

International Banking

THIRD YEAR B.A. Programme

Semester – 5

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B.A. THIRD YEAR

Semester – 5 : International Banking

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining a 'A' Grade from the NAAC in the year 2014, the Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 285 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education with the aim to bring higher education within reach of all. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even housewives desirous of pursuing higher studies. With the goal of bringing education in the door step of all such people. Acharya Nagarjuna University has started offering B.A, and B, Com courses at the Degree level and M.A, M.Com., L.L.M., courses at the PG level from the academic year 2021-22 on the basis of Semester system.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers invited respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn facilitate the country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Coordinators, Editors and Lesson -writers of the Centre who have helped in these endeavours.

Prof. P.Rajasekhar
Vice –Chancellor,
Acharya Nagarjuna University

THIRD YEAR B.A.

SEMESTER – V

COURSE – 6 : 515BSE21 INTERNATIONAL BANKING

| | | | |
|---------------------------------|---------------------------------|----------|------------|
| No. of hours per week: 5 | Max. Marks | : | 100 |
| No. of Credits : 04 | Semester end examination | : | 70 |
| | Internal Assessment | : | 30 |

Learning Objectives :

In this course the students will learn about the evolution of international banking and finance, the processes, the prevailing competition and the issue of cross-border risk exposure. The course plan provides a review of salient global financial events such as the merger of European currencies into one single currency : the Eurodollar and the expansion of high speed electronic global payments. This course is designed for all level bankers, investment bankers or junior officers wishing to pursue a career in international banking.

SYLLABUS :

UNIT – I :

Meaning, Scope, Importance & Evolution of International banking. International Banking Vs. Domestic Banking. Reasons for the growth of International Banking – International Financial Transactions – FERA and Regulatory Frame Work in India.

UNIT – II :

Foreign Exchange : Market; rate and Currency Exchange rate determination under Fixed exchange rate and Floating exchange rate regimes – Determination of exchange rates : Spot and Forward – Basic exchange arithmetic – Forward Cover and Hedging.

UNIT – III :

International Financial Institutions and Functions : World Bank ; IMF ; Asian Development Bank – International Financial Corporation; International Development Association – World trade organization – international bank for reconstruction and development.

UNIT – IV :

Sources of Foreign Exchange – Export Earnings – Invisible Export Earnings – Role of NRI Remittances – Foreign Direct Investment – Foreign Institutional Investment – External Commercial Borrowings – Global Depositors Receipts – Offshore Borrowings – Documentary Letter of credit.

UNIT – V :

Foreign Exchange Management – Composition of Foreign Exchange Reserves : Foreign Currencies – Gold and SDR – Current Account Convertibility – Capital Account Convertibility and Precautions.

Reference books :

1. Modern Banking – Sayers, R.S.
2. Contemporary Banking Trends – Basu, S.K.
3. Banking Systems of Great Britain – Machenize, K. French, Germany and U.S.A.
4. Introduction to Banking – Barbara Casu, Claudia Girardone, Philip Molyneu, 2nd edition.
5. Domestic and International Banking – Mervyn Lewis, Kevin T. Davis, MIT Press Cambridge.

(515BSE21)

MODEL QUESTION PAPER
B.A. DEGREE EXAMINATION,
Third Year – Fifth Semester
Part – II : Banking
Paper – VI : **International Banking**

Time : Three hours

Max. Marks: 70

SECTION A-(5 x 4 = 20 marks)
Answer any FIVE of the following.
Each answer carries 4 marks.

1. Define International Banking
2. Describe Foreign exchange Rate
3. Define Forward cover and Hedging
4. What is meant by ADB
5. Offshore banking
6. Foreign currency
7. FERA
8. Letter of credit

SECTION B - (5 x 10 = 50 marks)
Answers the following questions.
Each answer carries 10 marks.

9. a.) What is the scope of international banking?

(Or)

- b.) What are the differences between international Banking and Domestic Banking?

10. a.) Define foreign exchange market?

(Or)

b.) Determine the exchange rate?

11. a.) What are the international financial institutions?

(Or)

b.) Write about WTO.

12. a.) Briefly explain about FDI.

(Or)

b.) Distinguish between FDI and FII.

13. a.) Write about the composition of foreign exchange Reserves.

(Or)

b.) What are the differences between current account and capital account convertibility?

CONTENTS

| Unit No. | Lesson No. | Title of the Lesson | Page No. From To |
|----------|------------|----------------------------------------------------------------|--------------------------|
| Unit - 1 | 1 | International Banking | 1.1 - 1.10 |
| | 2 | International Banking and Domestic Banking | 2.1 - 2.11 |
| Unit - 2 | 3 | Foreign Exchange Market | 3.1 - 3.16 |
| | 4 | Exchange Rate Determination | 4.1 - 4.11 |
| Unit - 3 | 5 | International Financial Institutions | 5.1 - 5.14 |
| | 6 | International Development Association & WTO | 6.1 - 6.16 |
| Unit - 4 | 7 | Sources of Demand or outflow of Foreign Exchange | 7.1 - 7.13 |
| | 8 | Foreign Direct Investment | 8.1 - 8.17 |
| | 9 | External Commercial Borrowings | 9.1 - 9.17 |
| | 10 | Off–shore Borrowings & Documentary Letter of Credit | 10.1 - 10.11 |
| Unit - 5 | 11 | The Foreign Exchange Management Act, 1999 | 11.1 - 11.29 |
| | 12 | Foreign exchange reserves | 12.1 - 12.12 |
| | 13 | Current and Capital Account Convertibility in India | 13.1 - 13.16 |

LESSON – 1

INTERNATIONAL BANKING

Objectives :

After studying this lesson, the student be able to :

- understand the meaning and concept of International Banking
- describe the brief history of International Banking
- distinguish various forms of International Banking.

