrowing costs.

- These allow companies and governments to tap into foreign markets and access new sources of funds.
- Many domestic markets are too small or too costly for companies to borrow in.
- By using the international capital markets, companies, governments, and even individuals can borrow or invest in other countries for either higher rates of return or lower borrowing costs.

Diversifying risk

- The international capital markets allow individuals, companies, and governments to access more opportunities in different countries to borrow or invest, which in turn reduces risk.
- The theory is that not all markets will experience contractions at the same time.

15.3 Structure of the Capital Markets

- The structure of the capital markets falls into two components—primary and secondary.

Primary Market

- The primary market is where new securities (stocks and bonds are the most common) are issued.
- If a corporation or government agency needs funds, it issues (sells) securities to purchasers in the primary market.

- Big investment banks assist in this issuing process as intermediaries.
- Since the primary market is limited to issuing only new securities, it is valuable but less important than the secondary market.

Secondary Market

- The vast majority of capital transactions take place in the secondary market.
- The secondary market includes stock exchanges (the New York Stock Exchange, the London Stock Exchange, National Stock Exchange in India and the Tokyo Nikkei), bond markets, and futures and options markets, among others.
- All these secondary markets deal in the trade of securities.

What are 'Securities' in Capital Market?

- The term securities includes a wide range of financial instruments. You're probably most familiar with stocks and bonds.
- Investors have essentially two broad categories of securities available to them: equity securities, which represent ownership of a part of a company, and debt securities, which represent a loan from the investor to a company or government entity.
- Creditors, or debt holders, purchase debt securities and receive future income or assets in return for their investment.
- The most common example of a debt instrument is the bond. When investors buy bonds, they are lending the issuers of the bonds their money.
- In return, they will receive interest payments usually at a fixed rate for the life of the bond and receive the principal when the bond expires. All types of organizations can issue bonds.
- Stocks are the type of equity security with which most people are familiar.
- When investors buy stock, they become owners of a share of a company's assets and earnings.
- If a company is successful, the price that investors are willing to pay for its stock will often rise; shareholders who bought stock at a lower price then stand to make a profit.
- If a company does not do well, however, its stock may decrease in value and shareholders can lose money.
- Stock prices are also subject to both general economic and industry-specific market factors.
- The key to remember with either debt or equity securities is that the issuing entity, a company or government, only receives the cash in the primary market issuance.
- Once the security is issued, it is traded; but the company receives no more financial benefit from that security.
- Companies are motivated to maintain the value of their equity securities or to repay their bonds in a timely manner so that when they want to borrow funds from or sell more shares in the market, they have the credibility to do so.

15.4 Global Capital Markets And Companies

For companies, the global capital markets

- provide stability and predictability,
- help reduce risk, and
- provide access to more resources.

One of the fundamental purposes of the capital markets, both domestic and international, is the concept of liquidity, which basically means being able to convert a noncash asset into cash without losing any of the principal value.

- In the case of global capital markets, liquidity refers to the ease and speed by which shareholders and bondholders can buy and sell their securities and convert their investment into cash when necessary.
- Liquidity is also essential for foreign exchange, as companies don't want their profits locked into an illiquid currency.

Major Components of the International Capital Markets

- International Equity Markets
- International Bond Markets

International Equity Markets

- Companies sell their stock in the equity markets. International equity markets consists of all the stock traded outside the issuing company's home country.
- Many large global companies seek to take advantage of the global financial centers and issue stock in major markets to support local and regional operations.
- For example, ArcelorMittal is a global steel company headquartered in Luxembourg; it is listed on the stock exchanges of New York, Amsterdam, Paris, Brussels, Luxembourg, Madrid, Barcelona, Bilbao, and Valencia.
- While the daily value of the global market changes, in the past decade the international equity markets have expanded considerably, offering global firms increased options for financing their global operations.

Reasons Behind the Growth of International Equity Markets

- Growth of developing markets - As developing countries experience growth, their domestic firms seek to expand into global markets and take advantage of cheaper and more flexible financial markets.
- Drive to privatize- In the past two decades, the general trend in developing and emerging markets has been to privatize formerly state-owned enterprises.
- These entities tend to be large, and when they sell some or all of their shares, it infuses billions of dollars of new equity into local and global markets.
- Domestic and global investors, eager to participate in the growth of the local economy, buy these shares.
- Investment banks - With the increased opportunities in new emerging markets and the need to simply expand their own businesses, investment banks often lead the way in the expansion of global equity markets.
- These specialized banks seek to be retained by large companies in developing countries or the governments pursuing privatization to issue and sell the stocks to investors with deep pockets outside the local country.
- Technology advancements- The expansion of technology into global finance has opened new opportunities to investors and companies around the world.
- Technology and the Internet have provided more efficient and cheaper means of trading stocks and, in some cases, issuing shares by smaller companies.

15.5 Valuation of foreign stocks

Investors require techniques for appraising international stocks when they think about investing in them.

Dividend discount model

Using the dividend discount model with an adjustment to account for anticipated exchange rate fluctuations is one option for valuation.

Dividends from foreign stocks are paid in the currency that they are worth. The dividend (in the foreign currency) multiplied by the foreign currency's value in US dollars equals the cash flow every period to Australian investors.

Typically, it is easier to predict the dividend than the value of the foreign currency.

The value of the foreign stock from the standpoint of an Australian investor is highly unpredictable due to exchange rate instability.

Price/earnings method

Price/earnings ratios are a different approach to appraising overseas stocks.

The suitable price of the firm's stock is calculated by multiplying the predicted profits per share of the foreign company by the appropriate price/earnings ratio (depending on the risk of the company and its industry).

This method is simple to use, but it has some restrictions when used to value foreign stocks.

In some international markets, the price/earnings ratio for a particular industry may fluctuate constantly, particularly if there are just a few companies in the sector.

It's challenging to decide the price-to-earnings ratio to use for a given international company. Also, since reported earnings might be impacted by the firm's accounting standards and tax rules, the price/earnings ratio for any specific industry may need to be modified for the country in where the company is based.

Furthermore, the value obtained using this method is expressed in foreign currency (as the anticipated earnings are expressed in that currency), even if foreign investors are confident in their estimation of the appropriate price/earnings ratio. Foreign investors would therefore still need to take exchange rate effects into account.

Even if the company is undervalued abroad, if the local currency weakens versus the dollar, investors may not see a profit that is reasonable.

Other approaches

Some investors use these techniques to choose overseas equities.

For instance, they might evaluate every country's macroeconomic situation first to weed out those where conditions are predicted to be unfavourable in the future.

Then, they value particular companies in the alluring countries using different techniques, such the dividend discount model or the price/earnings strategy.

International Bond Markets

- Bonds are the most common form of debt instrument, which is basically a loan from the holder to the issuer of the bond.
- The international bond market consists of all the bonds sold by an issuing company, government, or entity outside their home country.
- Companies that do not want to issue more equity shares and dilute the ownership interests of existing shareholders prefer using bonds or debt to raise capital (i.e., money).
- Companies might access the international bond markets for a variety of reasons, including funding a new production facility or expanding its operations in one or more countries.
- There are several types of international bonds, which are detailed in the next sections.

15.6 Capital Makrkets

- Capital market, also known as the securities market is a market where the funds from the investors are made available to the companies and government for the development of the projects.
- Similarly, if a company wants money to expand its business, then it can issue shares in the stock market and investors who want to invest in that company can buy these shares.
- The Capital Market includes the bond market as well as the securities market.
- It serves as a pathway for entities that have a surplus fund that is being transferred to the ones who need capital for their business purpose.
- These funds are being utilized by the companies in multiple ways into productive areas.

Functions of the Capital Market

The main functions of the capital market are:

- The capital market acts as the link between the investors and savers.
- It helps in facilitating the movement of capital to more productive areas to boost the national income.
- It boosts economic growth.
- It helps in the mobilization of savings for financing long term investment.
- It facilitates the trading of securities.
- It reduces transaction and information cost.
- It helps in quick valuations of financial instruments.
- Through derivative trading, it offers hedging against market risks.
- It helps in facilitating transaction settlement.
- It improves the effectiveness of capital allocation.
- It provides continuous availability of funds to the companies and government.

Types of capital market instruments

- Equities
- Debt securities
- Derivatives
- Exchange traded funds (ETFs)
- Foreign exchange instruments ($ ¥ £ €)
- Commodities

(1) Equities

- Equity securities refer to the part of ownership that is held by shareholders in a company.
- In simple words, it refers to an investment in the company's equity stock for becoming a shareholder of the organization.
- The main difference between equity holders and debt holders is that the former (equity) does not get regular payment, but they can profit from capital gains by selling the stocks.
- Also, the equity holders get ownership rights and they become one of the owners of the company.
- When the company faces bankruptcy, then the equity holders can only share the residual interest that remains after debt holders have been paid.

- Companies also regularly give dividends to their shareholders as a part of earned profits coming from their core business operations.

(2) Debt Securities

Debt Securities can be classified into bonds and debentures:

1) **Bonds**

- Bonds are fixed-income instruments that are primarily issued by the center and state governments, municipalities, and even companies for financing infrastructural development or other types of projects.
- It can be referred to as a loaning capital market instrument, where the issuer of the bond is known as the borrower.
- Bonds generally carry a fixed lock-in period. Thus, the bond issuers have to repay the principal amount on the maturity date to the bondholders.

2) **Debentures**

- Debentures are unsecured investment options unlike bonds and they are not backed by any collateral.
- The lending is based on mutual trust and, herein, investors act as potential creditors of an issuing institution or company.

(3) Derivatives

- Derivative instruments are capital market financial instruments whose values are determined from the underlying assets, such as currency, bonds, stocks, and stock indexes.
- The four most common types of derivative instruments are forwards, futures, options and interest rate swaps:

Types of Derivative Instruments

- Forward: A forward is a contract between two parties in which the exchange occurs at the end of the contract at a particular price.
- Future: A future is a derivative transaction that involves the exchange of derivatives on a determined future date at a predetermined price.
- **Options:** An option is an agreement between two parties in which the buyer has the right to purchase or sell a particular number of derivatives at a particular price for a particular period of time**.**
- **Interest Rate Swap:** An interest rate swap is an agreement between two parties which involves the swapping of interest rates where both parties agree to pay each other interest rates on their loans in different currencies, options, and swaps.

(4) Exchange-Traded Funds

- Exchange-traded funds are a pool of the financial resources of many investors which are used to buy different capital market instruments such as shares, debt securities such as bonds and derivatives.
- Most ETFs are registered with the Securities and Exchange Board of India (SEBI) which makes it an appealing option for investors with a limited expert having limited knowledge of the stock market.

- ETFs having features of both shares as well as mutual funds are generally traded in the stock market in the form of shares produced through blocks.
- ETF funds are listed on stock exchanges and can be bought and sold as per requirement during the equity trading time.

(5) Foreign Exchange Instruments

- Foreign exchange instruments are financial instruments represented on the foreign market. It mainly consists of currency agreements and derivatives.
- Based on currency agreements, they can be broken into three categories i.e. spot, outright forwards and currency swap.

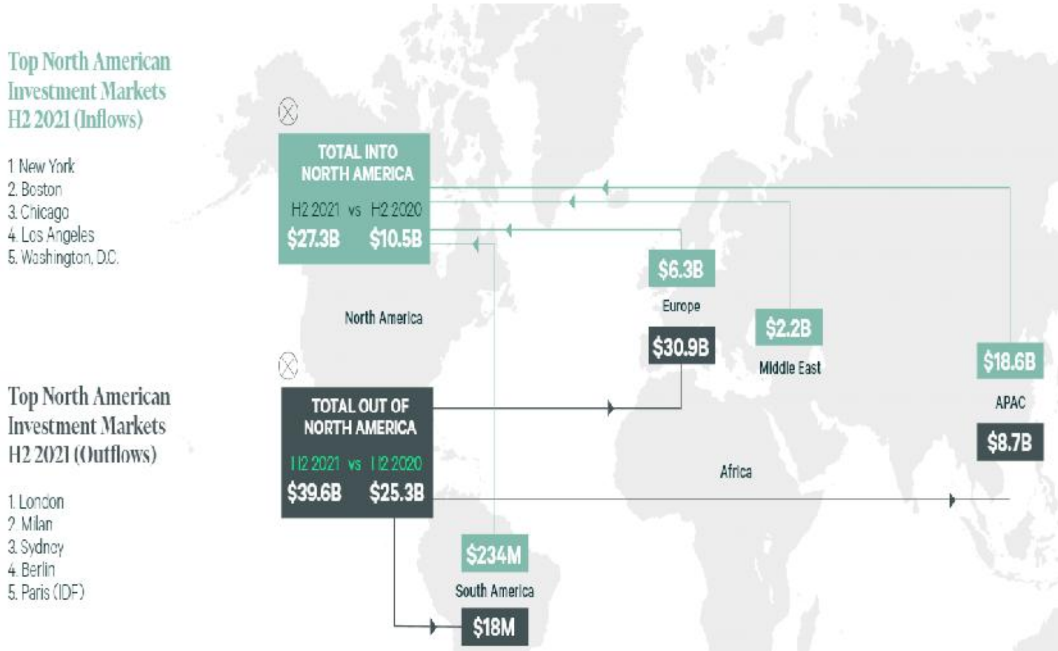
15.7 Globalization of Financial Markets

- Even the most cursory review of major international economic trends over the past several decades shows there have been revolutionary changes in world financial markets.
- During the 1950s and 1960s, financial institutions and their regulatory structures in major industrial countries evolved in relative isolation from external developments.
- During those years, most countries, including the United States, imposed restrictions on international capital movements
- Major international institutional agreements after World War II, such as the Bretton Woods agreement and the General Agreement on Tariffs and Trade, liberalized world trade but did little to free the movement of international capital.
- After the financial disruptions of the 1930s, many had questioned whether free capital flows and liberalized capital markets were even desirable.
- In the International Monetary Fund, the basic obligation of member nations—their code of good behavior—was framed exclusively in terms of avoiding restrictions on current account payments: that is, payments for merchandise trade, international services, investment incomes, and payments, remittances, and official government transfers.
- Meanwhile, the rules and the philosophy with respect to capital transactions were far different: many countries restricted outward capital transfers either because they preferred their capital to be invested within their domestic economies or because they wished to prevent downward pressure on their exchange rates.
- That situation and those views changed dramatically in the 1970s, and the pace of change accelerated in the 1980s.
- The interaction of several powerful forces has produced massive capital flows across national boundaries.
- At the same time, the structure and operation of world financial markets have been transformed.
- Today, world financial markets are highly integrated, and transactions have become increasingly complex.
- These phenomena are reflected in the cross-listing of securities in several countries, cross-country hedging and portfolio diversification, and 24-hour trading in financial instruments at exchanges around the world.
- Many of the channels used for financial transactions have also changed.
- There has been a major shift, relatively, from banks to nonbank financial intermediaries, such as brokerage houses, securities firms, insurance companies, and pension funds.
- There has also been a shift from loans to securities and a rise in the use of foreign financial centers.
- In addition, there has been a surge in the use of new financial instruments and, in particular, derivative products (such as financial options, futures, and swaps on interest rates, foreign currencies, stocks, bonds, and commodities).

- These instruments have been developed to meet the needs and preferences of different customers, including their desire to hedge risks in an environment of fluctuating exchange rates, interest rates, stock prices, and commodity prices.
-

Recent Trends in Global Capital Flows (Asia-Pacific)

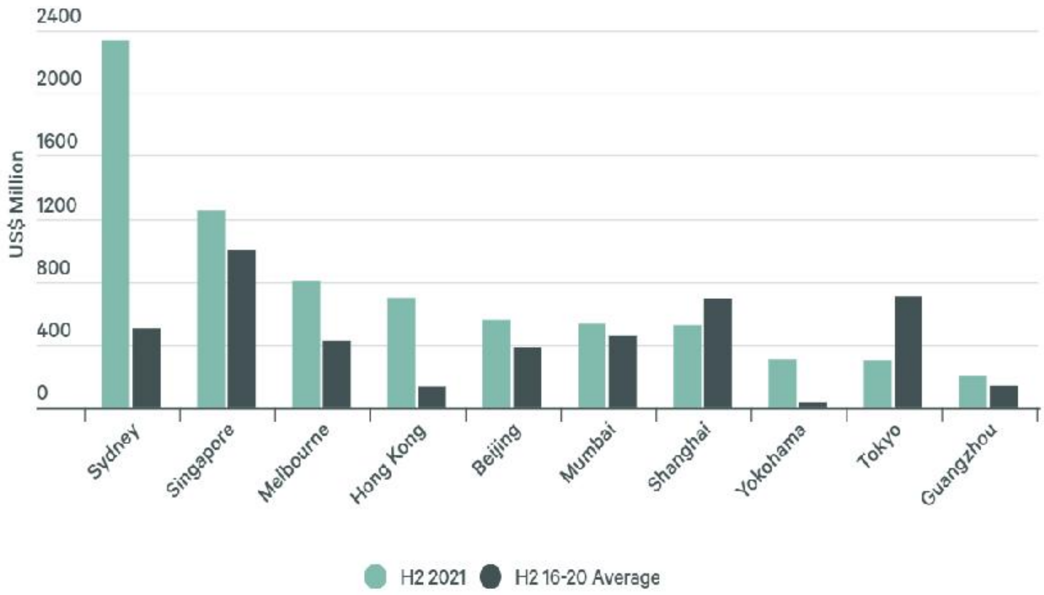
Recent Trends in Global Capital Flows (New YorkInvestment Markets)



- Cross-regional global capital flows to APAC, North America, and Europe in H2 2021 increased by 60% year-over-year to a near-record half-year total of US$77.5 billion. This represented a 13% increase over the average H2 total between 2016 and 2020.
- Despite market turbulence due to the COVID pandemic, certain cross-regional investment trends remained intact.
- APAC investors were the most aggressive relative to their market size, registering the largest amount of outflows versus inflows across all major regions.
- Europe remained the biggest recipient of foreign inbound investment, both nominally and relative to its market size while being the smallest contributor to cross-regional outflows.

North America was again the largest contributor to global cross-regional outflows and the second largest recipient of foreign inflows.

Cross Regional Inflows by Market (Asia-Pacific)



Cross Regional Inflows by Market (North-america)

Further Growth Expected in 2022

- Robust global cross-regional capital flows to APAC, North America, and Europe totaling a record US$77.5 billion in H2 helped to catalyze a surge in global investment volume in 2021.
- This was in sharp contrast with H2 2020 when cross-regional capital flows bottomed out due to COVID-driven market uncertainty and travel restrictions.
- Travel restrictions have eased in most regions and pandemic-related market uncertainty is waning.
- APAC and North American investors are expected to remain very active outside their home regions in 2022, while the recovery of outflows from Europe and the Middle East likely will continue.

Role of International Capital Movements

- Traditionally the capital movements were considered important as they assisted in the maintenance of BOP equilibrium.

- A country, having a BOP surplus, will invest or lend capital abroad and thereby offset the payments surplus.
- On the opposite, given a BOP deficit, it could borrow capital from abroad and remove the deficit.
- In other words, the capital movements had a specific role in balancing the international payments and receipts.
- In the context of LDC's like India, the international capital flows or foreign aid have much vital role to play.
- The international capital assistance may be in the form of private and public foreign investments, loans from foreign nationals, business and financial institutions, central banks, governments, and international economic institutions such as the International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD),
- International Finance Corporation (IFC), International Development Association (IDA), and several other agencies.
- The capital transfers may also be in the form of private or inter-governmental unilateral assistance and technology transfer.

Benefits of International Capital Flows

- The major benefits or advantages of capital transfer from the advanced to the LDC's are as follows
- Increase in the Rates of Saving and Investment
- Technological Change
- Creation of Economic and Social Overheads
- Development of Heavy and Basic Industries
- Undertaking of Initial Risk
- Check upon Inflationary Pressures
- Creation of Employment Opportunities
- Removal of BOP Deficit
- Beneficial for Labour
- Modern Value System

15.8 Problems of International Capital Flows

- Even if the benefits of international capital flows are fully acknowledged, yet it is not realistic to overlook certain dangers inherent in it or the problems that are associated with them

(1) Wasteful Use of Foreign Capital

- The foreign capital, when easily available or when available free or at the concessional interest rate is likely to be mutualized in the low priority projects engaged in the production of luxury goods or other wasteful products.
- In the LDC's, foreign collaborations are sometimes sought to produce non-food consumer articles such as toilet soaps, tooth pastes, cosmetics etc.
- There is not only the wastage of foreign capital, when it is utilized in the production of these items, there is also the wastage of indigenous capital that supplements the foreign capital.

(2) No Increase in Net Investment

- The LDC's frequently resort to controls on the inflow and use of foreign capital.
- There are also restrictions on the remittances of profits and repatriation of capital.
- It results in a reduction in the inflow of capital from abroad.
- The regime of controls makes the indigenous and foreign enterprises to operate with excess capacity.
- There is some tendency among both the domestic and foreign investors to shy away from such countries.
- On account of the outflow of capital due to exit policy of foreign and indigenous investors coupled with heavy annual debt servicing liabilities, the capital outflow many often exceeds the inflow of capital.
- This amounts to a net reduction in the inflow of capital or investment in the LDC's.
- In addition, an easy availability of foreign capital tends to reduce the domestic tax effort for stepping up investment.
- Thus the foreign capital may not promote investment. It may rather lead to a net reduction in investment.