Structure of the Lesson :

- 1.1 Introduction
- 1.2 Background
- 1.3 International Banking – features
- 1.4 Benefits
- 1.5 Types of Services Offered
- 1.6 Types of International banking
- 1.7 Reasons for International Banking
- 1.8 International payment or Methods by which Exporter can receive payment
- 1.9 Summary
- 1.10 Key words
- 1.11 Self Assessment Question
- 1.12 Suggested Books

1.1 INTRODUCTION :

Origin and Evolution of international banking – global trends as reasons for growth of international banking- future prospects of international banking – Need for regulation of international banking in the current scenario. International financial institutions – international financial centres.

Meaning :

International banking is just like any other banking service, but it takes place across different nations or internationally. To put it another way, it is an arrangement of financial services by a residential bank of one country to the residents of another country. Most multinational companies and individuals use this banking facility for transacting.

Example :

Suppose Microsoft, an American company is functioning in London. It is in need of funds to meet its working capital requirements. In such a scenario, Microsoft can avail of the banking services in form of loans, overdrafts or any other financial service through banks in London. Here, the residential bank of London shall be giving its services to an American company. Therefore, the transaction between them is said to be a part of an international banking facility.

International markets, offer opportunities to the traders and corporate and multinational companies, to expand their business, across different parts of the globe. International investors explore more investment avenues for their investments.

The international markets in the financial sector offers a wide range of opportunities for expansion of trade and financial activities across the borders of nations. “International Banking” can be defined as a sub-set of commercial banking transactions and activity having a cross-border and / or cross currency element.

Multinational banking refers to the location and ownership of banking facilities in a large number of countries and geographic regions. International banking comprises a range of transactions that can be distinguished from purely domestic operations by

- (a) the currency of denomination of the transaction,
- (b) the residence of the bank customer and
- (c) the location of the booking office.

1.2 BACKGROUND :

Internationalization can be seen as overcoming distance and globalize the world economy (McDonald, Mayer, Buck, 2004). Internationalization is also based on obtaining a national knowledge and transferring that knowledge abroad. The internationalization move can also be used for future orientation as a learning process (Blomstermo, Sharma, 2003). The concept of internationalization is constantly being explored, leading to different forms of results and theories. Much of the information gained is from studying outcomes and experimental knowledge to provide answers to the behavior of internationalization (Marquardt, 1994). In the last couple of years researchers have increased interest in internationalization of service firms. Particularly banking, finance and insurance firms have developed and increased their internationalization leading to new research taking place. The increased research in the field of service firms has been brought up due to changes in regulations, technology and changes in customer demand (Blomstermo, Sharma, 2003).

Most case studies in service firms show that many firms enter countries choosing the ones neighboring their own country. After a while the firm generally moves to more distant markets (Blomstermo, Sharma, 2003). This can also be seen in the Uppsala internationalization model which states that firms gradually internationalize by starting with countries nearby (Johanson, Vahlne, 1977).

International banking was enlightened in the 1970's (Mullineux, Murinde, 2003). The

process of internationalization contributes to economic effects in Europe and occurs in different forms when a company goes international. The European Union as well as the Euro currency has led to increased internationalization and a higher concentration of the banks. This have enlarged the competition in the banking industry and also increased the incentives for the banks to be more aware of their products and try to constantly improve strategies and products offered to the customers. Another factor that keeps moving globalization further is the new technology that is making communication and long-distance business easier and is also contributing to global banking competition (Bikker, Wesseling, 2003).

Nordea is an important player in the Swedish banking industry. The bank is a result of mergers between four different Nordic banks which originates from Finland, Denmark, Norway and Sweden. This indeed gave Nordea an international benefit with a strong base in all of the Nordic countries. In the Nordic and Baltic Sea region Nordea is the largest provider of financial services. Nordea sees itself as a major player in the banking internationalization within Introduction 2 the region that the bank operates in and claims to be in head of the progress of integrating banking and insurance activities across borders (Nordea, 2011).

The Swedish bank SEB has since the 1970's been active in different countries. The bank is operating in more than 20 countries and is constantly expanding. Today the bank is established in markets all over the world with its biggest market in the Nordic countries, the Baltic's and Germany. SEB has diverse strategies and structures in the different countries in which the bank operates in. In the other Nordic countries they are more focused on corporate and investment banking while in Sweden and the Baltic's it operates as a full scale universal bank. SEB has a vision to become the leading Swedish merchant bank within north Europe (SEB, 2011).

Previous studies of trends in internationalization by Smith & Walter (1998) found an increase in the activity for banks between the years 1985-95. The increased activity for financial institutes was mainly acquisitions of banks in developed countries and in some emerging markets (Smith, Walter, 1998). The Bank of International Settlements (BIS) finds that the later year's documentation on internationalization shows an increase of foreign entry in emerging markets (BIS, 2001).

1.3 INTERNATIONAL BANKING – FEATURES :

Expansion :

International Banking assists traders to expand their business and trade activities beyond the boundaries of a nation. Economic growth and conducive climate for carrying out the business activities in new nations are the factors because of which many enterprises are looking beyond the borders of their own nations for their business growth. Competitive advantages in respect of price, demand and supply factors, future growth opportunities, cost of production and operating costs, etc., are some of the other important factors for expansion of international trade and finance. In view of this, the presence of banks across the nations has led to the growth of international banking.

Legal and Regulatory framework: Flexible legal and regulatory framework encourages

traders and investors to enter into the international markets. Quick approval to set up business, less complicated compliance requirements and stable political situations help many new players to enter into a number of nations to expand their activities. Also, due to lesser tax rates or no taxes to be payable, certain tax havens play important roles as off shore banking centers which encourages many international banking units to open their branches in such off shore centers.

Cost of Capital :

The operating efficiency of an enterprise depends upon the average cost of capital. Many companies enter into new emerging markets to take advantages of the lower cost of capital in such markets. Banks as a financial intermediary play an important role as source of funds. Banks through their professional skills take advantage of the arbitrage opportunity in different international markets and increase their profits.

Current account and Capital account transactions: Banks play crucial role in export and import trade. By providing different types of financial and non financial support, banks help enterprises, corporate customers and individuals doing business in different countries, by extending trade finance and investment opportunities. Banks also facilitate movement of funds (inward and outward remittances) through their network and correspondent banking arrangements.

Risks :

Different risks paved ways for diversification, thereby global investors look for alternative destinations to invest their savings with twin objectives of safety of funds and better returns. In view of their presence in different time zones, international banks also face various risks.

1.4 BENEFITS :

Flexibility :

International banking facility provides flexibility to multinational companies to deal in multiple currencies. The major currencies that multinational companies or individuals can deal with include the euro, dollar, pounds, sterling, and rupee. The companies having headquarters in other countries can manage their bank accounts and avail of financial services in other countries through international banking without any hassle.

Accessibility :

International banking provides accessibility and ease of doing business to companies from different countries. An individual or MNC can use their money anywhere around the world. This gives them the freedom to transact and use their money to meet any requirement of funds in any part of the world.

International banking allows the business to make international bill payments. The currency conversion facility allows the companies to pay and receive money easily. Also, benefits like overdraft facilities, loans, deposits, etc. are available every time for overseas transactions.

Accounts Maintenance :

A multinational company can maintain the records of global accounts in a fair manner with the help of international banking. All the transactions of the company are recorded in the books of banks across the globe. By compiling the data and figures, the accounts of the company can be maintained.

Globalization and growing economies around the world have led to the development of international banking facilities. The world is now a marketplace and each business wants to exploit it. Geographical boundaries are no more a concern. With access to technology, banking facilities have grown vastly. One prime example of it is international banking. In the years to come, such banks would see higher growth and higher profitability. Big business houses are expanding themselves at a rapid pace. To maintain the growth, these businesses will need the financial services of international banking. Therefore, the demand for its facilities will increase.

1.5 TYPES OF SERVICES OFFERED :**To arrange trade finance :**

An international bank arranges the finance for the traders who want to deal with the foreign country.

To arrange foreign exchange :

The core services provided by the international bank are to arrange a foreign exchange for the import-export purpose.

To hedge the funds :

The international bank hedges the funds by buying the securities at the lower price level and sell it when the price level rises.

Offer investment banking services :

It also offers investment banking services by signing underwriting of shares, financial decisions for investment.

A correspondent bank relationship :

Established when two banks maintain a correspondent bank account with one another. The correspondent banking system provides a means for a bank's MNC clients to conduct business worldwide through his local bank or its contacts.

A representative office :

A small service facility staffed by parent bank personnel that is designed to assist MNC clients of the parent bank in its dealings with the bank's correspondents. It is a way for the parent bank to provide its MNC clients with a level of service greater than that provided through merely a correspondent relationship.

A foreign branch bank- Operates as a local bank, but legally it is a part of the parent

bank. As such, a branch bank is subject to the banking regulations of its home country and the country in which it operates. The primary reason a parent bank would establish a foreign branch is that it can provide a much fuller range of services for its MNC customers through a branch office than it can through a representative office.

A subsidiary bank- is a locally incorporated bank that is either wholly-owned or owned in major part by a foreign subsidiary. An affiliate bank is one that is only partially owned but not controlled by its foreign parent. Both subsidiary and affiliate banks operate under the banking laws of the country in which they are incorporated.