(3)Increase in External Debt Burden

- If the foreign capital is employed for unproductive purposes or for financing consumption, the burden of external debt tends to increase.
- Except for only a few among the developing countries, there has been a general failure in raising the income-earning capacity through external capital.
- Between 1991 and 2000, the external debt burden rose from 116.5 billion U.S. dollars to 238.0 billion dollars in the case of Brazil,
- From 101.7 billion dollars to 150.3 billion dollars in case of Mexico and
- From 71.6 billion dollars to 100.4 billion dollars in case of India. India's external debt stood at US $ 262.3 billion in 2010. It increased sharply up to US $ 442.3 billion in 2014.

(4)Inflationary Conditions

- Foreign aid has moderating effect on inflation. However, the foreign capital and investment may reinforce the inflationary pressures in the LDC's.
- It is generally found that foreign capital is used in the developing countries for setting up ambitious capital-intensive projects which have a prolonged gestation period.
- The increased investment spending and consequent increase in factor incomes, given the less elastic supply function of output, is bound to strengthen the inflationary conditions.

(5)Balance of Payments Problem

- The LDC's have low capacity to export which is eroded further because of increasing domestic price trends.
- A larger flow of aid in the form of commodities, services and capital, at the same time, tends to increase the BOP deficit.

(6) Financing of Uneconomic Activities

- It is believed that the foreign assistance can contribute in relieving the shortages of food and raw materials and in promoting the production of exportable goods and import substitutes.
- But the experience has shown otherwise. The foreign aid, in the form of loans, is frequently used in the financing of uneconomic activities or projects

(7)Unsuited Technology

- It is true that the foreign capital can bring new technology into the LDC's.
- But it has been the experience of these countries that technology offered to them is either obsolete from the standards of the advanced countries or it is not in conformity with their resource endowments.
- The introduction of capital-intensive and labor-saving technology in the capital-deficient and labor-surplus poor countries causes the serious problems like inflation, unemployment and BOP deficit.

Summary

We gave a general summary of the world's equities markets in this section. The chapter offered practical statistical data that supports our discussion. Over time, there has been an increase in stock trading internationally, but this growth has been constrained by three factors: transaction costs, information costs, and exchange rate risk. Many investors buy equities outside of their native nation, just as some MNCs issue stock outside of their home country. Such a tactic makes sense for a number of reasons. Initially, these investors might purchase equities in local companies because they anticipate favourable economic prospects in that nation. Second, since doing so would increase the return on their investment, investors could choose to purchase stocks denominated in currencies they anticipate strengthening over time.Lastly, some investors diversify their portfolios by purchasing equities from different nations. As a result, their investment is less vulnerable to potential negative stock market conditions in their place of residence. In general, countries where management of companies are encouraged to make decisions that promote shareholder interests have stronger stock market involvement and trading activity. Investors are unlikely to purchase stocks of a country's companies if they think their money won't be utilised to further their interests or that the companies don't provide clear reporting of their financial or operational status. Local investors must have confidence in the market in order for it to be active, and as investor confidence grows, so does trading.

Keywords

International mutual funds (IMFs) : Own stock portfolios from a variety of nations.

Dealer market: a market where trade is facilitated by a market middleman, the dealer, who buys and sells from their own inventory.

Market Order: anorder to buy or sell something at the current market value.

Limit order: anorderto buy or sell something at a certain maximum or minimum price.

Floating Rate Bonds: In the case of floating rate bonds, the interest rate on bonds (or loans) will change over time in accordance with market reference interest rates, such as the bank bill swap rate or the London Interbank Offered Rate (LIBOR);

Self Assessment

1. Which of the following statements is wrong in regard to choice between fixed and floating rate debt?

A. The main consideration is whether the company expects interest rates to rise or fall during the tenure of the bond.

B. In the case of floating rate bonds, the coupon rate on bonds (or interest rate on loans) will fluctuate over time in accordance with market reference interest rates

C. The coupon rate of a floating rate bond changes with the market reference rate

D. A floating coupon rate is beneficial to the bond issuer during periods of increasing interest rates

2. Identify which is wrong in regard to choice between fixed and floating rate debt?
A. An MNC should first forecast the LIBOR for each year to estimate its annual interest rate before deciding to finance with floating rate loans whose rate is tied to the LIBOR.
B. The company can therefore forecast interest payments for all years of the loan.
C. Using these estimates, it can then estimate the annualised cost of financing.
D. This cost should then be compared to the cost of financing with a non-fixed interest loan before a decision is made to take either floating rate or fixed rate loans.

3. Identify which is wrong in regard to choice between fixed and floating rate debt?
A. An MNC's subsidiary may consider long-term financing in a foreign currency different from its local (host country) currency in order to reduce financing costs.
B. The international bond market has two segments: eurobonds and foreign bonds.
C. A eurobond issue is denominated in a particular currency and issued to investors in a country with a different currency.
D. None of These

4. A foreign bond is one issued by a foreign borrower but denominated in the foreign currency.
A. When determining the debt denomination to finance a specific project, an MNC can conduct the capital budgeting by deriving the NPV based on the equity investment, and the cash flows from the debt can be directly accounted for within the estimated cash flows.
B. This allows for explicit consideration of the exchange rate effects on all cash flows after considering debt payments.
C. This allows for implicit consideration of the exchange rate effects on all cash flows after considering debt payments.
D. By applying this method an MNC can assess the feasibility of a particular project based on various debt financing alternatives

5. Which of the following is wrong about Financing costs of loans with different maturities?
A. When there is an upward-sloping yield curve, the MNC may be tempted to finance the project with debt over a shorter maturity in order to achieve a lower cost of debt financing, even if doing so means that funds will still be required beyond the life of the loan.
B. The MNC may incur higher financing costs when it attempts to obtain additional funding after the existing loan matures if market interest rates are higher at that time.
C. The MNC always incurs lower financing costs when it attempts to obtain additional funding after the existing loan matures if market interest rates are higher at that time.
D. It must therefore decide whether to obtain a loan with a maturity that perfectly fits its needs, or one with a shorter maturity and a more favourable interest rate and then seek additional financing when this loan mature.

6. Which of the following is wrong in regard to Accounting for uncertainty of financing costs?
A. The estimated cost of debt financing by the subsidiary when it borrows a different currency than that of its host country is highly sensitive to the forecasted exchange rates.
B. An MNC that uses inaccurate exchange rate forecasts could make the wrong decision regarding the currency in which to denominate its subsidiary's debt.

C. It can at least account for the uncertainty surrounding the point estimates of exchange rates by using sensitivity analysis, in which alternative forecasts of the exchange rate are tested for each period in which a loan payment will be provided.

D. For each set of exchange rate forecasts, the MNC need not estimate the cost of financing.

7. Which of the following is wrong in regard to Combining debt financing with forward hedging

A. When a subsidiary becomes more exposed to exchange rate risk by borrowing a currency other than that of its host country, it might be worthwhile to consider hedging that risk.

B. Forward contracts may be available on some currencies for five years or longer, which could allow the subsidiary to hedge its future loan payments in a particular currency.

C. However, this hedging strategy may not be enough for the subsidiary to achieve a lower debt financing rate than it could by borrowing its host country currency

D. When a subsidiary becomes more exposed to exchange rate risk by borrowing a currency other than that of its host country, it is not worthwhile to consider hedging that risk.

8. Which of the following is wrong in regard to Debt decision in host countries with high interest rates?

A. When an MNC's subsidiaries are based in developing countries such as Brazil, Indonesia, Malaysia, Mexico and Thailand, they may be subject to relatively high interest rates.

B. An Australia-based MNC may consider providing a loan in Australian dollars so that the subsidiary can avoid the high cost of local debt. It will not force the subsidiary to convert some of its funds to dollars in order to repay the loan.

C. Recall that countries where interest rates are high tend to have high expected inflation and that currencies of countries with relatively high inflation tend to weaken over time.

D. Thus, by attempting to avoid the high cost of debt in one currency, the subsidiary of an Australian MNC becomes more highly exposed to exchange rate risk.

9. Which of the following is wrong in regard to DEBT DENOMINATION DECISION BY SUBSIDIARIES?

A. If subsidiaries of MNCs match the currency they borrow with the currency they use to invoice their products, then their cost of debt will depend on the local interest rate of their host country.

B. long-term risk-free bond yields can vary among countries.

C. The cost of debt to a subsidiary in any of these countries would beslightly lower than the risk-free rates shown here because it would contain a credit risk premium.

D. A subsidiary in a host country where interest rates are high might consider borrowing in a different currency in order to avoid the high cost of local debt.

10. Which of the following is wrong in regard to FINANCING WITH EURONOTES AND EURO-COMMERCIAL PAPER?

A. Issuers have two choices in financing with euronotes. They may use the note issuance facility (NIF) or euro-medium-term notes (euro-MTNs).

B. The NIF allows borrowers to issue their own short-term notes, which are then placed by financial institutions providing the NIF.

C. Several NIFs include underwriting arrangements as part of the deal.

D. When the borrower is ready to push the facility, it issues euronotes with one-month, three-month, six-month and 12-month maturities

11. Which of the following is wrong about THE EUROBOND AND FOREIGN BOND MARKETS?

A. A eurobond issue is denominated in a particular currency and sold to investors in a capital market other than the country that issued the denominating currency.

B. An example of a eurobond issue is the bond issued by an Australian company denominated in Australian dollars to New Zealand investors.A foreign bond, on the other hand, is one offered by a foreign borrower to investors in a national capital market denominated in the nation's currency.

C. A foreign bond, on the other hand, is one offered by a foreign borrower to investors in a national capital market denominated in the nation's currency.

D. For example, bonds denominated in Chinese renminbi and sold to offshore investors are called dim rum bonds.

12. Which of the following is wrong in regard to Investment in MNC stocks?

A. The operations of an MNC are a form of international diversification

B. Like an investor with a well-managed stock portfolio, an MNC can reduce risk (variability in net cash flows) by diversifying sales not only among industries but also among countries.

C. the MNC as a single company can achieve stability similar to that of an internationally diversified stock portfolio.

D. If MNC stocks behave like an international stock portfolio, then they should not be sensitive to the stock markets of the various countries in which they operate

13. Which of the following is wrong in regard to Direct purchases of foreign stocks?

A. Foreign stocks can be purchased on foreign stock exchanges.

B. Such purchases require the services of brokerage companies that can execute the trades desired by investors at the foreign stock exchange of concern.

C. However, this approach is efficient because of market perfections such as sufficient information, absence of transaction costs, and tax differentials among countries.

D. An alternative method of investing directly in foreign stocks is to purchase stocks of foreign companies that are sold on the local stock exchange

14. Which of the following is wrong in regard to taxes?

A. The tax effects of dividends and capital gains also vary among countries

B. The lower a country's tax rates, the higher the share of pretax cash flows received that the investor can retain

C. Other things being equal, investors based in high-tax countries should value stocks higher.

D. The valuation of stocks by investors within a given country changes in response to changes in tax laws

15. Which of the following is wrong in regard required rate of return ?

A. Some investors attempt to value a stock according to the present value of the future cash flows that it will generate.

B. The dividend discount model is one of many models that employ this approach.

C. The required rate of return that is used to discount the cash flows can vary substantially among countries, but it is always based on the prevailing risk-free interest rate available to investors plus a risk premium.

D. Investors in an emerging country that has a low risk-free rate would be unwilling to accept such a low return. If they can earn a high return by investing in a risk-free asset, they would require a still higher return to invest in risky assets such as stocks.

Answers for Self Assessment

1.	D	4.	C	7.	D	10.	D	13.	C
2.	D	5.	C	8.	B	11.	D	14.	C
3.	D	6.	D	9.	C	12.	D	15.	D

Review Questions

(1) Will the price of equity decrease if foreign equity is issued in active markets?

(2) Describe the rationale behind an MNC issuing equity in a currency other than its home currency to fund local operations. Describe the danger involved.

(3) An Australian multinational corporation has the option of selling shares in the nation where its subsidiary is located or in its home market. What are the primary elements that the business should think about when making this choice?

(4) Active international investor Jenna Schott sold shares of the Nestle Company for 5200 Swiss francs (CHF). She had previously paid CHF4500 for this stock. The current exchange rate is A$1.3520 to CHF. The currency exchange rate was A$1.60 to CHF at the time of purchase. Just before she sold her shares, Jenna got a dividend of CHF 100. Compute the rate of return on her investment in Australian dollar terms

(5) Rob Grady bought shares of the Chinese company Vopka a year ago. The stock's value dropped by 20% during the past year. Yet, the value of the Chinese yuan increased by 40% over this time. What would Rob's percentage return be if he sold the Vopka stock right now?

Further Readings

International Financial Management 2ndEdition by Jeff Madura Ariful Hoque Chandrasekhar Krishnamurti, 2018

International Financial management by Eun,Resnick and Chuluun. Ninth edition. McGraw-Hill Education

International Accounting by Timothy S Doupnik_ Hector Perera, McGraw-Hill Education (2014).

Unit 16: Capital Market Operations

CONTENTS

Learning Outcome:

After studying this unit, you should be able to understand:

- understanding debt and non-debt flows
- impact on the economy of debt and non-debt flows
- understand the historical perspective on global capital flows
- analyse the factors affecting global capital flows
- understand impact of Interest rate differentials on exchange rates

Introduction

Capital flows are transactions involving financial assets between international entities. Financial assets to be included can be bank deposits, loans, equity securities, debt securities, etc. Capital outflow generally results from economic uncertainty in a country, whereas large amounts of capital inflow indicate a growing economy.Capital flows refer to the movement of money for the purpose of investment, trade, or business operations. Inside of a firm, these include the flow of funds in the form of investment capital, capital spending on operations, and research and development (R&D).Capital flows occur at nearly every scale, from individuals to firms to national governments. Different sub-sets of capital flows are often scrutinized by analysts such as asset-class movements, venture capital flows, mutual fund flows, capital spending budgets, and the federal budget.On a larger scale, a government directs capital flows from tax receipts into programs and operations and through trade with other nations and currencies. Individual investors direct savings and investment capital into securities, such as stocks, bonds, and mutual funds.Within the United States, the federal government and state-level organizations aggregate capital flows for the purpose of analysis, regulation, and legislative efforts.In the financial markets, asset-class movements are measured as capital flows between cash, stocks, bonds, and other financial instruments, while venture capital shifts in regards to investments being placed in startup businesses. Mutual fund flows track the net cash additions or withdrawals from broad classes of funds.It is widely recognized that international capital flows have nontrivial consequences for macroeconomic outcomes. The history of financial crises has taught us that the vulnerability to external shocks can vary greatly depending on which economic sector(s) are on the receiving side of capital inflows. For example, sovereign debt proved to be the Achilles' heel in the Latin American crises, while private sector debt financed by capital inflows was the key source of fragility in the Asian financial crises. During the 2008 global financial crisis, in the US, the culprit was the domestic household debt held by the US and global banks. By contrast, in the European countries, sovereigns' and banks' external borrowing played the central role, which culminated in a sudden stop.Capital-spending budgets are examined at the corporate level to monitor growth plans, while federal budgets follow government spending plans. The relative strength or weakness of capital markets can be shown through analyzing such capital flows, especially in contained environments like the stock market or the federal budget. Investors also look at the growth rate of certain capital flows, such as venture capital and capital spending, to find any trends that might indicate future investment opportunities or risks.As part of standard business operations, companies may look to purchase commercial real estate to house production activities. Additionally, many individuals see the purchase of real estate as an investment that produces rental income. These may be classified as investment or business capital flows depending on the analysis.

16.1 Trends in Capital Flows

- One of the biggest investing trends of the past several years involves the massive amounts of capital flow from active management into passive strategies such as exchange-traded funds (ETFs).
- For January 2018, \$41.2 billion of investor capital flowed into U.S. equity passive funds, surpassing the \$22.5 billion of inflows in December.
- Meanwhile, \$24.1 billion in capital flowed out of active funds, compared to \$16.3 billion in December.
- The path of capital flows also moved to other asset classes. For example, the taxable bond category proved the most popular in January, seeing \$47.0 billion in inflows, with active and passive drawing almost equal capital.

Figure O.1 **Aggregate Net Financial Flows to Low and Middle-Income Countries, Excluding China, 2011–20**
US\$ (billion)

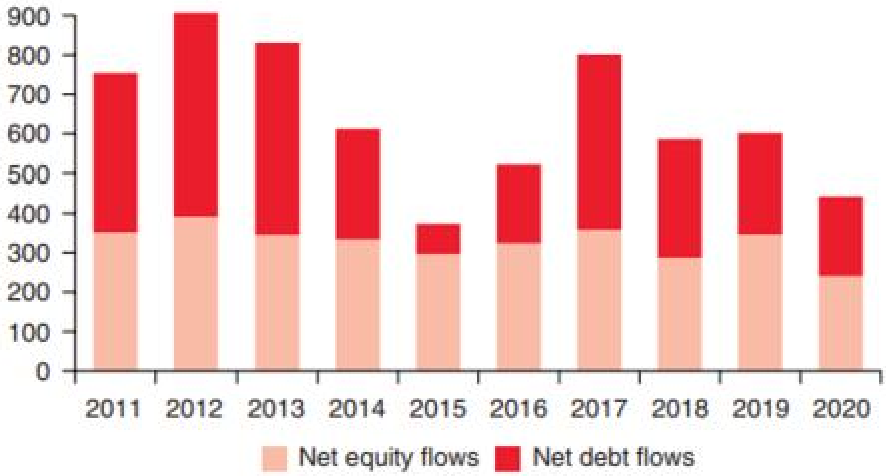


Figure O.2 Aggregate Net Financial Flows to Major Borrowers and Other Low- and Middle-Income Countries, 2019–20

US$ (billion)

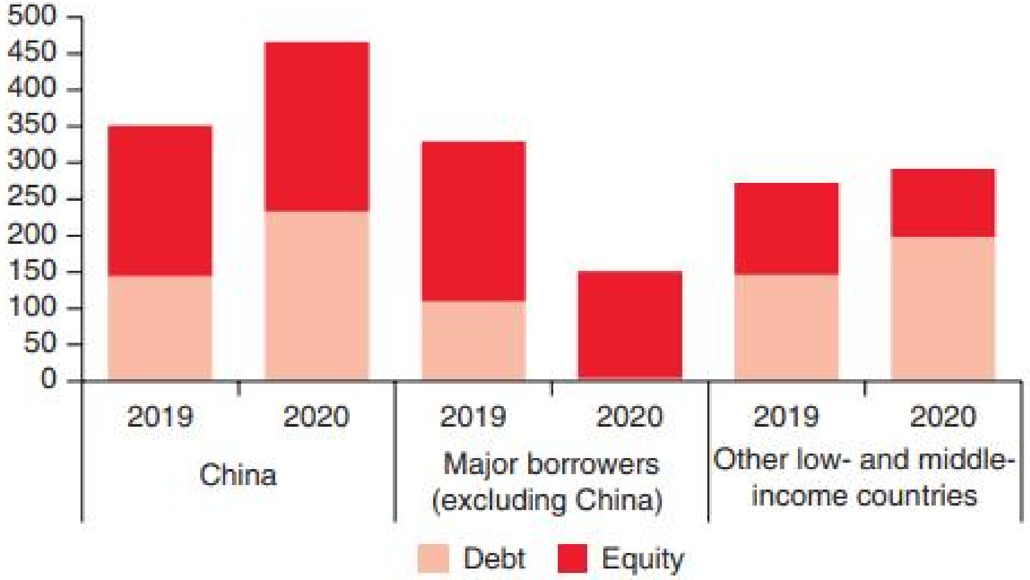
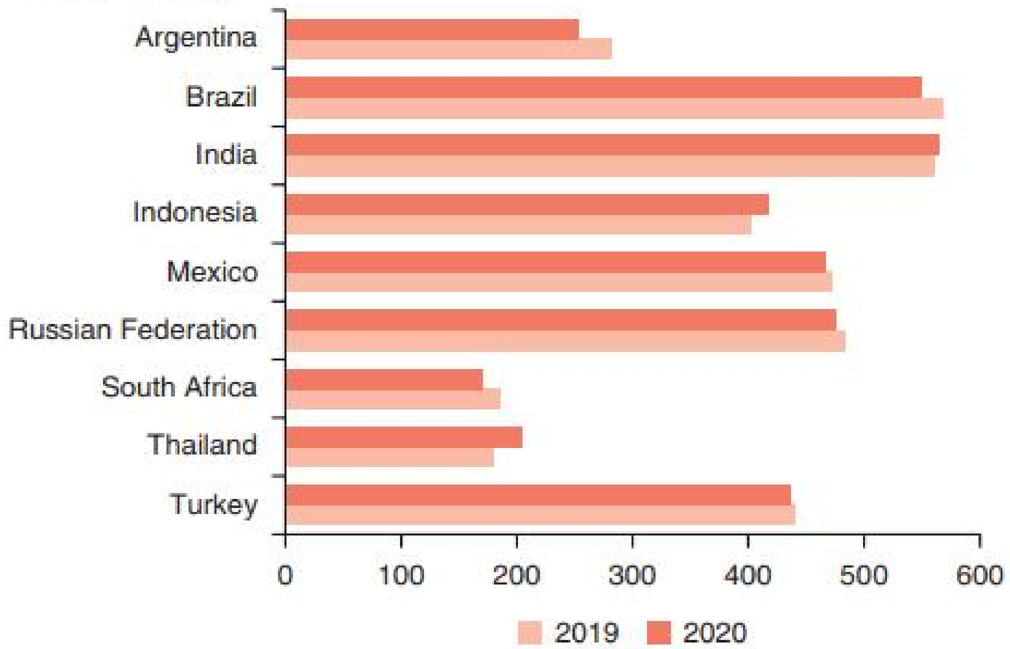


Figure O.4 Top-10 Low- and Middle-Income Borrowers, Excluding China, 2019 and 2020

US$ (billion)



16.2 A Perspective on Global Capital Flows

- Globalization has received a bad rap lately, being blamed for lost jobs, depressed wages, rising income inequality, Brexit, and the election of Donald Trump.
- As the European Central Bank's President Mario Draghi observed at a gathering of central bankers at Jackson Hole, the social consensus for open markets has weakened due to perceptions that the costs of globalization outweigh the benefits.
- Globalization has received a bad rap lately, being blamed for lost jobs, depressed wages, rising income inequality, Brexit, and the election of Donald Trump.
- As the European Central Bank's President Mario Draghi observed at a gathering of central bankers at Jackson Hole, the social consensus for open markets has weakened due to perceptions that the costs of globalization outweigh the benefits.
- Financial globalization, the flow of capital between countries, is also viewed through a glass-half-full/glass-half-empty prism: your view on global capital flows will depend on whether you concentrate on the benefits, or the problems associated with such flows.
- The Mckinsey Global Institute’s latest report on financial globalization analyses changes in cross-border capital flows in the decade after the global financial crisis.
- Since 2007 gross border capital flows have fallen by 65% in absolute terms and by four times relative to global GDP.
- Most of this decline is a reduction in foreign business by banks in Europe, Switzerland, the UK and some US banks, in part a response to their excessive foreign lending before the crisis and tighter regulation on capital and liquidity.
- But the McKinsey authors conclude that financial globalization is not dead, for the stock of foreign investment relative to global GDP has changed little since 2007 and, they argue, the changes in the capital flow should be more stable because less volatile FDI and equity flows now represent a greater share of capital flows.
- Greater efforts are needed to deal with the potential volatility of capital flows, but this will require much more than the IMF elevating the use of capital flow management tools in the advice it gives emerging markets.
- The challenge facing developing countries and emerging markets needs to be put in context.
- Specifically, in order for them to achieve the 2030 Sustainable Development Goals (SDGs) that were adopted by all countries in 2015, and commitments under the Paris Agreement on Climate Change, more rather than less financial globalization is required.
- Homi Kharas and John McArthur from the Brookings Institute have highlighted that new investment demands required under the Sustainable Development Goals (SDGs) and Paris Accord will involve a major increase and reorientation of public and private financing in emerging markets, and they will need a significant increase in foreign capital inflow.
- One of the positive developments in the structure of cross-border capital flows over the past decade is that developing countries have become net recipients of global capital rather than net providers.
- Theory suggests that capital should flow from richer economies with higher volumes of capital and lower marginal returns to (poorer) economies with lower capital stock and potentially more profitable investments.
- Prior to the crisis, however, the opposite was the case with capital flowing ‘uphill’ from poorer to richer economies.
- Since the crisis, capital is now flowing ‘downhill’ and developing countries are net recipients of global capital. To meet the Sustainable Development Goals (SDGs), this will have to increase.
- Dealing with the potential volatility associated with global capital flows is a challenge facing individual countries and the international community.
- The IMF introduced its Institutional View on liberalization and capital flow management in 2012.