1.6 TYPES OF INTERNATIONAL BANKING :

Correspondent banks :

Correspondent banks involve the relationship between different banks which are in different countries. This type of bank is generally used by the multinational companies for their international banking. This type of banks is in small size and provides service to those clients who are out of their country.

Edge act banks :

Edge act banks are based on the constitutional amendment of 1919. They will operate business internationally under the amendment.

Off – shore banking centre :

It is a type of banking sector which allows foreign accounts. Offshore banking is free from the banking regulation of that particular country. It provides all types of products and services.

Subsidiaries :

Subsidiaries are the banks which incorporate in one country which is either partially or completely owned by a parent bank in another country. The affiliates are somewhat different from the subsidiaries like it is not owned by a parent bank and it works independently.

Foreign branch bank :

Foreign banks are the banks which are legally tied up with the parent bank but operate in a foreign nation. A foreign bank follows the rules and regulations of both the countries i.e. home country and a host country.

Examples of international banking :

- City group
- HSBC Holdings
- Bank of America
- JP Morgan Chase
- Royal Bank of Scotland Group.

1.7 REASONS FOR INTERNATIONAL BANKING :

- **Low marginal costs :**

Managerial and marketing knowledge developed at home can be used abroad with low marginal costs.

- **Knowledge advantage**

The foreign bank subsidiary can draw on the parent bank's knowledge of personal contacts and credit investigations for use in that foreign market.

- **Home nation information services**

Local firms in a foreign market may be able to obtain more complete information on trade and financial markets in the multinational bank's home nation than is obtainable from foreign domestic banks.

- **Prestige**

Very large multinational banks have high perceived prestige, which can be attractive to new clients.

- **Regulatory advantage**

Multinational banks are often not subject to the same regulations as domestic Banks
Wholesale defensive strategy – Banks follow their multinational customers abroad to avoid losing their business at home and abroad.

- **Retail defensive strategy**

Multinational banks also compete for retail services such as travelers' checks and the tourist and foreign business market.

- **Transactions costs**

Multinational banks may be able to circumvent government currency controls.

- **Growth**

Foreign markets may offer opportunities for growth not found domestically.

- **Risk reduction**

Greater stability of earnings with diversification.

Functions of International Banks :

1. Linking the savers and borrowers of different countries.
2. Helping in foreign currency exchange rate
3. Holding the inventories of foreign currencies
4. Accepting deposits from savers
5. Lending the borrowers

6. Lowering transaction cost by reducing information cost and reducing the risk of investments
7. Stimulating financial innovation by creating new financial instruments
8. Facilitating imports and exports of their clients and arranging for foreign exchange.

1.8 INTERNATIONAL PAYMENT OR METHODS BY WHICH EXPORTER CAN RECEIVE PAYMENT :

Open Account :

This method is usually avoided by the seller (exporter) as there is a greater degree of risk involved in it. Because the payment is made by the importer only after receiving the goods or on agreed future date. Indian exporters can export their goods under this method only by taking permission from the RBI. Usually this permission is given to foreign companies operating in India.

Cash in advance :

The most secure method of trading for exporters and consequently the least attractive for buyers. Payment is expected by the exporter in full prior to goods being shipped.

Bill for Collection :

The exporter documentation is sent from the seller country bank to the buyer's bank. This invariably occurs after shipment and contains specific instructions that must be obeyed. The buyers bank will act on instructions provided by the exporter.

Letter of Credit (L / c) or Documentary Credit (DC) :

A bank to bank commitment of payment in favour of an exporter, guaranteeing that Payment will be made against certain documents. It is a guarantee by the bank to the suppliers of the goods that their bill will be honoured by the bank on behalf of the customer.

1.9 SUMMARY :

In this lesson, we will explore Origin and Evolution of international banking – global trends as reasons for growth of international banking- future prospects of international banking – Need for regulation of international banking in the current scenario. International banking is just like any other banking service, but it takes place across different nations or internationally. To put it another way, it is an arrangement of financial services by a residential bank of one country to the residents of another country. Most multinational companies and individuals use this banking facility for transaction.

International banking allows the business to make international bill payments. The currency conversion facility allows the companies to pay and receive money easily. Also, benefits like overdraft facilities, loans, deposits, etc. are available every time for overseas transactions. The world is now a marketplace and each business wants to exploit it. Geographical boundaries are no more a concern. With access to technology, banking

facilities have grown vastly. One prime example of it is international banking. In the years to come, such banks would see higher growth and higher profitability. Big business houses are expanding themselves at a rapid pace. To maintain the growth, these businesses will need the financial services of international banking.

1.10 KEY WORDS :

Account-dealing :

Foreign-exchange dealing that involves settlement from bank to bank in the due from accounts. No third party (bank) is involved.

Account Party :

The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

Ad Valorem :

A term meaning *according to value*, used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

American Depository Receipt (ADR) :

ADRs are depository receipts for shares of stock in a foreign company held in safekeeping by a U.S. bank. The ADRs are purchased and sold through listed exchanges.

Advance Against Documents :

An advance made on the security of the documents covering a shipment.

After Sight :

When a draft bears this name, the time to maturity begins at its presentation or acceptance.

1.11 SELF ASSESSMENT QUESTIONS :

1. Define international banking.
2. What are the benefits of international banking.
3. Evaluation of international banking.
4. Reasons for international banking.
5. Characteristics of international banking.

1.12 SUGGESTED READINGS :

1. Upgradation : "Impact on Service Quality", Chartered Financial Analyst, (Oct.), pp. 77-80 Batra, G.S. (2000).
2. Liberalization – New Developments, (Deep and Deep Publications : New Delhi).

3. Changing Paradigms, Chartered Financial Analyst, (Oct.), pp. 56-58.
4. Challenges, Chartered Financial Analyst, (Oct.), pp. 42-44.

D. Swapna

LESSON – 2

INTERNATIONAL BANKING AND DOMESTIC BANKING

Objectives :

After studying this lesson, the student be able to :

- understand the international banking and domestic banking differences
- describe the brief history of International Banking
- distinguish various forms of International Banking

Structure of the Lesson :

- 2.1 International Vs. Domestic Finance
- 2.2 Reasons Why International Banking is not only for Expats
- 2.3 International Financial Transactions
- 2.4 FERA and Regulatory Frame work in India
- 2.5 Difference between FERA and FEMA
- 2.6 The impact on Foreign Investments and business operations
- 2.7 Summary
- 2.8 Key words
- 2.9 Self Assessment Questions
- 2.10 Suggested Books

2.1 INTERNATIONAL VS. DOMESTIC FINANCE :

In international vs domestic finance, the term international finance is different from domestic finance in many aspects. And the first and the most significant of them is foreign currency exposure. Other aspects include the different political, cultural, legal, economic, and taxation environment. International financial management involves a lot of currency derivatives, whereas such derivatives are very less used in domestic financial management.

The term 'International Finance' has not come from Mars. It is similar to domestic finance in many aspects. If we talk on a macro level, the most significant difference between international finance and domestic finance is a foreign currency or, to be more precise, the exchange rates.

In domestic financial management, we aim to minimize the cost of capital while raising funds and optimize the returns from investments to create wealth for shareholders. We do not do anything different in international finance. So, the objective of financial management remains the same for both domestic and international finance, i.e., wealth

maximization of shareholders. Still, the analytics of international finance is different from domestic finance.

International vs Domestic Finance :

Let's check out the significant differences between International vs Domestic Finance

Exposure to Foreign Exchange :

The most significant difference between international and domestic finance is foreign currency exposure. Currency exposure impacts almost all the areas of an international business, starting from your purchases from suppliers, selling to customers, investing in plant and machinery, fundraising, etc. Wherever you need money, currency exposure will come into play. And as we know well that there is no business transaction without cash.



Macro Business Environment :

An international business is exposed altogether to a different economic and political environment. All trade policies are different in different countries. The financial manager has to critically analyze the policies to determine the feasibility and profitability of their business propositions. One country may have business-friendly policies, and others may not.

Legal and Tax Environment :

The other important aspect to look at is the legal and tax front of a country. Taxes directly impact your product costs or net profits, i.e., 'the bottom line' for which the whole story is written. The international finance manager will look at the taxation structure to determine whether the business that is feasible in his home country is workable in the foreign country.

Different Group of Stakeholders :

It is not only the money that matters but there are also other things that carry greater importance, viz., the group of suppliers, customers, lenders, shareholders, etc. Why do these groups of people matter? It is because they carry altogether different cultures, a different set of values, and most importantly, the language also turns different. When dealing with those stakeholders, you have no clue about their likes and dislikes. These stakeholders run a business, and keeping them happy is all you need.

Foreign Exchange Derivatives :

Since it is inevitable to expose foreign exchange risk in a multinational business, knowledge of forwards, futures, options, and swaps are required. A financial manager has to be strong enough to calculate the cost impact of hedging the risk with the help of different derivative instruments while making any financial decisions.

Different Standards of Reporting :

If the business has a presence in, say, US and India, it maintains the books of accounts in US GAAP and IGAAP.

It is not surprising that the booking of assets has a different treatment in one country compared to another. Managing the reporting task is another big difference. The financial manager or his team needs to be familiar with the accounting standards of different countries.

Capital Management :

In an MNC, the financial managers have ample options for raising capital. Several options create more challenges concerning selecting the right source of capital to ensure the lowest possible cost of capital.

There may be much more points of difference between international and domestic financial management. Mentioned above is a list of major differences. We need to consider each of them before deciding to involve a multinational financial environment.

| POINTS OF DIFF. | INTERNATIONAL FINANCE | DOMESTIC FINANCE |
|------------------------------|----------------------------------------------------------------|--------------------------------------------------------------------|
| Exposure to Foreign Exchange | Currency exposure impact this transaction | No impact of currency exposure |
| Macro Business Environment | Exposure to different economic and political environment | Exposure to same economic and political environment |
| Legal and Tax Requirement | Exposure to different tax laws and regulations | Exposure to same tax laws and regulations. |
| Stakeholder's group | Stakeholders with different cultures, beliefs, languages etc. | Stakeholders with similar cultures, beliefs, languages etc. |
| Foreign exchange derivatives | Knowledge of forwards, futures, options and swaps is required. | Knowledge of forwards, futures, options and swaps is not required. |
| Standards of reporting | Books of accounts needs to be maintained as per GAAP and AS. | No need to maintain separate books. |
| Capital Management | Ample options of financing creates challenges in selection. | Limited options are available, hence no such challenge |

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2.2 REASONS WHY INTERNATIONAL BANKING IS NOT ONLY FOR EXPATS :

There was a time when an international bank account was used mostly by high-fliers and corporate jet-setters who had a clear need for day-to-day offshore banking services.