- Its purpose is to provide a consistent basis on which the IMF makes recommendations to its members on capital flow management.
- At its core is the view that sound macroeconomic and fiscal policies, including exchange rate flexibility, are essential for countries to reap the benefits of capital flows while mitigating risks.

16.3 Factors Affecting Global Capital Flows

Global macroeconomic factors have a continuous impact on capital flows. Let's explore them to understand the impact on global flows.

1) The Rate Of Interest

The differences in the rate of interest between countries serve as the most important stimulus for the export and import of capital.

Capital will flow from a low-return yielding country to a high-income yielding country because a country which has a low rate of interest apparently finds it profitable to export capital to the country in which the interest rates are high.

2) Speculation

Speculation may also determine the short-term capital flow between countries. Speculation may pertain to either expected change in the interest rate or anticipation of the change in the rate of exchange.

When people expect the rate of interest to rise at home in the future, they would like to take advantage of the consequent lower bond price then, but presently they will invest abroad in short-term securities.

Thus, when a country expects a rise in interest rate in future it will experience an outflow of capital for the present.

Contrarily, when a country anticipates a fall in the rate of interest in future, it pays foreigners to buy bonds and securities at their current low price and sell them later on at a high price. Eventually, it will experience an inflow of capital.

Similarly, if a devaluation of a country's currency {i.e., a fall in its exchange rate) is expected, residents of the country will tend to hold foreign balances by converting their currency into foreign assets – bonds and securities; in the same manner, non-residents of the country also may withdraw their investments in the short-term securities of their country by selling them and taking back their capital.

As such, an anticipated devaluation leads to capital flight abroad.

Similarly, if revaluation, i.e., a rise in the exchange rate of a country's currency, is expected the inflow of capital will get momentum.

3) Bank Rate

Since bank rate has a link with market rates of interest, the central bank can use the bank rate as means of including short-term capital flows.

The raising of bank rate, thus, may stimulate an inflow of capital or prevent the flight of capital abroad.

4) Marginal Efficiency of Capital

For investing abroad entrepreneurs may compare the marginal efficiency of capital against the rate of interest between different countries and in different areas of investment.

Thus, the country which has a marginal efficiency of capital will attract an inflow of capital.

Likewise, a particular field of long-term investment will be chosen where the expected rate of returns is higher than that of alternative investments abroad.

5) Political Climate

Apart from good prospects for foreign capital, if a country has political stability and internal and external peace, so that, economic and social progress is maintained, it will experience a better inflow of long-term direct investment than otherwise.

6) Government's Policy

If the government is bent upon nationalization and expansion of public sector and adopts a hostile attitude towards foreign capital, private foreign capital will not move into such a country.

On the other hand, if government adopts an encouraging policy in respect of foreign capital, it may induce inflow of foreign capital.

7) Economic Climate

The overall healthy economic position of the country, such as the development of infrastructure of the economy, growth of financial institutions, availability of trained and skilled labour and other production facilities will play a significant role in attracting inflow of capital from abroad.

Similarly, certain unexploited fields of exporting industries like plantations, mines etc., also provide a good attraction to foreign investors.

8) Tariff Policy

A high protective duty may prevent foreigners export to such a country, so it will be profitable for the foreigner to start production in the protected country to compete with domestic producers.

Direct foreign investment is thereby attracted.

9) Exchange Control Policy

A country resorting to severe exchange control will put automatic restriction on the outflow of capital abroad.

10) Business Condition

Capital will tend to flow from a country experiencing depression into a country which is in prosperity.

16.4 Interest Rate Differential (IRD)

The direct difference between the percentage interest rates of two investments that are comparable is known as the interest rate differential (IRD).

IRD is mainly sought after in the carry trade, real estate, and FX markets.

By attempting to maximise profits or reduce cost/loss, it might help in comparing two mortgage or investment possibilities. This makes decision-making more effective.

In contrast to IRD, which presumes a difference in interests between two countries, net interest rate differential (NIRD) is a sort of IRD. As a result, there is a relationship between the exchange rate and the interest rate disparity.

IRD can assist investors in choosing the assets they wish to purchase. Investors continually check the IRD and steer clear of a negative one because trading and investing are about making money. Similarly, individuals can look at the differences in mortgage interest rates and make wiser borrowing decisions in the property market. Interest rate differential has become a popular financial term, particularly in the wake of the economic developments that occurred during the first ten years of the twenty-first century. As a result, people were aware of how negative IRD might harm their profitability.

Yet, why are the interest rates different? First off, it can be because the investments' risk profiles differ. Investment risk has an impact on returns. Second, another element is the asset's nature. Depending on the form of security—a bond, stock, etc.—the interest rate varies.

Thirdly, the interest rate may change as a result of market flaws and inefficiencies. This frequently depends on the nation's economic status. Finally, supply and demand have an impact on interest rate, just like they do on price. This may also be the reason why the interest rates on two comparable assets vary.

Let's now talk about the function of IRD. First, there is a significant correlation between the exchange rate and the interest rate disparity. The NIRD has an impact on currency trading specifically. Second, it is most noticeable over the entire mortgage and is also reflected in mortgage interest rates.

The role of IRD in stock trading can also be evident when two comparable assets have varying interest rates. It is employed specifically in the carry trade, a technique where investors borrow money at low rates of interest and then invest the money in a high-return asset.

Calculation

Let's talk about the formula for the interest rate differential:

IRD is equal to the difference between the interest rates on the two investments.

The calculation is quite straightforward, and numerous internet tools, such as an interest rate differential calculator, make it simple for investors or borrowers to figure out the difference.

Let's now examine some illustrations.

#1 – Bond

The comparison of EUR/USD would be the greatest illustration. Let's say John has $500 on him. He exchanges it for euros and purchases shares of German company X. The investment is anticipated to have an interest rate of 9%. The interest rate on John's investment would have been 8% had he instead used the dollars to invest in US company Q. Thus, the IRD in this case is,

= 9% – 8%

= 1%

Interest Rate Differential (IRD) vs Net Interest Rate Differential (NIRD)

The primary distinction between IRD and NIRD is that the former is utilised in relation to the foreign exchange market, stock market, real estate market, etc. Nonetheless, NIRD is utilised to determine the difference between interest rates in two nations. Hence, NIRD refers to currencies and is employed in the context of FX markets.

To comprehend the variation in interest rates and how they can effect the returns on investment, traders and financial specialists thoroughly study NIRD. The difference in interest rates for various assets or investments, mortgage interest rates, etc. is what both essentially compare.

16.5 COMPARISON OF THE IRP, PPP AND IFE

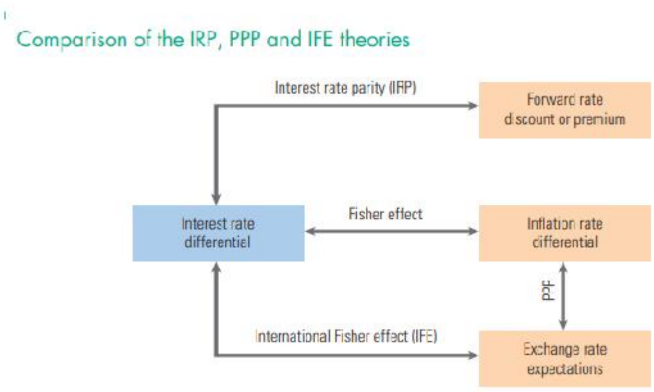
Three related theories of international finance—interest rate parity (IRP), purchasing power parity (PPP), and the international Fisher effect—can be compared at this point (IFE).

Each theory's major ideas are summarised in Exhibit 7.14. Even though all three of these ideas deal with how exchange rates are set, their effects are distinct. The IRP hypothesis focuses on the reasons why the forward rate and spot rate are different, as well as how much of a difference there should be at any given time.

The PPP and IFE theories, on the other hand, both concentrate on how the spot rate of a currency will alter over time. IFE theory predicts that the spot rate will change in response to interest rate differentials, as opposed to PPP theory's prediction that it will fluctuate in response to inflation differentials. Nonetheless, PPP and IFE are connected because nominal interest rate differentials between two countries are influenced by projected inflation differentials.

Theory	Key variables of theory		Summary of theory
Interest rate parity (IRP)	Forward rate premium (or discount)	Interest rate differential	The forward rate of one currency with respect to another will contain a premium (or discount) that is determined by the differential in interest rates between the two countries. As a result, covered interest arbitrage will provide a return that is no higher than a domestic return.
Purchasing power parity (PPP)	Percentage change in spot exchange rate	Inflation rate differential	The spot rate of one currency with respect to another will change in reaction to the differential in inflation rates between the two countries. Consequently, the purchasing power for consumers when purchasing goods in their own country will be similar to their purchasing power when importing goods from the foreign country.
International Fisher effect (IFE)	Percentage change in spot exchange rate	Interest rate differential	The spot rate of one currency with respect to another will change in accordance with the differential in interest rates between the two countries. Consequently, the return on uncovered foreign money market securities will, on average, be no higher than the return on domestic money market securities from the perspective of investors in the home country.

Source: Jeff Madura, Ariful Hoque, Chandrasekhar Krishnamurti, 2018



Source: Jeff Madura, Ariful Hoque, Chandrasekhar Krishnamurti, 2018

Using these theories allows for the creation of some generalisations regarding nations. Countries with high inflation typically have high nominal interest rates (due to the Fisher effect). Due to the PPP and IFE, their currencies tend to depreciate over time, and the future rates of their currencies typically show significant discounts (due to IRP).

Financial managers who support PPP are aware that the exchange rate movement in any given period won't necessarily follow the difference in inflation rates between the two countries under consideration. Yet, these managers may continue to base their best assessment of the anticipated exchange rate movement on the inflation differential. Financial managers who adhere to IFE understand that the movement of the exchange rate in any given period won't always follow the difference in interest rates between the two countries in question, but they may still use the interest rate differential to determine their best estimate of the expected exchange rate movement.

From an Australian perspective, the forward premium of a currency is affected by both the interest rate of that currency and the interest rate of the Australian dollar. As these interest rates fluctuate over time, it follows that the future premium does as well. So, if a currency's interest rate climbs above the Australian level, a forward premium that was significant and positive in one period when that currency's interest rate was relatively low, could turn negative (indicating a discount).

16.6 Demand and Supply for Foreign Exchange

Demand for Foreign Exchange:

1. Import of Goods and Services
2. Unilateral Transfers Sent Abroad
3. Tourism.
4. Investments
5. Lending Abroad
6. Repayment of Interest and Loans
7. Purchase of assets abroad
8. Speculation

Supply of Foreign Exchange

1. Exports
2. One-sided/Unilateral Transfers from Abroad
3. Tourism
4. Foreign Direct Investments(FDI) in India
5. Foreign Portfolio Investments(FPI) by Foreign Investors
6. Deposits by Non-Resident Indians(NRI
7. Speculation

Summary

In emerging economies, capital flows can be particularly volatile as the economy may experience periods of rapid growth followed by subsequent contraction. Increased capital inflows can lead to credit booms and the inflation of asset prices, which may be offset by losses due to the depreciation of the currency based on exchange rates and declines in equity pricing.Emerging economies also are quite sensitive to flows of foreign direct investment (FDI), which takes place when an investor, corporation, or foreign government invests directly in, or establishes foreign business operations or acquires foreign business assets abroad. Often, FDI is a large source of capital flows to a country and greatly supports the economy.In India, for instance, periods of fluctuation have been noted beginning in the 1990s. Capital flows during the earlier period, from the 1990s into the early 2000s, was marked by steady growth, transitioning to a rapid influx of funds between the early 2000s and 2007. This rapid growth eventually shifted, partially due to the implications of the financial crisis in 2008, leading to a high level of volatility regarding capital flows.

Key words

Interest rate parity (IRP) line: Represents the equilibrium condition under which the covered interest arbitrage is not possible.

Interest rate parity (IRP): States that the forward rate differs from the spot rate by a sufficient amount to offset the interest rate differential between two currencies.

Covered interest arbitrage Capitalizing on the difference in interest rates between two countries while covering the exchange rate risk with a forward contract.

nternational Fisher effect (IFE) theory: States the relationship between two countries' interest rate difference and the change in their exchange rates over time

Review questions

1. Changing interest rate differentials cause changes in global capital flows. Is there a reason why foreign capital flows won't inevitably shift dramatically as the interest rate differentials in this scenario change? Explain

2. What drives differences in interest rates?

3. What is the difference in interest rates between the two nations?

4. What is a mortgage with an interest rate differential?

5. How do you determine the difference in interest rates?

Objective Questions

1. Which of the following is wrong in regard to interest rate differentials ?
A. The international Fisher effect (IFE), purchasing power parity (PPP), and the IRP all have an impact on how exchange rates are calculated.
B. The IRP hypothesis focuses on the reasons why the forward rate and spot rate are different, as well as how much of a difference there should be at any given time.
C. PPP theory predicts that the spot rate will fluctuate in response to differences in inflation,
D. Whereas IFE theory predicts that it will not fluctuate in response to differences in interest rates.

2. Which of the following is wrong in regard totheory of interest rate parity?
A. The level of the forward premium (or discount), in accordance with the interest rate parity (IRP) hypothesis, ought to be equal to the difference in interest rates between the two countries under consideration.
B. Covered interest arbitrage is not possible if IRP is valid
C. Any interest rate advantage in the foreign country will be offset by the discount on the forward rate.
D. Covered interest arbitrage would produce larger returns than a domestic investment would.

3. Which of the following is right in regard to forward premium of a currency ?
A. Since the forward premium of a currency (from an Australian perspective) is influenced both by the interest rate of that currency and by the Australian dollar interest rate, and since those interest rates change over time, it follows that the forward premium does not change over time.
B. A forward premium that is large and positive in one period, when the interest rate of that currency is relatively low, could become negative (reflecting a discount) if its interest rate rises above the Australian level
C. Thus, a forward premium that is small and negative in one period, when the interest rate of that currency is relatively low, could become positive (reflecting a discount) if its interest rate rises above the Australian level
D. Thus, a forward premium that is large and negative in one period, when the interest rate of that currency is relatively low, could become further negative (reflecting a discount) if its interest rate rises above the Australian level

4. Which of the following is wrong in regard to Fisher effect ?
A. The first step in understanding the international Fisher effect is to recognise how a country's nominal (quoted) interest rate and inflation rate are related.
B. The Fisher effect presumes that the nominal interest rate consists of two components: the expected inflation rate and the real rate of interest.

C. The real rate of interest is defined as the return on the investment to savers after accounting for expected inflation, and it is measured as the nominal interest rate plus the expected inflation rate.

D. If the real rate of interest in a country is constant over time, then the nominal rate of interest there must adjust to changes in the expected rate of inflation.

5. Which of the following is wrong in regard to Applying the Fisher effect to derive expected inflation per country?

A. The first step is to derive the expected inflation rates of the two countries based on the Fisher effect's claim that the nominal interest rate in two countries differs because of the difference in their expected inflation.

B. By assuming that the real interest rate is the same in the two countries, the difference between them in terms of the nominal interest rate is completely attributed to the difference in their expected inflation rates.

C. Thus, the difference in expected inflation is equal to the difference in nominal interest rates between the two countries,

D. This means that expected inflation is lower in the country whose interest rate is higher

6. Which of the following is wrong in regard to Implications of the international Fisher effect?

A. Currencies with high interest rates will exhibit high expected inflation (because of the IFE) and that this relatively high inflation will cause those currencies to depreciate (because of PPP).

B. The exchange rate effect could offset the interest rate advantage.

C. The offset would not be exact in every (or even any) period, and the difference could be more pronounced in either direction.

D. Yet IFE advocates insist that, overall, both MNCs and investors benefit from investing in foreign securities with higher interest rates because the expected return from the strategy (after accounting for the exchange rate effect) in any period would exceed what they could earn domestically

7. Which of the following is wrong in regard to derivation of the international Fisher effect?

A. The actual return to investors who invest in money market securities (such as short-term bank deposits) in their home country is simply the interest rate offered on those securities.

B. However, the actual return to investors who invest in a foreign money market security depends not only on the foreign interest rate (if) but also the percentage change in the value of the foreign currency (ef) denominating that security.

C. r = 1(1 + if) (1+ef)- 1

D. The IFE theory states that the effective return on a foreign investment should, on average, be equal to the interest rate on a local money market investment: $E(r)=i_{h.}$ where r is the effective return on the home depositand $_{ih}$ is the interest rate on the foreign deposit.

8. Which of the following is wrong in regard to contention of the international Fisher effect?

A. IFE theory contends that if ih (interest rate on the home foreign deposit)> if(foreign interest rate), then ef (value of the foreign currency)will be positive because the relatively low foreign interest rate reflects relatively low inflationary expectations in the foreign country.

B. That is, the foreign currency will appreciate when the foreign interest rate is lower than the home interest rate.

C. This appreciation will improve the foreign return to investors from the home country, making returns on foreign securities similar to returns on home securities.

D. Conversely, if if>ih, then ef will be negative. That is, the foreign currency will appreciate when the foreign interest rate exceeds the home interest rate.

9. Which of the following is right in regard to flow chart of summary of international fisher effect?

A. Relatively high local interest rate>Relatively low expected local inflation>Imports will increase; exports will decrease>Local currency should depreciate by level of inflation differential

B. Relatively high local interest rate>Relatively high expected local inflation>Imports will increase; exports will decrease>Local currency should depreciate by level of inflation differential

C. Relatively high local interest rate>Relatively high expected local inflation>Imports will decrease; exports will increase>Local currency should depreciate by level of inflation differential

D. Relatively high local interest rate>Relatively high expected local inflation>Imports will increase; exports will decrease>Local currency should appreciate by level of inflation differential

10. Which of the following is right in regard to flow chart of summary of international fisher effect?

A. Relatively low local interest rate>Relatively high expected local inflation>Imports will decrease; exports will increase>Local currency value should appreciate by level of inflation differential

B. Relatively low local interest rate>Relatively low expected local inflation>Imports will increase; exports will decrease>Local currency value should appreciate by level of inflation differential

C. Relatively low local interest rate>Relatively low expected local inflation>Imports will decrease; exports will increase>Local currency value should depreciate by level of inflation differential

D. Relatively low local interest rate>Relatively low expected local inflation>Imports will decrease; exports will increase>Local currency value should appreciate by level of inflation differential

11. Which of the following is right in regard to flow chart of summary of international fisher effect?

A. Local and foreign interest rates are similar>Local and foreign expected inflation rates are similar>No impact of inflation on import or export volume>Local currency value is not affected by inflation

B. Local and foreign interest rates are similar>Local and foreign expected inflation rates are dissimilar>No impact of inflation on import or export volume>Local currency value is not affected by inflation
C. Local and foreign interest rates are similar>Local and foreign expected inflation rates are similar>Heavy impact of inflation on import or export volume>Local currency value is not affected by inflation
D. Local and foreign interest rates are similar>Local and foreign expected inflation rates are similar>No impact of inflation on import or export volume>Local currency value is heavily affected by inflation

12. Which of the following is wrong in regard to international capital flows ?
A. Capital flows are transactions involving financial assets between international entities.
B. Financial assets to be included can be bank deposits, loans, equity securities, debt securities, etc.
C. Capital outflow generally results from economic uncertainty in a country, whereas large amounts of capital inflow indicate a growing economy.
D. Capital flows are transactions involving financial assets between national entities.