Today, that is far from the case, with a growing number of clients adding an international bank account as an essential part of their broader financial plan.

This demand has been driven in part by globalisation, but even more so by rapid advances in technology that place powerful banking tools, quite literally, at your fingertips.

So, what had started out as functional transactional banking for a limited few is today more mainstream and accessible to a far wider audience.

Reasons an international account is worth considering.

1) Risk diversification :

The first reason you'd want to consider an international account is because it allows you to shift some of your eggs into another basket that will provide you with global diversification.

As has been highlighted by recent global events, risks are everywhere and not restricted to the political and currency instability that many developing economies have had to contend with.

It therefore makes sense to consider shifting some assets into other jurisdictions. This is a decision that is best made in consultation with a suitably-qualified advisor who can explain the legal and tax ramifications. Diversifying your risk may not shield you from every possible misfortune, but it will provide you with a buffer against all-out calamity.

One tactic you could use, if this makes sense to your overall financial plan, is to hold your assets in different currencies to counter exchange rate volatility.

2) Currency diversification :

The tactic of spreading your risk across currencies is a variation on the theme of mitigating currency risk if your home currency is weak or volatile. Few things destroy the value of your funds as quickly as a currency crisis.

An advisor would be useful to help understand the laws and make sure you don't contravene any exchange control restrictions that apply to your international transactions. In some circumstances even making an electronic transfer of funds could be deemed as unlawful.

Using an international bank account is prudent in many ways, but must also be used responsibly in accordance with international laws. Legitimate reasons ranging from financing business transactions to guarding against a potential currency crisis are acceptable and prudent.

Holding cash in foreign currency also simplifies your life because you're not constantly making foreign exchange transactions to pay for day-to-day expenses if you're

travelling abroad.

3) Flexibility and agility :

This ability to transact from your international account without the forex hassle is undoubtedly one of its most valuable benefits.

Whether for business or pleasure, an international account truly is the passport that allows you to live, work and play in the most convenient way.

Looking beyond the day-to-day, having funds in a foreign currency allows you to act quickly in response to opportunities you may otherwise miss.

4) Personal freedom :

The final two benefits are more psychological than practical, but they underpin the appeal of an international bank account.

Being able to bank in a currency that best suits your needs, no matter where you are on the globe, breaks so many shackles that would traditionally have held you back.

And with this ability to bank as you want, you can also unlock new international financial services and opportunities you wouldn't have had access to.

5) Peace of mind :

Ultimately, all these benefits add up to give you a greater sense of security about your financial future.

The beauty of an international bank account is that you could use it simply to store money offshore when the exchange rate is favourable, or you can walk through the many doors that are now open to you.

While your international bank account is unlikely to limit the amount of funds you hold offshore, be sure to check whether exchange control or other restrictions apply to your international funds.

With a full suite of transactional banking, international savings, investment, lending and fiduciary services available to you *subject to terms and conditions, it's easy to see why your international bank account is the ideal launching pad for your long-term financial planning. Which you can now manage using mobile or online banking services that allow you to bank anywhere, anytime.

Unlike expat banking of the past, a Standard Bank international bank account is a fully-featured transactional account that is but the starting point for your offshore banking journey.

2.3 INTERNATIONAL FINANCIAL TRANSACTIONS :

International financial transactions fall into two broad categories; international trade and international asset transactions.

All cross-border purchases and sales of currently produced goods and services are called international trade. This involves exchanging one nation's distinct currency for another.

Thus, money flows from the buyers of the goods, services, or assets to the sellers of the goods, services, or assets.

So, one can say that all financial transactions necessarily involve exchanging one nation's distinct currency for another.

International asset transactions :

All cross-border purchases and sales of real or financial assets in which the property rights to those assets are transferred from a citizen of one country to a citizen of another country are called international asset transactions. For example, international asset transactions include selling a business to foreign investors and purchasing a vacation home from a local citizen in another country.

Thus, even without the import and export of goods and services, international financial transactions can still occur.

2.4 FERA AND REGULATORY FRAME WORK IN INDIA :

Understanding the difference between FERA and FEMA is essential. It is vital for anyone interested in international business, finance, or law in India. The acronyms FERA and FEMA are the Foreign Exchange Regulation Act (FERA) and Foreign Exchange Management Act (FEMA). Both laws are crucial for regulating foreign exchange. They have significant impacts on investment and business in India. However, they operate on different principles and frameworks. These reflect the economic philosophies and needs of their times.

Historical Background :

The shift from FERA to FEMA marks a significant change in India's economic history. It mirrors the nation's shift from a closed to a liberal economy. FERA was enacted in 1973. It was made for a post-independence India grappling with economic problems. India aimed to conserve its precious foreign exchange reserves. Its strict regulations reflected a protectionist period. The Indian government wanted to control foreign exchanges tightly to protect the national economy. This backdrop set the stage for the shift to FEMA in 1999. It happened as India embraced globalisation and economic reforms in the early 1990s. This transition highlights a fundamental policy shift from conservation and control to facilitating and liberalising foreign exchange.

What is FERA?

It was a law made by the Indian government to regulate the flow of foreign exchange. Its main goals were to save foreign currency and stop its misuse. Under FERA, strict rules were imposed on some types of payments. It covered trading in foreign exchange and securities. It also covered transactions that indirectly affected foreign exchange.

The Act mandated detailed documentation and prior approval for most foreign exchange transactions. It exerted much control over all dealings with foreign currency. FERA

requires strict compliance from people, businesses, and companies. It was a crucial part of India's strategy to manage its foreign exchange during economic limits and protectionism.

What is FEMA?

FEMA showed a new way to handle foreign exchange in India. FEMA is different from its predecessor. It aims to manage, not control, foreign exchange flows. This legislation eased restrictions on foreign transactions a lot. It made procedures simpler and reduced government oversight. It introduced a clear distinction between transactions for the capital and current accounts. It laid down the legal groundwork for the liberalised capital movement. It focused on facilitating trade and ensuring orderly forex markets. FEMA marked a shift to a more open and investor-friendly economic policy.

2.5 DIFFERENCE BETWEEN FERA AND FEMA :

The core distinction between FERA and FEMA lies in their underlying approach and operational mechanisms towards foreign exchange management. With its stringent regulatory framework, FERA aimed to conserve foreign exchange through tight control over forex transactions, imposing heavy compliance on individuals and corporations.

In contrast, FEMA adopts a more liberal, facilitative stance, focusing on managing rather than controlling foreign exchange flows. This act significantly relaxes restrictions, streamlines procedures, and minimises government oversight, promoting ease of transactions in the foreign exchange domain.

Thus, while FERA was characterised by restrictive measures to safeguard economic interests, FEMA facilitates an open, conducive environment for foreign trade and investment, aligning with India's liberalised economic outlook.

Following is a tabular comparison of FERA Vs FEMA

| Aspect | FERA | FEMA |
|------------------------------|-----------------------------------------------------------------|-------------------------------------------------------------|
| Enactment and Repeal | Passed in 1973, came into force in 1974 | Enacted in 1999, replaced FERA, and came into force in 2000 |
| Objective | Conservation of foreign exchange (considered a scarce resource) | Management of foreign exchange (considered an asset) |
| Number of Sections | 81 sections | 49 sections |
| Authorised Person Definition | Narrow definition | Widened definition, includes banks |
| Nature of Offence | Violations treated as criminal offences | Violations considered civil offences |
| Legal Help | No provision for legal assistance | Provides legal help to accused individuals |
| Appellate Mechanism | Appeals sent to High Courts | Special Director (Appeals) and Special Tribunal |

Deeper Dive into the Differences between FERA and FEMA :

The table we gave showcases a clear shift in India's approach to foreign exchange management. Let's delve deeper into the specific changes and their implications:

1. Objective :

FERA : Focused on conserving foreign exchange, treating it as a scarce resource. This meant strict regulations to limit outflows and maintain control.

FEMA: Focused on managing foreign exchange. It saw it as an asset that can be used strategically for growth. This opened doors for increased foreign trade and investment.

2. Number of Sections :

FERA : It had 81 sections, which indicates a complex and potentially cumbersome regulatory framework. Businesses and individuals might need help navigating these regulations.

FEMA : Reduced the number of sections to 49, suggesting a more streamlined and user-friendly approach. This could have simplified compliance and encouraged participation in foreign exchange activities.

3. Authorised Person Definition :

FERA : Had a narrow definition of Authorised Person. This likely limited the number of people who could handle forex transactions. This created a bottleneck in the system.

FEMA : Widened the definition to include banks. This allows for a quicker and more accessible system for foreign exchange.

4. Offence Nature :

FERA: Treated violations as criminal offences. This could have led to harsh penalties, including jail. They might have discouraged legal economic activity due to fear of mistakes.

FEMA: Shifted to treating violations as civil offences. It is a less punitive approach. It encourages fixing problems instead of punishing them.

5. Legal Help :

FERA: Did not offer legal aid to accused individuals. This could have put them at a disadvantage during the process.

FEMA: Introduced the availability of legal help for those facing accusations. This ensures a fairer system by allowing individuals to defend themselves effectively.

6. Appeals :

FERA: Made directed appeals to High Courts. This could have increased wait times and costs for resolving disputes.

FEMA: Set up a dedicated system. It has a Special Director (Appeals) and a Special

Tribunal. This system can handle foreign exchange-related appeals faster and more specialised.