13. Which of the following is wrong in regard to international capital flows ?
A. Capital flows refer to the movement of money for the purpose of charity and not for investment, trade, or business operations.
B. Inside of a firm, these include the flow of funds in the form of investment capital, capital spending on operations, and research and development (R&D).
C. Capital flows occur at nearly every scale, from individuals to firms to national governments.
D. Different sub-sets of capital flows are often scrutinized by analysts such as asset-class movements, venture capital flows, mutual fund flows, capital spending budgets, and the federal budget.

14. Which of the following statement is wrong in regard to Volatile Capital Flows in Emerging Economies?
A. In emerging economies, capital flows can be particularly volatile as the economy may experience periods of rapid growth followed by subsequent contraction.
B. Increased capital inflows can lead to credit booms and the inflation of asset prices, which may be offset by losses due to the depreciation of the currency based on exchange rates and declines in equity pricing.
C. Emerging economies also are quite sensitive to flows of foreign direct investment (FDI), which takes place when an investor, corporation, or foreign government invests directly in, or establishes foreign business operations or acquires foreign business assets abroad
D. One of the biggest investing trends of the past several years involves the massive amounts of capital flow from passive management into active strategies such as exchange-traded funds (ETFs).

15. Which of the following is wrong in regard to international global capital flow trends?
A. One of the positive developments in the structure of cross-border capital flows over the past decade is that developing countries have become net donors

B. Prior to the crisis, however, the opposite was the case with capital flowing 'uphill' from poorer to richer economies.

C. Since the crisis, capital is now flowing 'downhill' and developing countries are net recipients of global capital. To meet the Sustainable Development Goals (SDGs), this will have to increase.of global capital rather than net providers.

D. Theory suggests that capital should flow from richer economies with higher volumes of capital and lower marginal returns to (poorer) economies with lower capital stock and potentially more profitable investments.

Answers

1.	D	4.	C	7.	D	10.	D	13.	A
2.	D	5.	D	8.	D	11.	A	14.	D
3.	**B**	6.	D	9.	B	12.	D	15.	A

Further readings

- International Financial Management 2ndEdition by Jeff Madura, Ariful Hoque, Chandrasekhar Krishnamurti, 2018
- International Financial management by Eun, Resnick and Chuluun. Ninth edition. McGraw-Hill Education
- International Accounting by Timothy S Doupnik_ Hector Perera, McGraw-Hill Education (2014).

Web links

- https://www.wallstreetmojo.com/interest-rate-differential/

Unit 17: Derivatives

CONTENTS

Objectives

After studying this unit, you should be able:

- exploring treasury management operations,
- analysing treasury management functions of banks and corporates.
- explore the derivatives universe from the risk management perspective,
- take the trades in derivative instruments.
- understand the rules and guidelines for banks to deal in derivative instruments.

Introduction

Treasury management is an umbrella term that encompasses several functions involved in managing an enterprise's holdings. The ultimate goal of treasury management is to optimize financial liquidity, minimize risk, and drive value creation.Overall, treasury management ensures that the business always has access to the cash required to operate and uses surplus cash efficiently.Treasury Management is a primary component of business operations in any enterprise. In the current business landscape, the importance of treasury management really can't be understated. As regulation and technology in the financial sector change at an ever-increasing pace and the business landscape becomes increasingly competitive, there is more pressure on corporates to manage cash efficiently.Therefore, Treasury management (sometimes referred to as Treasury Operations) is the overall management of a business's financials and holdings.Each treasury management department's primary goal is to mitigate any risks that may arise from a financial viewpoint – liquidity management, operational finances, and, also reputation.Overall, treasury management ensures that the business always has access to the cash required to operate and uses surplus cash efficiently.Corporate Treasury plays a central role in the firm's overall strategy with responsibility for providing appropriate funding to support all firmwide activity while maximizing net interest income. The treasury division allocates financial resources, raises funding and capital to support firm activity, and dynamically manages the firm's asset-liability risk and liquidity portfolio.Corporate Treasury actively engages in public markets and with businesses across the firm, investors, rating agencies, and regulators. The division is ideal for collaborative individuals with strong quantitative analysis skills, interest in portfolio management, and a risk management mindset.

17.1 Treasury Management at Banks

- A bank's markets division, also known as its Treasury, is part of its wholesale banking business.
- It is a highly specialized area that seeks to meet institutional and corporate customers' investment and risk coverage needs.
- The retail banking area serves individual customers and also receives support from the markets area to design and manage products and manage the associated risks.
- A bank's Treasury is part of its investment banking business (also known as wholesale or corporate banking) and other business areas like mergers and acquisitions, project finance, syndicated loans, and global transactional banking.
- But without a doubt, the Treasury – or the markets area – is a fundamental part of a bank's investment banking structure.

Fundamental Pillars of Treasury Management

1. Technology
2. Products
3. Distribution channels
4. Capability to manage and hedge the risks associated with the products being sold

Technology

- Technology is essential to access real-time information on financial markets.
- It is also crucial to develop systems that make it possible to calculate the price of the different products for sale and the associated risks.
- Technology also enables the proper confirmation and liquidation of operations.
- And it is key to comply with current and future regulatory requirements.

Products

The Treasury offers customers risk coverage and investment solutions for the most simple to the most complex products (structured products) and all kinds of financial assets – generally fixed income, interest rates, equities, and exchange rates, and in some financial institutions, also commodities.

Distribution Channels

- The capacity to provide the product to customers at a competitive price, when and where they need it.

Capability to Manage and Hedge the Risks Associated with the Products Being Sold

- Once the institution's creditworthiness has been determined with each of its customers, these risks are then assessed and managed.
- Technology, knowledge, and experience play a key role in this aspect.

How Treasury Areas have Evolved Over Time

- Treasury areas have changed considerably since the start of the financial crisis in 2007.
- Regulation has been crucial to changing the banking business in general, and in markets in particular.
- Regulations were established that discourage banks from taking on their own risks (proprietary trading).
- They also require greater control, management, and monitoring of the risks derived from operations with customers, all while optimizing capital consumption.
- Greater transparency and customer and shareholder protection are also fundamental goals, and banks are intended to have not just an economic, but a social component as well.

17.2 Key Functions of the Treasury Department

- The responsibility for making sure that this strategic money management is carried out effectively falls to the business' treasury department (which could be outsourced), which must plan, organize and control the cash assets in order to meet the financial goals of the business, whatever they may be.
- Cash and Liquidity Management – One of the most important sub-functions of treasury management, cash management aims to maximize available cash and minimize shortfalls as quickly as possible.
- Liquidity and Risk Management in Treasury – The assessment and management of risks to liquidity to ensure that the business can always meet its financial obligations.
- Corporate Finance – Concerned with making both short and long-term financial and investment decisions to maximize value to the shareholders.
- Cash Flow and Advanced Forecasting – Identifying cash deficits and surplus in future months to help you to plan ahead.
- Treasury Management Systems and Software – The automation of important financial operations using systems that facilitates communication between treasury departments and their banking partners.
- Trade Finance Software – Software designed to help businesses find trade finance solutions and deal with accounts receivables, factoring payments, and assets.
- Trade Financial Supply Chain Management – Financing for all phases of the supply chain.

Bank Treasuries May have the Following Departments

- A fixed income or money market desk that is devoted to buying and selling interest-bearing securities.
- A foreign exchange or "FX" desk that buys and sells currencies.
- A capital markets or equities desk that deals in shares listed on the stock market.
- In addition, the Treasury function may also have an asset liability management (ALM) desk that manages the risk of interest rate mismatch and liquidity

Core Functions of a Corporate Treasury Department

1. Cash and Liquidity Management
2. Risk Management
3. Corporate Finance

Cash and Liquidity Management

- Cash- and liquidity management is often described as treasury's 'primary duty.'
- Essentially, a company needs to be able to meet its financial obligations as they fall due, i.e., to pay employees, suppliers, lenders, and shareholders.
- This can also be described as the need to maintain liquidity or solvency of the company: a company needs to have the funds available that will enable it to stay in business.
- In addition to dealing with payment transactions; cash management also includes planning, account organization, cash flow monitoring, managing bank accounts, electronic banking, pooling, and netting as well as the functions of in-house banks.

Risk Management

- Risk management is the discipline of managing financial risks to allow the company to meet its financial obligations and ensure predictable business performance.
- Risk Management aims to identify, measure, and manage risks that could have a significant impact on the business goals.
- It is important to note that the objective is not to eliminate all risks.
- Taking risk is a critical part of any business – "no risk, no profit".
- However, It is essential to take risks only in areas where the business has a competitive advantage. •For example, an automotive company wants to take risks in design and engineering but avoid risks in currencies and interest rates.
- On the other hand, a bank will be in a position to take risks in currencies and interest rates but will avoid operational and regulatory risks.

Treasurers are then typically responsible for managing:

- Liquidity risk - the company is unable to fund itself or is unable to meet its obligations;
- Market risk (or price risk) - changes in market prices (typically foreign exchange, interest rates, commodities) cause losses to the business;
- Credit risk - that a counterparty default causes loss to the business;
- Operational risk - fraud or error causes losses to the business.

Corporate Finance

Looking after contacts with banks and rating agencies, as well as discussions with credit insurers and, if applicable, suppliers concerning periods allowed for payment, in conjunction with the procurement of finance, also form part of the treasurer's core business.

17.3 Permissible Derivative Instruments

- Foreign Currency derivatives – Foreign Currency Forward, Currency Swap and Currency Option – (Separate guidelines regarding Foreign Currency derivatives are being issued).
- Over the Counter (OTC) – Forward Rate Agreements & Interest Rate Swaps
- Exchange Traded – Interest Rate Futures

Derivatives & Corporate governance Issues

a. While dealing with potentially complex products, such as derivatives, the board, and senior management should understand the nature of the business the bank is undertaking. This includes understanding the nature of the relationship between risk and reward, in particular, an appreciation that it is inherently implausible that an apparently low-risk business can generate high rewards.

b. The board of directors and senior management also need to demonstrate through their actions that they have a strong commitment to an effective control environment throughout the organization.

c. In addition to advocating prudent risk management, The board and senior management should encourage more stable and durable return performance and discourage high but volatile returns.

d. The board of directors and senior management should ensure that the organization of the bank is conducive to managing risk. It is necessary to ensure that clear lines of responsibility and accountability are established for all business activities, including derivative activities.

e. The central risk control function at the head office should also ensure that there is sufficient awareness of the risks and the size of exposure of the trading activities in derivatives operations.

Eligibility Criteria for Participants

(i) Market-makers: All Commercial Banks (excluding LABs & RRBs) & Primary Dealers (PDs).

Banks and PDs should develop sufficient understanding and expertise about derivative productsboth in terms of staff and systems in order to undertake derivative business as market makers

(ii) Users: Business entities with identified underlying risk exposure.

Broad Principles for Undertaking Derivative Transactions

The major requirements for undertaking any derivative transaction from the regulatory perspective would include:

Market-makers may undertake a transaction in any structured derivative product (a combination of permitted cash and generic derivative instruments) as long as it is a combination of two or more of the generic instruments permitted by RBI and does not contain any derivatives as underlying;

Market-makers should be in a position to arrive at the fair value of all derivative instruments, including structured products, on the basis of the following approach :

(a) Marking the product to market if a liquid market in the product exists.

(b) In the case of structured products, marking the generic constituent instruments to market.

(c) If (a) and (b) are not feasible, marking the product to model, provided:

(d) All the model inputs are observable market variables.

(e) Full particulars of the model, including the quantitative algorithm, should be documented.

(f) It may be ensured that structured products do not contain any derivative, which is not allowed on a stand-alone basis.

(g) All permitted derivative transactions, including roll over, restructuring, and novation shall be contracted only at prevailing market rates.

(h) All risks arising from derivatives exposures should be analyzed and documented at the transaction and portfolio levels.

(i) The management of derivatives activities should be an integral part of the overall risk management policy and mechanism.

(j) It is desirable that the board of directors and senior management understand the risks inherent in the derivatives activities being undertaken.

(k) Market-makers should have a 'Suitability and Appropriateness Policy' vis-à-vis users in respect of the products offered, on the lines indicated in these guidelines.

(l) Market-makers may, where they consider necessary, maintain cash margin/liquid collateral in respect of derivative transactions undertaken by users on a mark-to-market basis.

17.4 Hedging

- Financial derivatives are so effective in reducing risk because they enable financial institutions to hedge
    - Engage, in financial transaction that reduces or eliminates risk
- If a financial institution has bought an asset, it is said to have taken a long position
    - And this exposes the institution to risk if the returns on the asset are uncertain
- On the other hand, if it sold an asset that it has agreed to deliver to another party at a future date, it is said to have taken a short position
    - and this can also expose the institution to risk
- Financial derivatives can be used to reduce risk by invoking the following basic principle of hedging
    - Hedging risk involves engaging in a financial transaction that offsets a long position by taking an additional short position, or offsets a short position by taking an additional long position
    - If a financial institution has bought a security and has therefore taken a long position, it conducts a hedge by contracting to sell that security – take a short position at some future date
    - Alternatively, if it has taken a short position by selling a security that it needs to deliver at a future date, than it conducts a hedge by contracting to buy that security – take a long position at a future date

17.5 Forward Markets

Forward contracts are agreements by two parties to engage in a financial transaction at a future – forward point in time

- Interest-rate forward contracts
- Forward contracts for foreign currencies

Interest-Rate Forward Contracts

Interest-rate forward contracts involve the future sale or purchase of a debt instrument and have several dimensions

- Specification of the actual debt instrument that will be delivered at the future date

- Amount of the debt instrument to be delivered
- Price – interest rate on the debt instrument when it is delivered
- Date on which delivery will take place

- An example of an interest-rate forward contract
- Agreement for the First National Bank to sell to the Rock Solid Insurance Company, one year from today, $5 million face value maturing in 2029 Treasury bonds – with a 6% coupon rate that mature in 2029 at a price that yields the same interest rate on these bonds at today's, say 6%.
  - Rock Solid will buy the security at a future date – long position
  - The First National Bank will sell the security at a future date – short position

- The First National Bank have previously bought $5 million maturing in 2029 Treasury bonds, which currently sell at par value and so their yield to maturity is 6%
- Because these are long-term bonds you recognize that you are exposed to substantial interest-rate risk and worry that if interest rates rise in the future, the price of these bonds will fall (inverse relationship between interest rates and bond prices)
- How to hedge a risk?
- Knowing the basic principle of hedging, you see that your long position in these bonds must be offset by an equal short position for the same bonds with a forward contract
- That is, you need to contract to sell these bonds at a future date at the current par value price
- As a result, you agree with another party, in this case, Rock Solid Insurance Company, to sell them the $5 million of the 6s of 2029 Treasury bonds at par one year from today
- By entering into this forward contract, you have locked in the future price and so have eliminated the price risk First National Bank faces from interest-rate changes
- Why would the Rock Solid Insurance Company want to enter into the forward contract with the First National Bank?
  - Rock Solid Insurance Company expects to receive premiums of $5 million in one year's time that it will want to invest in bonds maturing in 2029 but worries that interest rates on these bonds will decline now and next year
  - By using the forward contract, it is able to lock in the 6% interest rates on the Treasury bonds

Pros and Cons of Forward Contracts

- The advantage of forward contracts is that they can be flexible as the parties involved in want to be
- However, forward contracts suffer from two problems that severely limit their usefulness
  - The first is that it may be very hard for an institution to find another party – counterparty to make the contract with
  - There are brokers to facilitate the matching up of parties
  - But this mean that it may prove impossible to find a counterparty when a financial institution want to make a specific type of forward contract
  - Furthermore, even if the institution finds a counterparty, it may not get as high a price as it wants because there may not be anyone else to make the deal with
  - A serious problem for the market in interest-rate forward contract, then, is that it may be difficult to make the financial transaction of that it will have to be made at a disadvantage price

    - This market suffers from a lack of liquidity
- The second problem with forward contracts is that they are subject to default risk
    - The presence of default risk in forward contracts means that parties to these contracts must check each other out to be sure that the counterparty is both financial sound and likely to be honest and live up to its contractual obligations
- Because this is a costly process and because all the adverse selection and moral hazard problems
    - Default risk is a major barrier to the use of interest-rate forward contracts
    - When the default risk is combined with a lack of liquidity, we see that these contracts may be of limited usefulness to financial institutions

Financial Futures Markets

- Given the default risk and liquidity problems in the interest-rate forward market, another solution to hedging interest-rate risk was needed
- This solution was provided by development of financial futures contracts
- A financial futures contract is similar to an interest-rate forward contract in that is specified that a financial instrument must be delivered by one party to another on a stated future date
- However, it differs from an interest-rate forward contract in several ways that overcome some of the liquidity and default problem of forward markets
- To understand what financial futures contracts are all about, let's look at one of the most widely traded futures contracts, that for Treasury bonds
- The contract value is for $100.000 face value of bonds
- Prices are quoted in points, with each point equal to $1.000
- This contract specifies that the bonds to be delivered must have at least 15 years to maturity at the delivery date
- If the Treasury bonds delivered to settle the future contract have a coupon rate different from the 6% specified in the future contract, the amount of bonds to be delivered is adjusted to reflect the difference in the value between the delivered bonds and the 6% coupon bond
- In line with the terminology used for forward contracts, parties who have bought a future contract and thereby agreed to buy of the bond are said to have taken a long position
- Parties who have sold a future contract and thereby agreed to sell – deliver bonds have taken a short position
- Let's consider what happens when you buy or sell one of these Treasury bond futures contracts
- On February 1, you sell one $100.000 June contract at a price of 115 (that is $115.000)
- By selling this contract, you agree to deliver $100.000 face value of the long-term Treasury bonds to the contract's counterparty at the end of June for $115.000
- By buying the contract at a price of 115, the buyer has agreed to pay $115.000 for the $100.000 face value of bonds when you deliver the, at the end of June
- If interest rates on long-term bonds rise so that when the contract mature at the end of June the price of these bonds has fallen to 110 ($110.000 per $100.000 of face value), the buyer of the contract will have lost $5.000 because he paid $115.000 for the bonds but he can sell them only for the market price of $110.000
- But you the seller of the contract, will have gained $5.000 because you can now sell the bonds to the buyer for $115.000 but have to pay only $110.000 for them in the market

- It is even easier to describe what happens to the parties who have sold futures contracts if we recognize the following fact:
- At the expiration date if a future contract, the price of the contract converges to the price of the underlying asset to be delivered
- On the expiration date of the June contract at the end of June, when the price of the underlying $100.000 face value Treasury bond is 110 ($110.000)
- If the futures contract is selling below 110, say, at 109
- A trader can buy the contract for $109.000, take delivery of the bond, and immediately sell it for $110.000, thereby earning a quick profit of $1.000
- Because this profit involves no risk, it is a great deal that everyone would like to get it on
- That means that everyone will try to buy the contract, and as a result, its price will rise
- Only when the price rises to 110 will the profit opportunity cease to exit and the buyer pressure disappear
- Conversely, if the price of the futures contract is above 110, say at 111, everyone will want to sell the contract
- Now the sellers get $111.000 from selling the futures contract but have to pay only $110.000 for the Treasury bonds that they must deliver to the buyer of the contract
- $1.000 difference is their profit
- Because this profit involves no risk, traders will continue to sell the futures contract until its price falls back down to 110, at which price there are no longer any profits to be made
- The elimination of riskless profit opportunities in the futures market is referred to as an arbitrage, and it guarantees that the price of a futures contract at expiration equals the price of the underlying asset to be delivered
- The hedge just described is called a micro hedge
- Because the financial institution is hedging the interest rate risk for a specific asset it is holding
- A second type of hedge that financial institution engage in is called a macro hedge
- In which the hedge is for institution’s entire portfolio
- E.g., if a bank has more rate-sensitive liabilities than assets
- By selling interest-rate future contracts that will yield a profit when interest rate rise, the bank can offset the losses on its overall portfolio from an interest-rate rise and thereby hedge its interest-rate risk

Organization of Trading in Financial Futures Markets

- Financial futures contracts are traded on organized exchanges such as the Chicago Mercantile Exchange, National stock exchange, the New York Futures Exchange, etc
- These exchanges are highly competitive with one to another, and each organization tries to design contracts and set of rules that will increase the amount of futures trading on its exchange
- Because American futures exchanges were the first to develop financial futures, they dominated the trading of financial futures in the early the 1980’s
- With rapid growth of financial futures markets and the resulting high profits made by American exchanges, foreign exchanges saw a profit opportunity and began to enter this business
- By the 1990’s, Eurodollar contracts traded on the London International Financial Futures Exchange
- Japanese government bond contracts and Euroyen contracts traded on the Tokyo Stock Exchange, etc.

- Even developing countries are getting into the act.
    - In 1996, seven developing countries also referred as a emerging market countries established futures exchanges

Explaining the Success of Futures Markets

- Several features of futures contracts were designed to overcome the liquidity problem inherent in forward contracts
    - In contrast to forward contracts, the quantities delivered and the delivery dates of futures contracts are standardized
        - Making more likely that different parties can be matched up in the futures market, thereby increasing the liquidity of the market
    - After the futures contract has been bought or sold, it can traded – sold or bought again at any time until the delivery date
    - Trading on the futures market has been organized differently from trading on forward markets to overcome the default risk problems arising in forward contracts
- In both types, for every contract there must be a buyer who is taking a long position and a seller who is taking a short position
- However, the buyer and seller of a futures contract make their contract not with each other but with the clearing house associated with the futures exchange
- This setup means that the buyer of the futures contract does not need to worry about the financial health of the seller and vice versa, as in the forward market
- As long as the clearing house is financially solid. Buyers and sellers of futures contracts do not have to worry about default risk
- A final advantage that futures markets have over forward markets is that most futures contracts do not result in delivery of underlying asset on the expiration date, whereas forward contract do
    - A trader who sold a futures contract is allowed to avoid delivery on the expiration date by making an offsetting purchase of a futures contracts
- Because the simultaneous holding of the long and short position means that the trader would in effect be delivering the bonds to itself, under the exchange rules the trader is allowed to cancel both contracts
- In this way lowers the cost of conducting trades in the futures market relative to the forward market in that that futures trader can avoid the costs of physical delivery, that is not so easy with forward contracts

17.6 Options

- Another vehicle for hedging
    - Interest-rate risk
    - Stock market risk
- Options
    - Contracts that give the purchaser the option, or right, to buy or sell the underlying financial instrument
        - at a specified price – exercise price or strike price
        - within a specific period of time
- The seller – thewriter of the option is obligated to buy or sell the financial instrument to the purchaser if the owner of the option exercises the right to sell or buy
    - The owner or buyer of an option does not have to exercise the option he or she can let option expire without using

    - The seller of an option, by contrast, has no choice, he or she must buy or sell the financial instrument if the owner exercise the option
- Because the right to buy or sell a financial instrument the owner of an option is willing to pay an amount for it called a premium
- There are two types of option contracts
    - American options
        - Can be exercised at any time up to the expiration date of the contract
    - European options
        - Can be exercised only on the expiration date
- Option contracts are written on a number of financial instruments
    - Individual stocks – stock option that existed for long time
    - Financial futures – financial futures option or futures option
- Why option contracts are more likely to be written on financial futures than on underlying debt instruments such as bonds or certificates of deposit?
    - The price of the futures contract and of the deliverable debt instrument will be the same because of arbitrage
    - So investor should be indifferent about having the option written on the debt instrument or on the futures contract
    - However, financial futures contracts have been so well designed that their markets are often more liquid that the markets in the underlying debt instruments
        - Investors would rather have the option contract written on the more liquid instrument, in this case the futures contract
- A call option is a contract that gives the owner the right to buy a financial instrument at the exercise price within a specific period of time
- A put option is a contract that gives the owner the right to sell a financial instrument at a exercise price within a specific period of time

Examination How Profits and Losses Occur

Major difference between a futures contract and an option contract

    - Futures contract has a linear profit function
        - Profits grow by an equal dollar amount for every point increase in the price of the underlying financial instrument
    - The option contract is highly non linear
        - Profits do not always grow by the same amount for a given change in the price of the underlying financial instrument
            - The reason for this nonlinearity is that the call option protects the investor from having losses that are greater than the amount of the $2.000 premium
            - This insurance-like feature of option contracts explains why their purchase price is referred as a premium
            - Once the underlying financial instrument's price rise above the exercise price, the investor's profit grow linearly
- Two other differences between options and futures contracts must be mentioned
    - The first is that the initial investment on the contracts differs

- When a futures contract is purchase, the investor must put up a fixed amount, the margin requirement, in a margin account
- When an option contract is purchased, the initial investment is the premium that must be paid for the contract

- The second important difference between the contracts is that
  - the futures contract requires money to change hands daily when contract is marked to market
  - the option contract requires money to change only when it is exercised

Factors Affecting the Prices of Option Premiums

- When the strike (exercise) price for a contract is set at a higher level
  - The premium for the call option is lower and the premium for the put option is higher
  - The higher the strike price, the lower the profits on the call option contract and the lower the premium that investor are willing to pay
- The period of time over which the option can be exercised gets longer, the premiums for both call and put options rise
- The fact that premiums increase with the term to expiration is also explained by the nonlinear profit function for option contracts
  - At the term to expiration lengthens, there is a greater chance that the price of the underlying financial instrument will be very high or very low by the expiration date
- If the price becomes very high and goes well above the exercise price, the call option will yield a high profit
  - If the price becomes very low and goes well below the exercise prices, the losses will be small because the owner of call option will simply decide not to exercise the option
- Similar, the put option will become more valuable as the term to expiration increases, because of the possibility of greater price variability of the underlying financial instrument increases as the term to expiration increases
- When the volatility of the price of the underlying instrument is great, the premiums for both call and put options will be higher

Interest-Rate Swaps

- Swaps are financial contracts that obligate each party to the contract exchange (swap) a set of payments it owns for another set of payments owned by another party
- Currency swaps
  - Exchange of a set a payments in one currency for a set of payments in another currency
- Interest-rate swaps
  - The exchange of one set of interest payments for another set of interest payments, all denominated on the same currency

Interest-rate Swap Contracts

- Important tool for managing interest-rate risk
- First appeared in the U.S. in 1982 when there was an increase in the demand for financial instruments that could be used to reduce interest-rate risk

- The most common type of interest-rate swap – plain vanilla swap specified
    - The interest rate on the payment that are being exchanged
    - The type of interest payments
        - Variable or fixed
    - The amount of notional principal, which is the amount on which the interest is being paid
    - Time period over which the exchange continue to be made

Advantages of Interest-Rate Swaps

- Financial institutions can also hedge interest-rate risk with other financial derivatives such as futures contracts or futures options
- Interest-rate swaps have one big advantage over hedging with these derivatives
    - They can be written for very long horizons, sometimes as long as 20 years, whereas financial futures and futures options typically have much shorter horizons, not much more than a year
    - If a financial institutions needs to hedge interest-rate risk for a long horizon, financial futures and option markets may not do it much good

Disadvantages of Interest-Rate Swaps

- Swap markets like forward markets can suffer from a lack of liquidity
    - It might to be difficult to arrange the swap
    - It might not be able to negotiate a good deal because it could not find any institutions to negotiate with
    - Swap contracts are subject to default risk
        - If interest rates rise up a particular company would love to get out of the swap contract because the fixed-rate interest payments it receives are less that it could get in the open market
        - It might then default on the contract, exposing the another company to the loss

Major Concerns About Derivatives

- Financial derivatives allow financial institutions to increase their leverage
    - They can in effect hold an amount of the underlying asset is many time greater than the amount of money they have had to put up
    - Increasing their leverage enables them to take huge bets on currency and interest-rate movements, which if they are wrong can bring down banks
    - The concern is valid
        - The amount of money places in margin accounts is only a small fraction of the price of futures contract, meaning that small in the price of the contact can produce losses that are many times the size of the initial amount put in the margin account
- Although, financial derivatives can be used to hedge risk, they can be used by financial institutions to take on excessive risk
- The second concern is that financial derivatives are too sophisticated for managers of financial institutions because they are so complicated

- A third concern is that banks have holding of huge national amounts of financial derivatives, particularly swaps, that greatly exceed the amount of bank capital and so these derivatives expose the banks to serious risk of failure
- The conclusion is that financial derivatives do have their danger for financial institutions, but some of these dangers have been overplayed. The biggest danger occurs in trading activities of financial institutions, and regulators have been paying increased attention to this danger

Summary

Interest-rate forward contracts, which are an agreement to sell a debt instrument at a future (forward) point in time, can be used to hedge interest rate risk. The advantage of forward contract is that it is flexible. Disadvantages are that they are the subject of default risk and their market is illiquid. An option contract gives the purchaser the right to buy (call option) or sell (put option) a security at the exercise (strike) price within the specific period of time. Interest-rate swaps involve the exchange of one set of interest payments for another set of interest payments and have default risk and liquidity problems similar to those of forward contracts. As a result, interest-rate swaps often involve intermediaries such as large commercial banks and investment banks that make a market in swaps. Interest-rate swaps have one big advantage over financial futures and options, they can be written for very long horizons. Contracts for currency futures establish a standard volume of a given currency to be exchanged on a particular settlement date. Hence, although currency futures contracts differ from forward contracts in terms of how they are transacted, they are comparable to forward contracts in terms of their obligation. MNCs typically employ these contracts to protect their foreign exchange holdings. Also, speculators trade them in an effort to profit from their anticipated changes in exchange rates.

Keywords

Derivatives: derivative is a financial instrument whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the 'underlying')

Exchange-traded derivatives: Derivative products that are traded on an exchange.

Call: Provide the buyer the option to buy the underlying asset at a certain price and within a specified window of time.

Put: gives Grant the authority to sell an underlying asset within a specified time frame and at a specified price.

Self Assessment

1. Which of the following statements is wrong about Call options?

A. A call option gives its owner the right to purchase a specified currency at a specified exchange rate by a specified expiration date

B. Currency call options are often purchased by corporations that have payables in a currency that is expected to appreciate

C. Call options on a specific currency can be purchased by speculators who expect that currency to appreciate

D. Currency call options are frequently purchased by corporations that have receivables in a currency that is expected to depreciate

2. Which of the following statements is wrong about options contracts?

A. An option is a contract giving the owner the right, but not the obligation, to buy or sell a given quantity of an asset at a specified price at some time in the future.

B. The stated price paid (or received) is known as the exercise or striking price
C. buyer of an option is frequently referred to as the long
D. An American option can be exercised only at the maturity or expiration date of the contract

3. Which of the following statements is wrong about Currency options market
A. Prior to 1982, all currency option contracts were over-the-counter options written by international banks, investment banks, and brokerage houses.
B. Over-the-counter options are not tailor-made according to the specifications of the buyer in terms of maturity length, exercise price, and the amount of the underlying currency
C. Frequently, they are written for U.S. dollars, with the euro, British pound, Japanese yen, Canadian dollar, and Swiss franc serving as the underlying currency, though options are also available on less actively traded currencies
D. Over-the-counter options are typically European style.

4. Which of the following statements is wrong about currency future options?
A. Options on currency futures behave very similarly to options on the physical currency since the futures price converges to the spot price as the futures contract nears maturity.
B. Exercise of a futures option results in a long futures position for the call buyer or the put writer and a short futures position for the put buyer or the call writer.
C. If the futures position is not offset prior to the futures expiration date, receipt or delivery of the underlying currency will, respectively, result or be required
D. If the futures position is offset prior to the futures expiration date, receipt or delivery of the underlying currency will, respectively, result or be required

5. Which of the following statements is wrong about American option?
A. An American call or put option can be exercised at any time prior to expiration.
B. American call and put premiums at time t will be at least as large as the immediate exercise value, or intrinsic value, of the call or put option.
C. American call and put premiums at time t will be at least as small as the immediate exercise value, or intrinsic value, of the call or put option.
D. Because the owner of a long-maturity American option can exercise it on any date that he could exercise a shorter maturity option, or at some later date after the shorter maturity option expires, it follows that all else remaining the same, the longer-term American option will have a market price at least as large as the shorter-term option.

6. Which of the following statements is wrong about European option?
A. The pricing boundaries for European put and call premiums are more complex because they can only be exercised at expiration
B. there is no time value element to the boundary expressions
C. A European option is a version of an options contract that limits rights exercise to only the day of expiration.
D. Investors usually don't have a choice of buying either the American or the European option and most indexes use European options

7. Which of the following statements is wrong aboutcurrency futures and options on foreign exchange?

A. currency futures and options on foreign exchangeThese instruments are useful for speculating and hedging foreign exchange rate movements.
B. Forward, futures, and options contracts are derivative, or contingent claim, securities.
C. their value is derived or contingent upon the value of the asset that underlies these securities.
D. None of these are contracts to buy or sell a certain quantity of a specific underlying asset at some specific price in the future

8. The …… price is a price representative of futures transaction prices at the close of daily trading on the exchange
A. Settlement
B. Revaluation
C. historical
D. market

9. Which of the following statements is wrong aboutspeculators or hedgers?
A. A speculator attempts to profit from a change in the futures price
B. the speculator will take a long or short position in a futures contract depending upon his expectations of future price movement.
C. A hedger, on the other hand, wants to avoid price variation by locking in a purchase price of the underlying asset through a long position in the futures contract or a sales price through a short position.
D. In effect, the speculator passes off the risk of price variation to the hedger, who is better able, or at least more willing, to bear this risk.

10. In futures markets, a …….house serves as the third party to all transactions.
A. Clearing
B. Discount
C. Rediscount
D. Forward

11. Which of the following are not a type of market participants which are necessary for a derivatives market to operate most efficiently:
A. speculators
B. hedgers
C. Bull
D. Dear

12. CME stands for
A. Chicago Mercantile Exchange
B. Canberra Mercantile Exchange
C. Canadian Mercantile Exchange
D. Chennai Mercantile Exchang

13. For each contract, the …interest is also presented.

A. Open
B. Closed
C. Semi-closed
D. Zero

14. seller of an option is referred to as the of the option
A. writer
B. Long
C. Reader
D. Holder

15. Futures contract is……
A. Exchange traded
B. Over the counter traded
C. unorganized exchanges traded
D. not traded

Answers for Self Assessment

1.	D	2.	D	3.	D	4.	A	5.	A
6.	D	7.	C	8.	A	9.	D	10.	A
11.	B	12.	B	13.	D	14.	A	15.	A

Review Questions

1. Should traders use options or currency futures?

2. Examine the differences between forward and futures contracts.

3. Recognize the differences between currency call and currency put options.

4. When should a trader buy an Australian dollar call option? When should a trader buy an Australian dollar put option?

5. List the variables that influence the premiums of currency put options and briefly describe how each one is related to the others.

Further Readings

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International Financial management by Eun,Resnick and Chuluun. Ninth edition. McGraw-Hill Education

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Unit 18: Capital Market Operations

CONTENTS

Learning Outcome:

After studying this unit, you should be able to understand:

- the concept derivatives
- the risk aspects of derivative trading
- the uses of derivatives
- the mathematics of derivative valuation and pricing
- the risk assessment of derivatives

Introduction

A derivative is a financial instrument that derives its value from something else. Because the value of derivatives comes from other assets, professional traders tend to buy and sell them to offset risk.For less experienced investors, however, derivatives can have the opposite effect, making their investment portfolios much riskier.Financial derivatives are used for two main purposes to speculate and to hedge investments. A derivative is a security with a price that is dependent upon or derived from one or more underlying assets. The derivative itself is a contract between two or more parties based upon the asset or assets. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies,. Interest rates and market indexes.Derivatives can be traded privately (over-the-counter, OTC) or on an exchange.OTC derivatives constitute the greater proportion of derivatives in existence and are unregulated, whereas derivatives traded on exchanges are standardized. OTC derivatives generally have greater risk for the counterparty than do standardized derivatives. Derivatives are complex financial contracts based on the value of an underlying asset, group of assets or benchmark. These underlying assets can include stocks, bonds, commodities, currencies, interest rates, market indexes or even cryptocurrencies.Investors enter into derivative contracts that clearly state terms for how they and another party will respond to future changes in value of the underlying asset.Derivatives may be traded over-the-counter (OTC), meaning an investor purchases them through a brokerage-dealer network, or on exchanges like the National Stock Exchange in India.While exchange-traded derivatives are regulated and standardized, OTC derivatives are not. This means that one may be able to profit more from an OTC derivative, but also face more danger from counterparty risk, the chance that one party will default on the derivative contract.

18.1 Types of Derivatives

There are four main types of derivatives:

a) Futures,

b) Forwards,

c) Options and

d) Swaps.

As an everyday investor, one will probably only ever deal directly with futures and options.

1) Futures

- With a futures contract, two parties agree to buy and sell an asset at a set price on a future date.
- Because futures contracts bind the parties to a particular price, they can be used to offset the risk that an asset's price rises or falls, leaving someone to sell goods at a massive loss or to buy them at a large markup.
- Instead, futures lock in an acceptable rate for both parties based on the information they currently have.
- Notably, futures are standardized, exchange-traded investments, meaning everyday investors can buy them about as easily as they can stocks, even if one personally don't need a particular good or service at a particular price.
- Gains and losses are settled daily, meaning you can easily speculate on short-term price movements and aren't tied to seeing out the full length of a futures contract.
- Because futures are bought and sold on an exchange, there's much less risk one of the parties will default on the contract.

2) Forwards

- Forward contracts are very similar to futures contracts, except they are set up OTC, meaning they're generally private contracts between two parties.
- This means they're unregulated, much more at risk for default and something average investors won't put their money into.
- While they introduce more risk into the equation, forwards do allow for much more customization of terms, prices and settlement options, which could potentially increase profits.

3) Options

- Options function as non-binding versions of futures and forwards: They create an agreement to buy and sell something at a certain price at a certain time, though the party buying the contract is under no obligation to use it.
- Because of this, options typically require one to pay a premium representing a fraction of the agreement's value.
- In the future if the expected price falls below the spot price, one still have an option to purchase, "put options".
- It means, one will be provided with the benefit to sell at the strike price on the expiration date. There is no obligation to implement the rights here.
- Options can trade on exchanges or OTC.
- In India, options can be traded on indices and on single stocks via NSE.

- When they are traded on an exchange, options are guaranteed by clearinghouses and are regulated by the Securities and Exchange Board of India, which decreases counterparty risk.
- On the other hand, the seller has all the rights to buy the gold at the strike price on the expiration date with no obligation in the "call option" category.
- It completely depends on the seller whether he implements his rights on the expiration date.
- Like forwards, OTC options are private transactions that allow for more customization and risk.

4) Swaps

- Swaps allow two parties to enter into a contract to exchange cash flows or liabilities in an attempt to either reduce their costs or generate profits.
- This commonly occurs with interest rates, currencies, commodities and credit defaults, the last of which gained notoriety during the 2007-2008 housing market collapse, when they were overleveraged and caused a major chain reaction of default.
- The exact way swaps play out depends on the financial asset being exchanged.
- For the sake of simplicity, let's say a company enters into a contract to exchange a variable rate loan for a fixed-rate loan with another company.
- The company getting rid of its variable rate loan is hoping to protect itself from the risk that rates rise exponentially.
- The company offering the fixed rate loan, meanwhile, is making a bet that its fixed rate will earn it a profit and cover any rate increases that come from the variable rate loan.
- If rates go down from where they currently are, all the better.
- Swaps carry a high counterparty risk and are generally only available OTC to financial institutions and companies, rather than individual investors.

18.2 Uses of derivatives

Because derivatives involve significant complexity, derivatives aren't generally used as simple buy-low-sell-high or buy-and-hold investments.

The parties involved in a derivative transaction may instead be using the derivative to:

- Hedge a financial position- If an investor is concerned about where the value of a particular asset will go, they can use a derivative to protect themselves from potential losses.
- Speculate on an asset's price- If an investor believes an asset's value will change substantially, they can use a derivative to make bets on its potential gains or losses.
- Use funds more effectively- Most derivatives are margin-powered, meaning one may be able to enter into them putting up relatively little of your own money.
- This is helpful when traders are trying to spread money out across many investments to optimize returns without tying a lot up in any one place, and it can also lead to much greater returns than traders could get with their cash alone
- But it also means that one may be open to immense losses if one make the wrong bet with a derivatives contract.

18.3 Risk aspects of derivative trading

Derivatives can be incredibly risky for investors. Potential risks include:

- Counterparty risk - The chance that the other party in an agreement will default can run high with derivatives, particularly when they're traded over-the-counter.

Derivatives can be incredibly risky for investors. Potential risks include:

- Because derivatives have no value in and of themselves, they're ultimately only worth the trustworthiness of the people or companies who agree to them.

Changing conditions - Derivatives that contractually obligate the counter party to certain prices can lead to riches—or ruin.

- If you agree to futures, forwards or swaps, you could be forced to honor significant losses, losses that may be magnified by margin you took on.
- Even non-obligatory options aren't without risk, though, as you must put forth some money to enter into contracts you might not choose to execute.

Complexity - For most investors derivatives, particularly those based on investment types they're unfamiliar with, can get complicated fast.

- They also require a level of industry knowledge and active management that may not appeal to investors used to traditional hands-off, buy-and-hold strategies.

Interconnection Risk - Interconnection risk refers to how the interconnections between various derivative instruments and dealers might affect an investor's particular derivative trade.

- Some analysts express concern over the possibility that problems with just one party in the derivatives market, such as a major bank that acts as a dealer, might lead to a chain reaction or snowball effect that threatens the stability of financial markets overall.

18.4 Risk catching through derivatives

What is Risk hedging with options ?

Example:

In three months, a goldsmith from Surat aims to import 1,000 troy ounces of gold. He thinks that the price of gold is erratic. The cost per ounce might be $320, $340, or $360.

The goldsmith is considering investing $340 in a 3-month call option on 1,000 ounces of gold. Each ounce of the choice will cost $4. How much does it ultimately cost the goldsmith, given the various gold prices?

Solution:

When the price of gold exceeds the exercise price, the goldsmith would exercise the call option; otherwise, he would let it expire. The goldsmith will get the difference between the gold price and the exercise price when the gold price is higher than the exercise price.

The goldsmith must pay the following total:

	Gold price(dollar per ounce)		
	320	340	360
Cost of 1000 ounces	320000	340000	360000
Less pay off on call option	0	0	20000
Plus option premium	4000	4000	4000
	324000	344000	344000

What is risk hedging with forwards ?

Example

A corporation from India ordered equipment from the USA. The $5,000,000 price is due in six months. '45.75/$ is the current exchange rate. The corporation would need: 45.75 x 5,000 = '22,875,000 at the current currency rate.

Yet, the corporation expects the value of the Indian rupee to decline over time. If the value of the rupee falls when payment is made after six months, the cost to the corporation will rise in Indian rupees. What ought the business to do? With the execution of a forward contract, the corporation can fix the exchange rate and ignore any fluctuations. Let's say the exchange rate for the next six months is 45.95. The business may purchase future dollars. It will swap $22,975,000 for purchasing $5,000 at the moment of payment.

What is risk hedging with futures ?

Example

The revenue instability over the short term worries a coal mining corporation. Currently, coal costs £7,000 per tonne. However, the cost may increase to $7,400 per tonne or decrease to $6,500 per tonne. Next month, the business will give the market roughly 5,000 tonnes. What would happen if the corporation didn't hedge? What would it cost the business if it signs a futures contract to supply 5,000 tonnes of coal next month at the agreed-upon price of $7,050 per tonne?

If the business does not manage risk, it will not be able to predict the selling price after one month, and its revenues will be dependent on the final price.

By using coal futures to hedge, the corporation will lock in the selling price, which is currently $7,050 per tonne.

Solution:

Hedging Risk

Case 1

Futures price 7,050

Spot price 7,400

Profit/loss –350

Case II

Futures price 7,050

Spot price 7,000

Profit/loss 50

Case III

Futures price 7,050

Spot price 6500

Profit/loss 550

How to hedge risk with swaps ?

Example:

The portfolio manager at Osram Mutual Fund Company is Mr. John. He has a debt fund with $200 million invested in long-term corporate debentures. He desires to change the holding into a portfolio with a syntheic floating rate. The portfolio offers a fixed return of 9%. Imagine a swap dealer offers MIBOR (Mumbai Inter-Borrowing Rate) at a fixed rate of 9%. How should Mr. John proceed?

Mr. John should swap a payment at a fixed rate of 9% for getting MIBOR on a notional principal of $200 million. As seen here, the portfolio's cash flows will fluctuate with MIBOR.

	MIBOR Rate		
	8.50%	9.00%	9.50%

Fixed-rate portfolio return (9% × rs200 million)	18	18	18
plus Net cash flow on swap [(MIBOR – 0.09) × Rs200 million]	-1		1
Net payment	17	18	19

18.5 Methods of valuing Options

BINOMIAL MODEL FOR OPTION VALUATION:

We are aware that the DCF (discounted cash flow) method is used to appraise assets. An asset's worth is equal to the discounted present value of its future cash flows. Isn't an object's value alternative its current value? Due to the difficulty in calculating an option's needed rate of return, the DCF approach does not apply to options. Derivative securities include options. The risk of the underlying security serves as a basis for their risk. compared to the underlying assets, options are riskier. A share's market value is constantly fluctuating. As a result, a stock option's needed rate of return is likewise dynamically altering. As a result, employing the DCF method to value options is not practical. The right to benefit from an asset's favourable results is provided by an option. Yet, these results carry a considerable degree of risk. Yet, a buyer pays a lot less for an option than the asset is actually worth. With high-risk outcomes, the buyer invests a very little amount of money.

A Simple Binomial Approach to Option Valuation

Consider that you possess a share with a market value of $150. There are two options for its pricing at the end of a year: either $100 or $300. Let's say you spend $200 to purchase a call option on the share. If the share price reaches 300 at the end of the year, you will exercise your option, and the option's value will be: 300 - 200 = 100. If the share price is 100, you will not exercise your call option, and the option's value will be 0. The two circumstances are depicted below:

Share price at the beginning: Rs. 150

Share price at the end of the year: Case 1: 300, Case 2: 100

Portfolio value of the end of the year:

Case 1: Max [$300 – $200, 0] = $100

Case 2: Max $`100 – $200, 0] = $0

Binomial-tree for option valuation

Share price at beginning of year P=150

Value of long position in shares at the end of the year Case 1 =300Δ, Case 2= 100Δ

Value of short position in one call option at end of the year Case 1 =-100, Case 2= 0

Portfolio value end of the year Case 1 =300Δ-100

Case 2= 100Δ

OPTION VALUATION USING THE BLACK-SCHOLES MODEL

As was covered in the last section, the reasoning behind valuing a call option is pretty straightforward. Nonetheless, the structure can be expanded beyond two timeframes. Also, we have the ability to greatly reduce both the time frame and share price change. The calculation would be quite difficult. Thankfully, the Black and Scholes (B-S) model4 may be used to value options as the time period becomes continuous if certain assumptions are made.

Assumptions

The following presumptions form the foundation of the B-S model:

1. Return rates on shares are distributed logarithmically.

2. Throughout the life of the option, both the share's value (the underlying asset) and the risk-free rate remain constant.

3. There are no transaction fees or taxes, and the market is efficient.

4. Over the term of the option, no dividend will be paid on the share.

The B–S model is as follows:

$$C_0 = S_0\, N(d_1) - E\, e^{-r_f t} N(d_2)$$

where C0 = the current value of call option

S0 = the current market value of the share

E = the exercise price

e = 2.7183,

the exponential constant

rf = the risk-free rate of interest

t = the time to expiration (in years)

N(d1) = the cumulative normal probability density function

$$d_1 = \frac{\ln(S_0 / E) + \left[r_f + \sigma^2 / 2\right]t}{\sigma\sqrt{t}}$$

$$d_2 = d_1 - \sigma\sqrt{t}$$

where

ln = the natural logarithm;

σ = the standard deviation and

σ2 = variance of the continuously compounded annual return on the share.

The Black–Scholes model has two features.

First, the parameters of the model, except the share price volatility, are contained in the agreement between the option buyer and seller.

Second, in spite of its unrealistic assumptions, the model is able to predict the true price of option reasonably well.

The model is applicable to both European and American options with a few adjustments.

We know from put-call parity that the value of put is given by the following relationship:

$$\text{Value of put} = P_0 = C_0 - S_0 + E\,e^{-r_f t}$$

Once we know the value of call option, we can substitute this value in above Equation and determine the value of put option.

$$P_0 = S_0 N(d_1) - Ee^{-r_f t} N(d_2) - S_0 + Ee^{-r_f t}$$
$$= S_0\left[N(d_1) - 1\right] + Ee^{-r_f t}\left[1 - N(d_2)\right]$$

Example:

In order to write a six-month call option on L&T's stock, Rakesh Sharma is interested. Now, a share of L&T is going for Rs. 120. The projected volatility (standard deviation) of share returns is 67%. Rakesh requests a price of Rs.120 for the exercise. Ten percent is taken as the risk-free rate. What premium amount ought Rakesh to impose for writing the call option?We assume that the share is not a dividend-paying share.

Solution:

$$d_1 = \frac{\ln(S_0 / E) + \left[r_f + \sigma^2 / 2\right]t}{\sigma\sqrt{t}}$$

$$d_2 = d_1 - \sigma\sqrt{t}$$

S0 = the current market value of the share =120

E = the exercise price =120

e = 2.7183,

the exponential constant

rf = the risk-free rate of interest =10%

t = the time to expiration (in years) =half year=.5

σ = the standard deviation and =.67

σ2 = variance of the continuously compounded annual return on the share.=.67^2

$d_{1=.34}$

$d_{2= -0.14}$

N(d1)=N(.34)=.6331

N(d2)=N(.14)=4443

we obtain the call value as given below:

$$C_0 = S_0\, N(d_1) - E\, e^{-r_f t} N(d_2)$$

Co= Rs. 25.26

we obtain the put value as given below:

P_0=19.40

Summary

Options, forward contracts, futures contracts, and swaps are examples of derivatives. Investors and businesses alike are risk averse. By using derivatives for hedging, they seek to lower risk. Instruments known as derivatives derive their value and payout from an additional asset known as the underlying asset. Under straightforward circumstances, a basic binomial-tree approach can be used to estimate an option's value. We can value a European call option using the Black and Scholes (B-S) model in more complicated circumstances when the time period and share price fluctuations can be made very modest. An investor has a variety of trading tactics at their disposal.Combining a long position in the stock with a long position in a defensive put—a put that is bought at-the-money—he can form a hedged position (exercise and current share prices being the same).

Key words

Option: An option is a contract that grants the holder the freedom to purchase or sell an underlying asset at a defined exercise (or strike) price on or before a predetermined expiration date, with no obligation to do so. A share or any other asset could serve as the underlying asset, or asset on which the right is written.

Implied volatility: The volatility that the option price implies is known as implied volatility. An investor can contrast implied and actual volatility. Investors may decide that the option's fair price is higher than the observed price if the actual volatility is greater than the implied volatility.

The hedge ratio: The hedge ratio is a measure that allows us to sum up the overall risk associated with option portfolios with a range of exercise prices and maturities. The difference in an option's price for every one rupee increase in share price is known as the hedge ratio. The hedging ratio of a call option is positive, whereas that of a put option is negative.

Review questions

1. How can options aid in risk hedging?
2. Provide an example of how forward contracts are used to manage risk.
3. Describe derivatives. Why do businesses use derivatives to hedging risk?
4. Provide a straightforward binomial approach to valuing options.
5. Provide a straightforward binomial approach to valuing options.

Objective Questions

1. Which of the following is wrong in regard to options ?

A. When you buy insurance on your house, it is an explicit option that will protect you, in the event there is a fire or a theft in your house.

B. If you own shares of a company, your liability is limited. Limited liability is an implicit option to default on the payment of debt.

C. Options have assumed considerable significance in finance. They can be written on any asset, including shares, bonds, portfolios, stock indices, currencies, etc.

D. They are not useful in risk management.

2. Which of the following terminology is wrong in regard to options ?

A. The option to buy an asset is known as a call option, and

B. the option to sell an asset is called a put option.

C. The price at which option can be exercised is called an exercise price or a strike price.

D. The asset on which the put or call option is created is referred to as the outsourced asset.

3. Which of the following is wrong in regard to auctions lexicon?

A. A put or a call option is said to in-the-money when it is advantageous for the investor to exercise it. In the case of in-the-money call options, the exercise price is less than the current value of the underlying asset, while in the case of the in-the-money put options, the exercise price is higher than the current value of the underlying asset. ∩

B. A put or a call option is out-of-the-money if it is not advantageous for the investor to exercise it. In the case of the outof-the-money call options, the exercise price is higher than the current value of the underlying asset, while in the case of the out-of-the-money put options, the exercise price is lower than the current value of the underlying asset.

C. When the holder of a put or a call option does not lose or gain whether or not he exercises his option, the option is said to be at the-money.

D. Options do not come free. They involve cost. The option premium is the price that the holder of an option has to receive for obtaining a call or a put option.

4. Which of the following is wrong in regard to risk hedging with options ?

A. Option is a right and does not constitute any obligation on the part of the buyer or seller of the option to buy or sell the underlying asset.

B. A foreign currency option is a handy method of reducing foreign exchange risk.

C. Similarly, options on interest rates and commodities are quite popular with managers to reduce risk.

D. Options do not -trade on option exchanges.

5. Which of the following is wrong in regard to currency swaps ?

A. Currency swap involves an exchange of cash payments in one currency for cash payments in another currency.

B. Most international companies require foreign currency for making investments abroad

C. Currency swaps are a form of back-to-back loan.

D. currency swap markets does not enable firms to arbitrage the differences between capital markets

6. Which of the following is not a feature of swap ?

A. A swap is an agreement between two parties, called counterparties, to trade cash flows over a period of time.

B. Swaps arrangements are quite flexible and are useful in many financial situations.

C. The two most popular swaps are currency swaps and interest-rate swaps. These two swaps can be combined when interest on loans in two currencies are swapped.

D. Firms can not make use of their comparative advantage of borrowing in their domestic markets and arranging swaps for interest rates or currencies that they cannot easily access

7. Let's say Company X is a USA-based, AAA-rated business. For a capital investment, the corporation has borrowed a $10 million floating-rate loan. The London Interbank Offer Rate (LIBOR) serves as the index for the five-year floating-rate loan. For banks to borrow money from one another in the Derivatives for Managing Financial Risk 807 Eurodollar market, LIBOR is the market-determined interest rate. Low interest rates were in effect when the corporation offered the floating-rate loan. Interest rates are currently very volatile. The company's interest payments under the floating-rate loan will be based on the LIBOR rate. The annual interest will be $10 million at the LIBOR rate. Assume that the LIBOR rate is 5.75 percent. The corporation will pay the following interest at a variable rate:

A. 575,000

B. 625,000

C. 675,000

D. 775,000

8. Let's say Company X is a USA-based, AAA-rated business. For a capital investment, the corporation has borrowed a $10 million floating-rate loan. The London Interbank Offer Rate (LIBOR) serves as the index for the five-year floating-rate loan. For banks to borrow money from one another in the Derivatives for Managing Financial Risk 807 Eurodollar market, LIBOR is the market-determined interest rate. Low interest rates were in effect when the corporation offered the floating-rate loan. Interest rates are currently very volatile. The company's interest payments under the floating-rate loan will be based on the LIBOR rate. The annual interest will be $10 million at the LIBOR rate. Assume that the LIBOR rate is 6.25 percent. The corporation will pay the following interest at a variable rate:

A. 575,000

B. 625,000

C. 675,000

D. 775,000

9. Let's say Company X is a USA-based, AAA-rated business. For a capital investment, the corporation has borrowed a $10 million floating-rate loan. The London Interbank Offer Rate (LIBOR) serves as the index for the five-year floating-rate loan. For banks to borrow money from one another in the Derivatives for Managing Financial Risk 807 Eurodollar market, LIBOR is the market-determined interest rate. Low interest rates were in effect when the corporation offered the floating-rate loan. Interest rates are currently very volatile. The company's interest payments under the floating-rate loan will be based on the LIBOR rate. The annual interest will be $10 million at the

LIBOR rate. Assume that the LIBOR rate is 6.75 percent. The corporation will pay the following interest at a variable rate:

A. 575,000

B. 625,000

C. 675,000

D. 775,000

10. In continuation of previous example, Company X finds that currently the floating-rate loan based on LIBOR can be exchanged for 6.25 per cent fixed-rate loan. If the company decides to enter into a swap arrangement, it can agree to pay 6.25 per cent on notional amount of $10 million to a swap dealer and receive payment for the LIBOR rate on the same amount of the notional capital. Calculate Net cash flow on swap If Libor rate is 5.75% .

A. +50000

B. 0

C. -50000

D. 100000

11. In continuation of example in Q9, Company X finds that currently the floating-rate loan based on LIBOR can be exchanged for 6.25 per cent fixed-rate loan. If the company decides to enter into a swap arrangement, it can agree to pay 6.25 per cent on notional amount of $10 million to a swap dealer and receive payment for the LIBOR rate on the same amount of the notional capital. Calculate Net cash flow on swap If Libor rate is 6.25% .

A. +50000

B. 0

C. -50000

D. 100000

12. In continuation of example in Q9, Company X finds that currently the floating-rate loan based on LIBOR can be exchanged for 6.25 per cent fixed-rate loan. If the company decides to enter into a swap arrangement, it can agree to pay 6.25 per cent on notional amount of $10 million to a swap dealer and receive payment for the LIBOR rate on the same amount of the notional capital. Calculate Net cash flow on swap If Libor rate is 6.75% .

A. +50000

B. 0

C. -50000

D. 100000

13. In continuation of example in Q9, Company X finds that currently the floating-rate loan based on LIBOR can be exchanged for 6.25 per cent fixed-rate loan. If the company decides to enter into a swap arrangement, it can agree to pay 6.25 per cent on notional amount of $10 million to a swap dealer and receive payment for the LIBOR rate on the same amount of the notional capital. The net cash flow consequences of swap agreement and the floating-rate loan for the company under 5.75% LIBOR rates will be

A. 5,00,000

B. 6,00,000

C. 6,25,000

D. 7,25,000

14. In continuation of example in Q9, Company X finds that currently the floating-rate loan based on LIBOR can be exchanged for 6.25 per cent fixed-rate loan. If the company decides to enter into a swap arrangement, it can agree to pay 6.25 per cent on notional amount of $10 million to a swap dealer and receive payment for the LIBOR rate on the same amount of the notional capital. The net cash flow consequences of swap agreement and the floating-rate loan for the company under 6.25% LIBOR rates will be

A. 5,00,000

B. 6,00,000

C. 6,25,000

D. 7,25,000

15. In continuation of example in Q9, Company X finds that currently the floating-rate loan based on LIBOR can be exchanged for 6.25 per cent fixed-rate loan. If the company decides to enter into a swap arrangement, it can agree to pay 6.25 per cent on notional amount of $10 million to a swap dealer and receive payment for the LIBOR rate on the same amount of the notional capital. The net cash flow consequences of swap agreement and the floating-rate loan for the company under 6.75% LIBOR rates will be

A. 5,00,000

B. 6,00,000

C. 6,25,000

D. 7,25,000

Answers

1	D	4	D	7	A	10	A	13	C
2	D	5	D	8	B	11	B	14	C
3	**D**	6	D	9	C	12	C	15	C

Further readings

Financial management by I.M. Pandey. Eleventh edition. Vikas Publication

International Financial Management 2ndEdition by Jeff Madura, Ariful Hoque, Chandrasekha Krishnamurti, 2018

International Financial management by Eun, Resnick and Chuluun. Ninth edition. McGraw-H Education

International Accounting by Timothy S Doupnik_ Hector Perera, McGraw-Hill Educatio (2014).

Unit 19: Market Crisis

CONTENTS

Objectives

After studying this unit, you should be able

- understand the relationship between crude oil prices and foreign exchange.
- analyse the situation to trade in crude / currencies.
- understand the relationship between crude oil prices and foreign exchange.
- analyse the situation to trade in crude and currencies.
- understand the crises of 1990s in India.
- analyse and evaluate the steps taken by the government to come out of the crises.

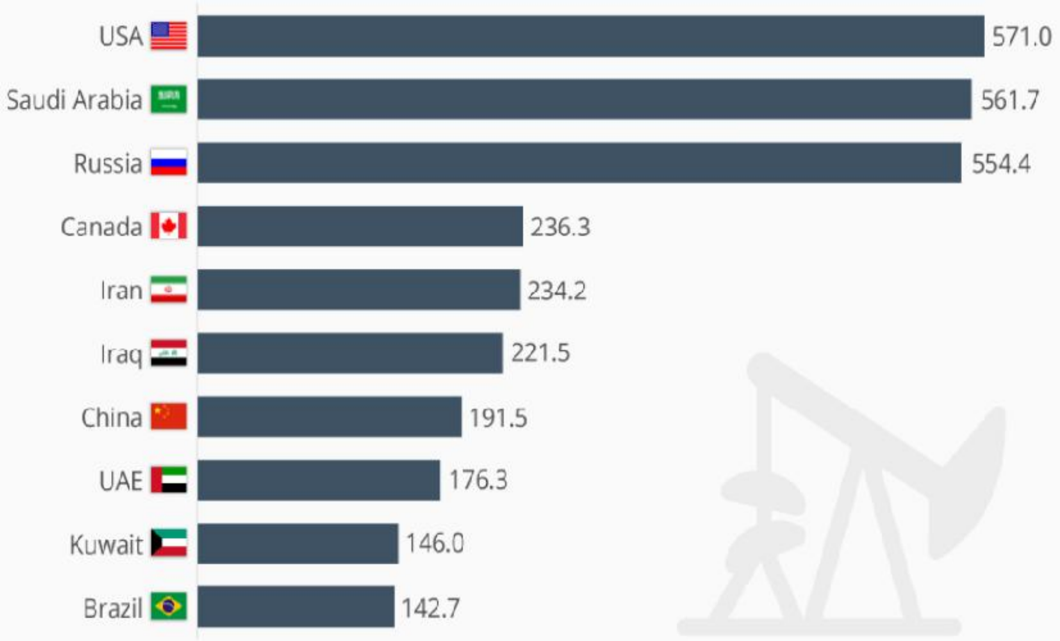
Introduction

There is a hidden string that ties currencies to crude oil. Price actions in one venue force a sympathetic or opposing reaction in the other. This correlation persists for many reasons, including resource distribution, the balance of trade (BOT), and market psychology.There's also crude oil’s significant contribution to inflationary and deflationary pressures that intensifies these interrelationships during strongly trending periods—both to the upside and to the downside.Recent Russia – Ukraine issue is the best example.Oil and currencies are inherently related wherein price actions in one force a positive or negative reaction in the other in countries with significant reserves.The USD has benefited from crude oil’s regular decline since the energy sector is a significant contributor to U.S. GDP.The U.S. shifted from being a net importer to a net exporter of energy in 2020 and was the largest global producer in 2021.Countries that buy crude oil and those that produce it exchange USD in a system called the petrodollar system.

19.1 Oil and Currency Relationship

- Countries that depend heavily on crude exports experience more economic damage than those with more diverse resources.
- Crude oil is quoted in U.S. dollars (USD).
- Countries that import oil pay for it in the US $.
- Similarly, those that export the commodity receive payment in USD.
- This system dates back to the early 1970s after the collapse of the Bretton Woods gold standard.
- This period saw the rise of the petrodollar system, which promoted the U.S. dollar's rise as the world's reserve currency.
- Oil producers and purchasers use this system to trade in the commodity in U.S. dollars.
- Each uptick and downtick in the dollar or in the price of the commodity generates an immediate realignment between the USD and numerous forex crosses.
- These movements are less correlated in nations without significant crude oil reserves, like Japan, and more correlated in nations that have significant reserves like Canada, Russia, and Brazil

Top 10 Oil Producing Countries



19.2 Oil-Producing Economies and Currency Prices

- When explaining what forex trading is and how does it work, it is important to bear in mind that the value of currency pairs is largely based on the economic performance and standing of the countries involved.
- Currency traders will often look at national economic developments to predict a correlating fall or rise in the value of currency pairs.
- When a country that is heavily dependent on oil exports, such as Russia or Saudi Arabia, experiences a collapse in oil prices, a correlating collapse in the value of their national currency, compared to currencies such as the US Dollar, nearly always follows.
- When oil prices are high, such countries often experience a rise in the value of their own currencies; which can be both a good and a bad thing.

19.3 Why is oil traded in US dollars only?

- The United States of America is the largest producer and exporter of oil in the world, so it makes sense that the US dollar would be impacted by global oil prices.
- However, the US economy is not very dependent on oil exports, which actually only makes up a small percentage of GDP.
- More important is the fact that crude oil prices are always quoted in US dollars. This means that no matter where you are in the world, you are essentially trading for oil in dollars.
- When the value of the dollar is high relative to other currencies such as the Euro and the Japanese Yen, you need fewer US dollars to pay for a barrel of crude.
- However, when the value of the dollar is low, more dollars are needed to pay for that same barrel.
- While this is good news for the US, it can be bad news for countries that are net importers of oil, such as Japan or the UK.
- Such countries can find themselves paying more for oil depending on the fortunes of the US dollar.
- Although some have argued that the US dollar's strong impact on the cost of oil is now loosening, it is still a vital consideration in energy markets around the world.
- There is no denying that oil remains the world's most important commodity for a number of reasons.
- The close correlation between crude oil prices and currency values will continue to shape economic trends for decades to come.

19.4 Exchange Rate vs Oil Price

- The oil price has been referred to as a non-monetary factor of exchange rate movements.
- For an oil-importing country, rise in the price of oil worsens the balance of payments and eventually leads to currency depreciation, while it generates the current account surplus for oil exporters.
- In countries having large oil imports, a small increase in the real oil price can result in a rise in the price of tradable goods and may result in the depreciation of the domestic currency.
- Recent researches has proved that an upsurge in oil price results in a weakening of the Indian currency against US dollar.

What Ties Crude Oil to Currencies?

- There are several factors that link crude oil to currencies such that there may be a related or opposing reaction to one when there is a change in price in another.
- This often has to do with the distribution of resources and a nation's balance of trade (the balance between a country's exports and imports).
- Behaviors and sentiment in the market, and the effect that crude oil has on inflation play out in the relationship between the commodity and currencies.

19.5 Introduction to the Indian 1991 crises

- On 24 July 1991, finance minister Manmohan Singh presented his first ever budget, just a month after being sworn in the cabinet of prime minister P.V. Narasimha Rao.

- The government also unveiled a game-changing new industrial policy removing many roadblocks that hindered industries from flourishing.
- But for both Rao and Singh, their initiation into the government was a trial by fire.
- No other government was faced with politically difficult decisions in the first few weeks of assuming power like theirs.
- Exactly 30 years have passed since this historic event that helped India avert a major economic crisis and placed it on the high growth trajectory.
- In 1991, India faced its worst economic crisis and was on the brink of a sovereign default.
- The 1990-91 Gulf War had led to a sharp increase in oil prices and a fall in remittances from the Indian workers working overseas.
- This led to a sharp depletion in India's forex reserves — at less than $6 billion, and this was just enough to meet around two weeks of the country's imports.
- The deteriorating fiscal deficit situation and burgeoning foreign debt levels did not help the government either.
- A fiscal deficit of 8 per cent of gross domestic product (GDP) and a current account deficit of 2.5 per cent of GDP all added to the government's woes.
- Double-digit inflation numbers also added to the burden of the common man.
- There was a huge Macroeconomic imbalance of high current account deficit and high fiscal deficit.
- The crisis did not develop overnight. It was caused by decades of imprudence.
- There was reliance on populist measures. The causes of Balance of Payment Crisis are listed below.
- The causes of Balance of Payment Crisis are listed below-
- 1) The Government Expenditure was more than the earnings. Hence the Fiscal Deficit was high. The Gross Fiscal deficit rose from 9 % of GDP in 1980-81 to 12.7 % of GDP in 1990-91.
- 2) The Internal Debt of the Government rose due to the above reason. It rose from 35 % of GDP in 1985-86 to 53 % of GDP in 1990-91.
- 3) In addition the country was importing more than exporting. India had to secure an emergency loan of $ 2.2 billion from the International Monetary Fund by pledging 67 tons of Gold as collateral security.
- In May 1991, India sent 20 tons of Gold to Union Bank of Switzerland, Zurich and in July, 47 tons of Gold was given to Bank of England to raise a total of $ 600 million.
- The crisis was converted into a golden opportunity to reform the country's economic situation and make-up and introduce fundamental changes in economic policy.
- 4) The current account deficit was triggered by the rise in crude oil prices because of the Gulf War. Due to this, the Forex Reserves of India depleted massively. Despite substantial borrowings from the International Monetary Fund (IMF) earlier in the year.
- 5) India did not have enough Forex reserves to conduct business with the world.
- 6)India was on the verge of defaulting on its International Debt Obligations.
- 7) Investors pulled out their money.
- 8) Short term credit dried up, as exporters were apprehensive that they would not be paid.
- 9) There was a massive rise in inflation rates.
-

  The effects of the Balance of Payment Crisis
- Imports were restricted.
- The price of fuels were raised.
- Bank rates were raised.

- Government had to cut its spending.
- India had to secure an emergency loan of $ 2.2 billion from the International Monetary Fund by pledging 67 tons of Gold as collateral security.
- In May 1991, India sent 20 tons of Gold to Union Bank of Switzerland, Zurich and in July, 47 tons of Gold was given to Bank of England to raise a total of $ 600 million.
- The crisis was converted into a golden opportunity to reform the country's economic situation and make-up and introduce fundamental changes in economic policy.
- The government brought in structural reforms and stabilization policies.
- While the former was aimed at removing the rigidities in the various sectors of the Indian economy, the latter was aimed at correcting the weaknesses that had emerged on the fiscal and BoP fronts.

19.6 Objectives of New Economic Policy 1991

- Enter into the field of 'globalization' and make the economy more market-oriented.
- Reduce the inflation rate and rectify imbalances in payment.
- Increase the growth rate of the economy and create enough foreign exchange reserves.
- Stabilize the economy and convert the economy into a market economy by the removal of unwanted restrictions.
- Allow the international flow of goods, capital, services, technology, human resources, etc. without too many restrictions.
- Enhance the participation of private players in all sectors of the economy. For this, the reserved sectors for the government were reduced to just 3.

Steps under economic reforms of 1991

The key steps taken under the new economic policy were -

1. Liberalization
2. Privatization
3. Globalization
4. The government sought to open up the Indian economy through these measures and gear India from a Soviet-model economy to a market economy. This is an ongoing process and the initiation was done in 1991.

Liberalization

- Commercial banks were given the freedom to determine interest rates. Previously, the Reserve Bank of India used to decide this.
- The investment limit for small scale industries was raised to Rs. 1 crore.
- Indian industries were given the freedom to import capital goods like machinery and raw materials from foreign countries.
- Previously, the government used to fix the maximum production capacity of industries.
- Now, the industries could diversify their production capacities and reduce production costs.
- Industries are now free to decide this based on market requirements.
- Industrial licensing and registration were removed: as per this, the private sector is free to start a new venture of business without obtaining licenses except for a few restrictive sectors.

Privatization

- Privatization refers to opening up the private sector to industries that were previously reserved for the government sector.
- This chiefly involved selling the PSUs (private sector undertakings) to private players.
- This was meant to remove the political interference in PSUs which was making them models of inefficiencies.
-

Key steps under the privatization as reforms -

- Selling shares of PSUs to the public and financial institutions. For example, shares of Maruti Udyog Ltd. were sold to private parties.
- Disinvestment in PSUs. This means selling PSUs to the private sector.

The number of industries that were reserved for the public sector was decreased from 17 to only 3. These were:

- Transport and railway
- Atomic energy
- Mining of atomic minerals

Globalization

Globalization refers to opening up the economy more towards foreign investment and global trade.

- **Reduction in tariffs**: a gradual reduction in the customs duties and tariffs on exports and imports to make India attractive to global investment.

Long term trade policy: trade policy was enforced for a longer duration. The main features of the trade policy are:

1. Liberal policy
2. Encouragement of open competition
3. Controls on foreign trade were removed

Some specific measures to mitigate the crisis

The immediate priority for the Rao government was to prevent a sovereign default — an ignominy that India had managed to avoid till then. It took two immediate measures.

- Devaluation of the rupee
- Pledging gold holdings to shore up forex reserves

1) Devaluation of the rupee

- The government, along with the Reserve Bank of India (RBI), undertook a two-step devaluation of the rupee, which was first devalued against major currencies by around 9 per cent on 1 July 1991, followed by another devaluation of 11 per cent two days later.
- This was done with the aim of making Indian exports more competitive.
- Rao, known for his political astuteness, preferred to undertake the devaluation in two phases to make it more palatable to all stakeholders.

2) Pledging gold holdings to shore up forex reserves

- The central bank pledged India's gold holdings with the Bank of England in four tranches from 4-18 July 1991 raising around $400 million through this route.
- Prior to this, in the midst of national elections, the State Bank of India sold 20 tons of gold on 16 May to the Union Bank of Switzerland or UBS to raise around $200 million.

- The government had also got emergency loans from the International Monetary Fund in two tranches totaling around $2 billion earlier in the year.

3) Structural reforms

- Trade policy: As part of its efforts to boost exports, the Indian government announced a new trade policy that sought to bring a change in the licensing process. It also linked non-essential imports to exports to discourage such imports.
- Taking into account the boost to exports from the massive devaluation of the rupee, the government did away with export subsidies.
- It introduced the concept of tradeable exim scrips granting such scrips to exporters for their use or for sale.
- Such scrips were calculated based on the value of exports. The policy also did away with the need for routing imports through state-owned firms.
- The private sector was allowed to make its own imports.
- New industrial policy: The game-changing new industrial policy was unveiled on the eve of Budget 1991.
- It proposed some massive changes in the way India treated its industries and foreign investment by moving away from a license raj regime.
- The policy relaxed some of the provisions in Monopolies and Restrictive Trade Practices Act to facilitate easier entry and restructuring of businesses by facilitating mergers and amalgamations.
- The policy ended the public sector monopoly in many sectors and announced a policy of automatic approval for foreign direct investment up to 51 per cent as against the earlier cap of 40 per cent for foreign equity investments.
- Public sector monopoly was restricted to only a few sectors important from the point of view of national security.
- It also abolished industrial licensing for all industries barring 18 irrespective of levels of investment.
- All these changes made it easier to do business in India and saw a deluge of foreign goods and investments flooding the Indian market in the subsequent years.
- Budget 1991-92: Presented by Manmohan Singh on 24 July, the budget was a continuation of the reform measures undertaken by the Indian government over the last few weeks. There were some difficult measures taken.
- Faced with a rising fiscal deficit, the budget increased corporate tax rates by 5 percentage points to 45 per cent and introduced the concept of tax deducted at source for some financial transactions like bank deposits.
- It also increased the prices of cooking gas cylinders, fertilizers and petrol and removed the subsidy on sugar.
- It opened up mutual funds to the private sector and relaxed rules for investment by non-residents.
- A scheme for people to declare unaccounted wealth was also announced. People were given immunity from prosecution and from the levy of interest and penalty.
- The reform push continued after budget
- Over the next eight months, the government announced many steps to continue the reforms momentum and pull India out of the crisis.
- These included a second trade policy package to boost exports and a package for developing small firms.
- The government also announced a committee under former RBI governor M. Narasimham for proposing financial sector reforms.

- This was followed by the constitution of another committee for recommending tax reforms under well-known public finance economist Raja Chelliah.
- The economic reforms of 1991 led to widespread economic development in the country.
- Many sectors such as civil aviation and telecom saw great leaps from deregulation and surged ahead.
- India is also home to many start-ups and mushrooming businesses because of the end of the dreaded License Raj.
- The process is, however, far from complete and many areas need improvement.

Summary

Oil, as the world's most heavily-traded natural resource and the bedrock foundation of some of the planet's largest economies, has always had a strong impact on virtually every area of economics and finance. The global oil trade is estimated to be worth something in the region of around $4 trillion a year in revenues, or about 3.8% of global GDP.One area where oil prices have an outsize, global impact is on currency values. Virtually every national currency in the world is regularly impacted by developments within oil markets on an almost daily basis. One of the most apparent correlations between currency prices and oil can be seen in countries that produce and export oil as a major component of their economies.Such countries are naturally very dependent on high oil prices, meaning that a collapse can have the effect of eroding the value of their national currency.New Economic Strategy 1991 India was conceived with the long-term objective of containing corruption, inefficiency, and growth stagnation. Due to the overregulation and overcontrol of the government, as well as the ineffective operation of public sector organisations, the economy was in disarray. Under such a circumstance, the new economic strategy brought about a number of reforms that brought fresh and cutting-edge concepts for creating a foundation for the Indian economy to stand strong in the international forum. The new economic strategy intends to accelerate economic growth through significant advancements and elevate India to a position among the world's top economic powers.

Keywords

Privatisation:Allowing private entrepreneurs to establish industries and businesses in areas that were formerly controlled by the government as the public sector and reserved for them

Liberalisation: Putting an end to the private sector's habit of obtaining licences before beginning a new business in India.

Globalisation: Globalization describes deliberate activities taken to improve relations with other nations and build a position in the global economy.

Review Questions

1. What were the major economic reforms of 1991 in India?
2. How is the devaluation different from depreciation of the currency ?
3. What strategic initiatives were taken to privatize Indian public sector ?
4. How industrial de-licensing helped to recover from 1991 economic crisis ?
5. What were the reasons for Indian 1991 economic crisis ?

Self Assessment

1. The new economic policy was introduced in India in the year

A. 1991

B. 1992

C. 1993

D. 1995

2. a gradual reduction in the customs duties is a measure towards
A. Liberalization
B. privatization
C. globalization
D. localization

3. Removing Controls on foreign trade Is a measure towards
A. Liberalization
B. privatization
C. globalization
D. localization

4. The number of industries that were reserved for the public sector was decreased from 17 to only 3. It was a step towards ..
A. Liberalization
B. privatization
C. globalization
D. localization

5. Selling shares of PSUs to the public and financial institutions was a step towards ….
A. Liberalization
B. privatization
C. globalization
D. localization

6. Disinvestment in PSUs …
A. Liberalization
B. privatization
C. globalization
D. localization

7. opening up the private sector to industries that were previously reserved for the government sector was a step towards ..
A. Liberalization
B. privatization
C. globalization
D. localization

8. Industrial licensing and registration were removed. It was a step towards ..
A. Liberalization
B. privatization
C. globalization
D. localization

9. Industries could diversify their production capacities and reduce production costs. It was a step towards ..
A. Liberalization
B. privatization
C. globalization
D. localization
E.
10. Commercial banks were given the freedom to determine interest rates. It was a step towards…..
A. Liberalization
B. privatization
C. globalization
D. localization

11. The investment limit for small scale industries was raised to Rs. 1 crore. It was a step towards…..
A. Liberalization
B. privatization
C. globalization
D. localization

12. Indian industries were given the freedom to import capital goods like machinery and raw materials from foreign countries
A. Liberalization
B. privatization
C. globalization
D. localization

13. Which of the following is not a Step under economic reforms of 1991?
A. Liberalization
B. privatization
C. globalization
D. localization

14. which of the following is not an Objective of New Economic Policy 1991?
A. Enter into the field of 'localization' and make the economy more domestic-oriented.
B. Reduce the inflation rate and rectify imbalances in payment.
C. Increase the growth rate of the economy and create enough foreign exchange reserves.
D. Stabilize the economy and convert the economy into a market economy by the removal of unwanted restrictions.

15. Which of the following were not the effect of the Balance of Payment Crisis?
A. Imports were liberalised.
B. The price of fuels were raised.
C. Bank rates were raised.

D. Government had to cut its spending.

Answers for Self Assessment

1.	A	2.	B	3.	B	4.	A	5.	D
6.	C	7.	B	8.	A	9.	A	10.	A
11.	A	12.	B	13.	A	14.	A	15.	A

Further Readings

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Unit 20: Contemporary Issues

CONTENTS

Objectives

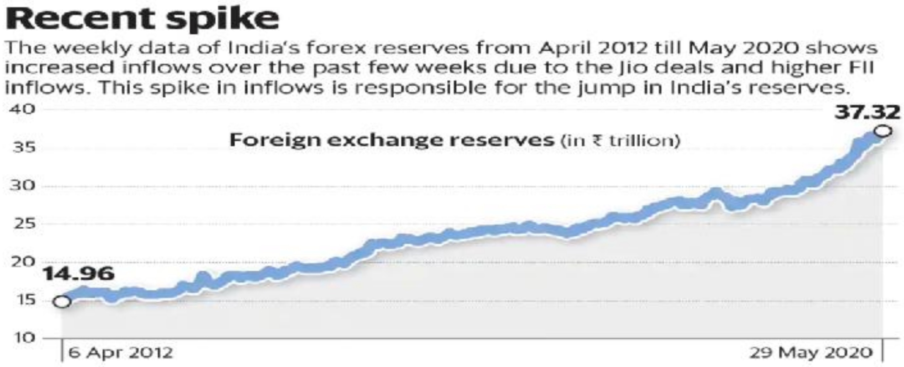
After studying this unit, you should be able

- Understand the importance of Forex for an economy
- How to generate Forex for the economic growth
- evaluate the benefits of Forex / currency market trading.
- analyse the impact of interest rate changes by the Federal Reserve on currency valuation.
- explore the world of crypto currencies and the associated challenges.

Introduction

Foreign exchange refers to exchanging the currency of one country for another at prevailing exchange rates.Foreign exchange is required for international trade. When India is trading with the United States (US) both INR and USD are involved. If India is importing from the United States, it needs to pay in dollars. exchange. This is why the foreign exchange market is important.When the US is importing from India it would need to pay in rupees. Foreign exchange is also important when a country is investing in another. If the US is investing in India, it has to invest in rupees. Such transactions create a demand for foreign exchange. This is why the foreign exchange market is important.In foreign exchange markets, currencies are bought and sold. In reality, foreign exchange is traded virtually 24X7. Forex is the world's largest market. Everyday trillions of dollars of transactions are done. The foreign exchange financial market is the most liquid in the world. Traders in this market involve several institutions. The institutions could be the government, central banks and commercial banks. It would also involve institutional investors, forex agents, individuals, and other businesses.Governments can use direct intervention by purchasing or selling currencies in the foreign exchange market, thereby altering demand and supply conditions and hence the currencies' equilibrium values

20.1 Forex Exchange Reserves

- Forex or foreign exchange reserves are essentially assets held by the central bank in foreign currencies as a reserve.
- They are usually used for backing the exchange rate and influencing monetary policy.
- In the case of India, our forex reserves include dollars, gold, and the International Monetary Fund's quota for Special Drawing Rights.
- All international transactions are settled in US dollars and are therefore needed to support our imports.
- More importantly, they are needed to support, maintain confidence for central bank action, whether monetary policy action or any exchange rate intervention to support the domestic currency.
- Most of the reserves are usually held in US dollars given the currency's importance in the international trading and financial system.
- Some central banks also hold reserves in British pounds, euros, Chinese yuan, or the Japanese yen, in addition to their US dollar reserves.
- It also helps limit any vulnerability because of a sudden disruption in foreign capital flows, which could happen during a crisis.
- Holding liquid forex thus provides a cushion against such effects and gives the confidence that there would still be enough forex to support the country's crucial imports in case of external shocks.
- 

20.2 How did India Increase its Reserves Amid Crises?

- The increase in India's reserves is an outcome of an increase in FDI.
- This comes along with FIIs pouring money into markets expressing confidence in the economy.
- The increase in FDI, however, is primarily an outcome of the successful capital raise by Reliance Industries' Jio Platforms amidst this global pandemic.
- Another reason is that a slowdown means lower domestic consumption, which implies lower imports.
- This coincides with low crude oil prices which further help on the current account front.
- The increase in reserves does give India adequate cushion to combat external shocks.
- India is one of the few nations whose forex reserves are more than forex debt.
- The increase in FDI signals faith in the future of the economy, rather than a commentary on its present state.
- Lower imports are a result of lower domestic demand, but currently, it is due to the lockdown too.
- It is, therefore, difficult to consider the increase in reserves as a direct sign of a healthy economy.

20.3 Benefits of Forex / Currency Trading

The foreign exchange market has emerged as the largest financial market in the world owing to its accessibility, liquidity, and international nature, among a host of other factors.

One can buy and sell currency over the counter to turn a profit, as there exists no physical exchange for such trading, unlike other markets.

Some of the benefits are as follows -

Market is Large and Global

- The foreign exchange market is truly expansive with traders participating from all parts of the world.
- The importance of foreign exchange market is evident from the fact that more than $4 trillion are exchanged on an average in the currency market every day.
- Other factors that make it a lucrative trading place are largely derived from the fact of the market's sheer size.

Good for Beginners

- First-time traders looking to make small investments can easily enter the forex market.
- One of the many advantages of foreign exchange is that brokers offer a provision of demo accounts.
- Using these, rookie traders can test their skills in a market simulation before committing to any deals.

Round the Clock Market

- Given that the forex market is global, trading can take place almost continuously as long as a market is open somewhere in the world.
- It operates five days a week, for 24 hours each day.
- The first major market opens in Australia's Sydney at 5 pm on Sunday and trading ends when the US' New York market closes at 5 pm on Friday.

Leverage

- Foreign exchange brokers allow retail traders to borrow against a small amount of capital, thereby offering a chance to open a high position.
- The amount of money one raises from leverage is generally represented as a ratio.
- For example, 1:30 would mean that your leverage is 30 times what you actually invested in the market.

Liquidity

- Due to the large volume of trading activity that occurs round the clock in the forex market, it is considered the most liquid market in the world.
- Liquidity refers to the ability of assets to be bought and sold with little effect on their value.
- In the case of forex markets, liquidity allows you to trade with minimal risk.
- Geopolitics, economic stability, policies, natural calamities and trade deals are among a long list of forces that influence the market.
- A small development in any of these translates into a major shift in the market.
- This sensitivity of a market is called its volatility.

Volatility

- When values of currencies change for the better due to these determinants, they result in major profits.
- However, if the values are affected adversely, traders can suffer significant losses.
- Since volatility cannot be avoided altogether, you should go about having strategies to deal with volatile markets.

No Restrictions on Directional Trading

- Unlike the stock market, the foreign exchange market does not have any restrictions on directional trading.
- Since traders are always either buying or selling a currency according to the state of the market, you can easily go long or sell short depending on your prediction of change in their value.
- Because of the high liquidity of currencies, brokers do not charge any transaction fees for such trading that are required in stock markets.

Nobody Controls the Market

- There is a large number of participants in the forex market, which is why no single player, but only external factors such as the economy can control prices.
- This factor reflects the importance of foreign exchange as an investment option on traders' portfolios.
- No middlemen exist in this market, and brokers only help connect buyers and sellers.

Low Transactional Charges

- A small capital sum is enough to start online forex trading, without any major costs of conducting transactions.
- The cost of transactions largely comprises the broker's fee, which he earns from spreads.
- The spread is measured in pips or points in percentage, which is the difference between the ask price and the bid.

Technology

- Since this market is relatively new, among the advantages of foreign exchange is that its participants have embraced technology willingly.
- There are plenty of software and mobile applications that facilitate trade in real-time from around the world.

20.4 Why Interest Rates Matter ForForeign Exchange Valuations?

- Interest rate changes made by any of the world's most influential central banks can have a major impact on the foreign exchange market.
- These rate changes usually are a response to economic indicators observed throughout the month.
- They potentially can move the market immediately and with full force.
- Sudden interest rate changes can have a substantial impact on forex valuations.

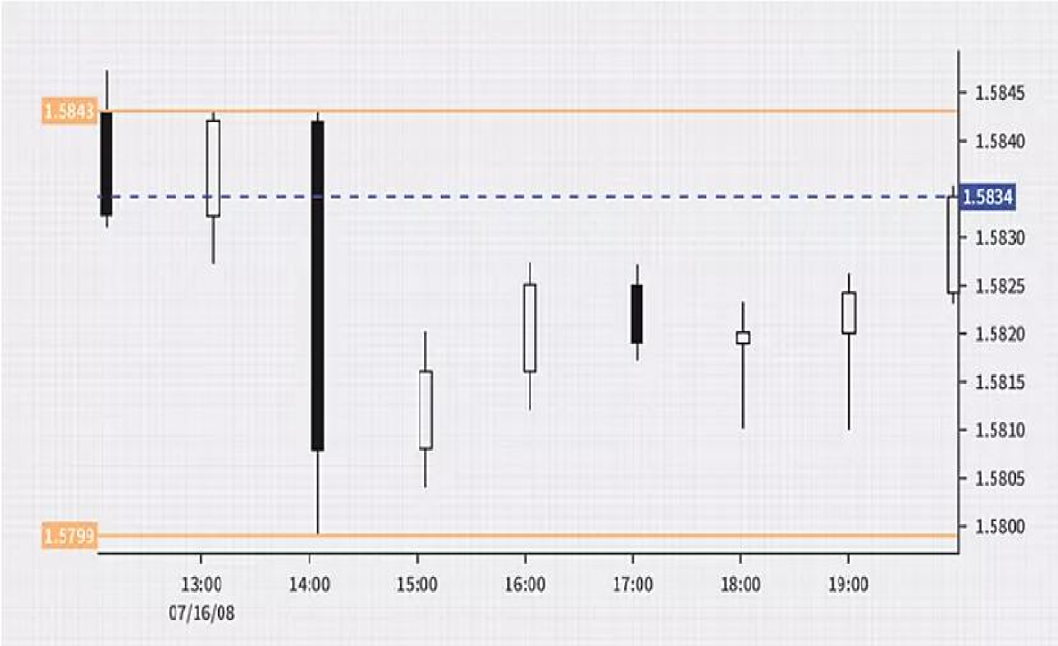
How Interest Rates are Determined

- Each central bank's board of governors controls the monetary policy of its country and the short-term rate of interest at which banks can borrow from one another.
- The central banks will raise rates in order to curb inflation and cut rates to inject money into the economy and encourage lending.

- Relevant economic indicators may provide an idea of actions a central bank may take. Some important U.S. economic indicators include:
    - Personal Consumption Expenditures Price Index (PCE)
    - Consumer Price Index (CPI)
    - Consumer spending
    - Employment levels
    - Subprime market
    - Housing market

20.5 Predicting Central Bank Rates

- Data from these and other economic indicators can help a trader project and prepare for an interest rate change.
- Healthy economic activity can mean rates may be left unchanged.
- If the economy is too strong, the central bank may raise rates. On the other hand, weakness measured by indicators can portend a rate cut to encourage borrowing.
- It's also possible to predict an interest rate decision by taking note of major announcements and analyzing economic forecasts.
- Major announcements from central bank leaders can provide vital information about interest rate moves.
- They shouldn't be overlooked in sole favor of economic indicators.
- When the board of any of the eight major central banks is scheduled to talk publicly, traders can glean insights into how a bank views inflation and, therefore, actions it might take.
- For example, on July 16, 2008, Federal Reserve Chair Ben Bernanke gave his semi-annual monetary policy report to the House Committee on Financial Services.
- At a typical session, Bernanke reads a prepared statement on the U.S. dollar's value and answers questions from committee members.
- Bernanke, in his statement and answers, was adamant that the U.S. dollar was in good shape and that the government was determined to stabilize it although fears of a recession were influencing all other markets.
- His statement was widely followed by traders who took it as a positive sign that the Federal Reserve would raise interest rates. This perception resulted in a short-term rally on the dollar in advance of the next rate decision.



- The EUR/USD declined 44 points over the course of one hour, which was good for the U.S. dollar. The move resulted in a $440 profit for traders who acted on the announcement.
- The second way to predict interest rate decisions is by analyzing forecasts.
- Interest rates moves can be anticipated. As a result, brokerages, banks, and professional traders will already have a consensus estimate of what the rate may be.
- Traders can take four or five of these forecasts (which should be very similar) and average them for a more accurate prediction.

20.6 What is Cryptocurrency?

- A cryptocurrency is a digital or virtual currency that is secured by cryptography, which makes it nearly impossible to counterfeit or double-spend.
- Many cryptocurrencies are decentralized networks based on blockchain technology—a distributed ledger enforced by a disparate network of computers.
- A defining feature of cryptocurrencies is that they are generally not issued by any central authority, rendering them theoretically immune to government interference or manipulation.

Blockchain

- Central to the appeal and functionality of Bitcoin and other cryptocurrencies is blockchain technology.
- As its name indicates, blockchain is essentially a set of connected blocks or an online ledger.
- Each block contains a set of transactions that have been independently verified by each member of the network.
- Every new block generated must be verified by each node before being confirmed, making it almost impossible to forge transaction histories.
- The contents of the online ledger must be agreed upon by the entire network of an individual node, or computer maintaining a copy of the ledger.
- Experts say that blockchain technology can serve multiple industries, such as supply chains, and processes such as online voting and crowdfunding.

- Financial institutions such as JPMorgan Chase & Co. are testing the use of blockchain technology to lower transaction costs by streamlining payment processing.
- Cryptocurrency functions through the network, where a large number of computers are employed, which is why cryptocurrency is decentralized, and control of the currency is not confined to the hands of a government authority or a central authority.
- With everything being available online, cryptocurrency was a new phenomenon that enabled people to buy, sell, invest and trade in a currency that had no physical form.
- It stands out because it was decentralized and had no third party involvement unlike other payment systems, and this is the reason why any transaction made using cryptocurrency does not fail.

Indian Perspective

- When it comes to India, it is estimated that Indians have invested more than 1billion US Dollars in the cryptocurrency market alone, even though the fact that the picture regarding legality or cryptocurrency still seems blurry and unclear, creates a lot of confusion in the mind of investors as government lacks to take a strong stand of where cryptocurrency stands today and most essentials, what is its future it beholds.
- Cryptocurrency has been a buzzword for many years now, but its popularity has been spiking in recent years.
- What was formerly an alternative investment solely in the domain of speculators is now being openly discussed as a viable option for a portion of any investor's portfolio, even in their retirement plans.
- In centralized banking and economic systems, governments control the supply of money, printing more when necessary.
- On the other hand, cryptocurrencies are intangible money that only exists in digital form, such as tokens.
- There is a fixed number of each type of cryptocurrency, meaning companies or governments cannot produce more.
- Today, cryptocurrency can be exchanged through platforms like Coinbase and used as traditional money to purchase physical things, not just investing/trading.

Benefits of Decentralized Nature of Cryptos

- Eliminate the Role of Banks– When transferring traditional money, the bank charges you fees as an intermediary.
- In the case of cryptocurrencies, the network members themselves in the blockchain act as an intermediary, and their compensation is minimal.
- In addition, anyone with a mobile phone can use crypto to make payments without the need to create a bank account (and pay the respective fees attached).
- Less Devaluation– Government central banks can print money in the event of economic crises, which can devalue the currency and generate side effects (such as inflation).
- Most cryptocurrencies come with a limited amount. When all available units are in circulation, there's no central entity to create new ones.
- The Money is Really Yours– People hand over their traditional money to the control of banks and governments.
- In times of crisis, some governments had already frozen citizens' bank accounts or confiscated their savings.
- In the case of cryptocurrencies, only you can access and use your money.

20.7 The Future of Cryptocurrency

- In 2013, a single Bitcoin was worth a thousand dollars, prompting many investors and speculators to look for cryptocurrencies.

- High demand caused the value to go down. Since then, the price has had many ups and downs, but in 2021 a Bitcoin cost almost $45,000.
- While some endorse it as the future of finance, many are still critical of the impact mining crypto has on the environment.
- Some companies, like Tesla, have stopped accepting Bitcoin due to such concerns.
- But in general, many investors are excited by the opportunity to trade in a non-government regulated space.
- Everything suggests that crypto could be a very lucrative investment for the future.
- Some experts even claim that Bitcoin could be worth $300,000 in the coming years.
- For young professionals or investors, cryptocurrencies sound like the business of the future.
- Although many people tend to buy only a few units to keep, hoping for potential growth in the future, active investors are dedicated to buying and selling crypto, maximizing their profit and revenue.
- However, it's not smart to throw yourself into the cryptocurrency universe without a plan and strategy like any new business.
- Experts warn that, with a large number of cryptocurrency options available, some may disappear from the market in a few years and never pay back the investment.
- with good planning and strategy, who knows, you might be lucky to see your investment skyrocket, as happened with Bitcoin. Or, better yet, in just a few years, crypto will completely replace traditional money, and you will be one of the pioneers in this brave new world.
- That is why cryptocurrency is rising in popularity.

Drawbacks of Cryptocurrency?

(Why Govt Wants to Ban Crypto)

- Sovereign Guarantee: Cryptocurrency is speculative. People invest in high amounts to attain big returns. This leads to Market Volatility. It means prices fluctuate a lot and many people can suffer big losses, thus has a huge risk.
- Illegal use: Cryptocurrency acts as an opportunity for those who plan to evade taxes or do money laundering.
- Easy mode of transfer in Cyber- terrorism, the most famous case was of WannaCry and Petya viruses in which $300 was paid in Bitcoin to decrypt files.
- Wanna cry is a perfect example crypto ransom that was used by criminals to extort money online.
- The hackers locked the individual's computer and in return demand ransomware in the form of cryptocurrency.
- The Petya attack did the same attack and demanded bitcoin as ransom.
- Risk in security -Digital currency is not operated by the govt and govt guarantee is not behind it.
- Cyber attacks - Anything that is available in cyberspace is always under constant threat of being hacked.
- Once the hackers find a way to penetrate the security system of cryptocurrency, they can create n number of cryptocurrencies, can sell them, and even steal cryptocurrency from other users. There is always a Malware Threat Because it is a digital currency, it can be hacked, one can lose their password, virus, etc.
- Money laundering - People will start investing in money laundering and very easy as one can send money from country to country without any accountability.

- As per a report criminals laundered US$2.8 billion through crypto exchanges in 2019, compared to US$1 billion in 2018. Research on the internet indicated that approx. 56% of cryptocurrency users have weak K.Y.C.
- Economic disbalance- The creation of cryptocurrency is very different from how actual cash is created in the economy. E.g.- In India, only RBI has the authority to create cash.
- It can do so only after maintaining the Minimum Reserve System and an asset whose value is up to 200 crore. This creates a balance of demand and supply.
- User error could result in the crypto being sent to the wrong address and it may then be unrecoverable.
- Companies using third parties to facilitate payment would be subject to processing fees and additional counterparty risk.
- Because of high price volatility there could be issues related to who bears the risk if the value declines rapidly between when a payment is due, made and ultimately received.
- Employees compensated in crypto would have to report it on their taxes, which would be more complicated than reporting traditional payments.
- The legal status of crypto is still in flux and may vary depending on the cryptocurrency.

20.8 Legality of Cryptocurrency in India

According to the latest development, the government is planning to impose Cryptocurrency and Regulation of Official Digital Currency Bill, 2021 which plans to impose a complete ban on private cryptocurrencies but also keeping in mind the grey areas will also provide a framework as to the regulation of cryptocurrency and will provide certain exceptions as to the transactions that can take place via cryptocurrencies.

Summary

Each nation has a central bank with the authority to interfere in the foreign exchange markets and limit the value of its currency. For instance, the Federal Reserve System is the country's central bank in the United States (the Fed). The Reserve Bank of Australia (RBA) is in charge of overseeing the currency markets in Australia and intervening as needed to preserve the value of the Australian dollar. In addition to acting in the foreign exchange market, the federal bank has other responsibilities. In particular, it aims to restrain the expansion of the money supply in the nation so as to keep inflation low and economic growth strong.Several central banks have different levels of control over, or "management," of the domestic currency. To smooth exchange rate movements, set implicit exchange rate bounds, and respond to transient disturbances, central banks like the federal bank frequently control exchange rates.

Keywords

Interest rate parity (IRP): It states that the forward rate differs from the spot rate by a sufficient amount to offset the interest rate differential between two currencies.

Real interest rate Nominal (or quoted) interest rate minus the inflation rate.

Cryptocurrency: A virtual coinage system that operates like a standard currency but without a central trusted authority, and which permits users to make virtual payments for goods and services

London Interbank Offered Rate (LIBOR) The rate most often charged for very-shortterm loans (such as for one day) between banks

Self Assessment

1. Which of the following is wrong in regard to INTERVENTION AS A POLICY TOOL?

A. The government of any country may consider influencing the value of its home currency in order to improve its economy

B. It may attempt to weaken its currency under some conditions and strengthen it under others

C. In essence, the exchange rate becomes a tool, like tax laws and the money supply, that the government can use to achieve its desired economic objectives

D. When the RBA increases interest rates as a form of indirect intervention, it may stimulate the Australian economy by reducing not only the dollar's value but also the financing costs of companies and individuals in Australia

2. Which of the following is wrong in regard toInfluence of a strong home currency?

A. A strong home currency can encourage consumers and corporations of that country to buy goods from other countries.

B. This situation lowers foreign competition and forces domestic producers to go for increasing prices.

C. Therefore, the country's overall inflation rate should be lower if its currency is stronger, other things being equal

D. When the RBA increases interest rates as a form of indirect intervention, it may reduce Australian inflation by increasing not only the dollar's value but also the cost of financing

3. Which of the following is wrong in regard to relative interest rates?

A. Changes in relative interest rates affect investment in foreign securities, which influences the demand for and supply of currencies and thus affects the equilibrium exchange rate.

B. Although a relatively high interest rate may attract foreign inflows (to invest in securities offering high yields), that high rate may reflect expectations of relatively high inflation

C. Because high inflation can place downward pressure on the local currency, some foreign investors may be discouraged from investing in securities denominated in that currency.

D. In such cases, it is useful to consider the nominal interest rate, which adjusts the real interest rate for inflation:

4. Which of the following is wrong in regard to formula of real interest rate?

A. Real interest rate = Nominal interest rate - Inflation rate

B. Real interest rate = Nominal interest rate + Inflation rate

C. Real interest rate = Nominal interest rate * Inflation rate

D. Real interest rate = Nominal interest rate / Inflation rate

5. Which of the following is wrong in regard to implications of real interest rate?

A. The real interest rate is appropriate for international comparisons of exchange rate movements

B. it incorporates both the nominal interest rate and inflation,

C. Both nominal interest rate and inflation influences exchange rates.

D. Other things held constant, a low Australian real rate of interest (relative to other countries) tends to boost the Australian dollar's value.

6. Which of the following is wrong in regard to Government controls?

A. The governments of foreign countries can influence the equilibrium exchange rate by imposing foreign exchange barriers;

B. The governments of foreign countries can influence the equilibrium exchange rate byintervening (buying and selling currencies) in the foreign exchange markets

C. The governments of foreign countries can influence the equilibrium exchange rate by affecting macro variables such as inflation, income levels

D. The governments of foreign countries can not influence the equilibrium exchange rate by affecting macro variables such as interest rates.

7. History was made in January 2009 with the launch of the ….., the first cryptocurrency to be issued

A. Bitcoin

B. Etherum

C. Cardano

D. Tether

8. Which of the following is wrong about cryptocurrency?

A. A cryptocurrency is a virtual coinage system

B. It operates like a standard currency

C. It has no backing from central trusted authority,

D. Central Bank permits users to freely make virtual payments for goods and services without any tax implications.

9. Which of the following is wrong about Bitcoin?

A. A bitcoin is actually a chain of digital signatures where each owner transfers the bitcoin to the next owner manually.

B. While there has been a steady increase in the number of transactions of bitcoins, bitcoin prices in recent years have been highly volatile

C. Bitcoin transactions can only be made by logging these transactions into a public ledger known as a blockchain

D. History was made in January 2009 with the launch of the bitcoin, the first cryptocurrency to be issued.

10. Which of the following is wrong about significance of interest rates for foreign exchange valuations?

A. Interest rate changes made by any of the world's most influential central banks can have a major impact on the foreign exchange market.

B. These rate changes usually are a response to economic indicators observed throughout the month.

C. They potentially can move the market immediately and with full force.

D. The central banks will lower rates in order to curb inflation and cut rates to inject money into the economy and encourage lending

11. Which of the following is wrong about Money market interest rates among currencies?

A. money market rates vary substantially among currencies

B. This variance is due to differences in the interaction between the country's total supply of short-term funds available (bank deposits) and that country's total demand for short-term funds by borrowers

C. money market interest rate paid by corporations that borrow short-term funds in a given country is slightly higher than the rate paid by that country's national government

D. Money market interest rates among countries tend to be not correlated over time because conditions that affect the supply and demand for short-term funds tend to change in a similar manner among countries

12. Which of the following is not a benefit of Forex / Currency Trading?
A. One can buy and sell currency over the counter to turn a profit, as there exists no physical exchange for such trading, unlike other markets
B. The foreign exchange market is truly expansive with traders participating from all parts of the world.
C. Given that the forex market is global, trading can take place almost continuously as long as a market is open somewhere in the world.
D. Foreign exchange brokers do not allow retail traders to borrow against a small amount of capital, thereby not offering a chance to open a high position.

13. Which of the following is not right about LIBOR?
A. The London Interbank Offered Rate (LIBOR) is the rate most often charged for very-short-term loans (such as for one day) between banks.
B. The LIBOR varies among currencies because both the market supply of and market demand for funds vary among currencies.
C. With the changes in supply and demand for funds, there is no change in the LIBOR.
D. The term LIBOR is commonly used even though many international interbank transactions do not pass through London.

14. Which of the following is not right aboutINTERNATIONAL MONEY MARKEt?The corporations and institutional investors have incentives to invest in a foreign currency because:
A. The interest rate receivable from investing in their home currency might be higher than what could be earned on short-term investments denominated in a different currency.
B. they may consider investing in a currency that will appreciate against their home currency because then, at the end of the investment period, they could convert that currency into their home currency at a more favourable exchange rate.
C. The preferences of corporations and governments to borrow in foreign currencies and of investors to make short-term investments in foreign currencies resulted in the creation of the international money market.
D. The intermediaries serving this market are willing both to accept deposits and provide loans in various currencies

15. US dollar deposits in banks in Europe (and on other continents) are known as
A. Eurodollars
B. Euros
C. Petrodollars
D. LIBOR

Answers for Self Assessment

1.	D	2.	A	3.	A	4.	D	5.	C

6.	B	7.	D	8.	D	9.	D	10.	A
11.	D	12.	D	13.	A	14.	D	15.	A

Review Questions

1. Take into account that the Reserve Bank of Australia thinks the Australian dollar should be weaker against the Korean won. Describe how the RBA could intervene directly and indirectly to reduce the value of the dollar relative to the won. Assuming that, regardless of the RBA's policies, future Australian inflation will be projected to be low.
2. Briefly describe the reasons the RBA would try to make the Australian dollar stronger.
3. Suppose Germany, one of the euro-using nations, would prefer a decline in the value of its currency relative to the Australian dollar. Can it accomplish this goal using central bank intervention? Explain
4. In what ways can a central bank intervene directly to alter the value of a currency? Describe the reasons a central bank might want to stabilise the fluctuation of its currency's exchange rate.
5. How can a central bank alter the value of a currency by indirect intervention?

Further Readings

International Financial Management 2ndEdition by Jeff Madura Ariful Hoque Chandrasekhar Krishnamurti, 2018

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