2.6 THE IMPACT ON FOREIGN INVESTMENTS AND BUSINESS OPERATIONS :

The shift from FERA to FEMA greatly boosted India's appeal to foreign investors. It also improved the situation for global businesses. FEMA has introduced a more liberal and investor-friendly framework. It has been vital in boosting a surge in foreign direct investments (FDI). These investments are essential for the country's economic expansion and technological advancement.

This change boosted Indian businesses globally. It made it easier to reach foreign markets and get foreign capital. It also encouraged residents to explore investments abroad and buy properties outside India. This change under FEMA has fostered a more dynamic, global business environment. It marks a positive stride towards India's international economic ambitions.

Conclusion :

The transition from FERA to FEMA symbolises a fundamental shift in India's economic policy from protectionism to liberalisation. This change mirrors India's journey to a more open economy. It also shows a move to align with global trade norms and attract foreign investment. India has shifted to a system that values management over strict foreign exchange control. This has created a good business environment. It is ripe for growth, trade, and development. The journey from the limits of FERA to the freedoms under FEMA shows India's ambition. India wants to be a big player on the global stage. It shows India is ready to embrace globalisation for its prosperity.

2.7 SUMMARY :

In international vs domestic finance, the term international finance is different from domestic finance in many aspects. And the first and the most significant of them is foreign currency exposure. Other aspects include the different political, cultural, legal, economic, and taxation environment. [International financial management](#) involves a lot of currency derivatives, whereas such derivatives are very less used in domestic financial management. The term 'International Finance' has not come from Mars. It is similar to domestic finance in many aspects. If we talk on a macro level, the most significant difference between international finance and domestic finance is a foreign currency or, to be more precise, the exchange rates.

Understanding the difference between FERA and FEMA is essential. It is vital for anyone interested in international business, finance, or law in India. The acronyms FERA and FEMA are the Foreign Exchange Regulation Act (FERA) and Foreign Exchange Management Act (FEMA). Both laws are crucial for regulating foreign exchange. They have significant impacts on investment and business in India. However, they operate on different principles and frameworks. These reflect the economic philosophies and needs of their times. FEMA showed a new way to handle foreign exchange in India. FEMA is different from its predecessor. It aims to manage, not control, foreign exchange flows. This legislation eased

restrictions on foreign transactions a lot. It made procedures simpler and reduced government oversight. It introduced a clear distinction between transactions for the capital and current accounts. It laid down the legal groundwork for the liberalised capital movement. It focused on facilitating trade and ensuring orderly forex markets. FEMA marked a shift to a more open and investor-friendly economic policy.

2.8 KEY WORDS :

Authority to Pay :

An advice from a buyer, sent by their bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's U.S. bank.

Authority to Purchase :

Similar to an authority to pay, except that drafts under an authority to purchase are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay, they are usually not confirmed by a U.S. bank. This type of transaction is unique to Far Eastern trade.

Baker Plan :

Proposed in 1985, this initiative encouraged banks, the International Monetary Fund, and the World Bank to jointly increase lending to less developed countries that were having difficulty servicing their debt, provided the countries undertook prudent measures to increase productive growth.

Balance of Payments :

The relationship between money flowing into and out of a country for a given period of time. Directly affected by the country's foreign trade position, capital inflows and outflows, remittances into and out of the country, grants and aid, and tourism. A deficit balance occurs when outflows exceed inflows with the converse situation reflecting a balance of payments surplus.

Balance of Trade :

The difference between a country's total imports and total exports for a given period of time. A favorable balance of trade exists when exports exceed imports. An unfavorable trade balance is reflected when imports exceed exports.

Band :

The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

Bank for International Settlements (BIS) :

Established in 1930 in Basel, Switzerland, the BIS is the oldest functioning international

financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues. The BIS board consists of representatives from the G-10 countries.

2.9 SELF ASSESSMENT QUESTIONS :

1. International financial transactions
2. Difference between FERA and FEMA
3. International vs. Domestic Finance

2.10 SUGGESTED READINGS :

1. "Impact on Indian Banking", Chartered Financial Analyst, (Oct.), pp. 61-64.
2. Banking Services : An Overview", Paper was introduced in International Conference sorted out by IILM, New Delhi (seventeenth – eighteenth, Feb.).

D. Swapna

LESSON – 3

FOREIGN EXCHANGE MARKET

Objectives :

After studying this lesson, the student be able to :

- understand the basic concept of foreign exchange market.
- provide necessary knowledge of foreign exchange market.
- understand the Different Types of Foreign Exchange Markets.

Structure of the Lesson :

- 3.1 Introduction
- 3.2 Different types of Foreign Exchange Markets
- 3.3 Advantages of Foreign Exchange Markets
- 3.4 Features of the Foreign Exchange Market
- 3.5 Who are the Participants in a Foreign Exchange Market
- 3.6 What factors Influence the Foreign Exchange Market
- 3.7 What is the Real Effective Exchange Rate (REER)
- 3.8 What Causes Exchange Rates to fall
- 3.9 What is the meaning of Foreign Exchange Rate
- 3.10 What are the types of Foreign Exchange Rate Systems
- 3.11 Factors Influencing Exchange Rates
- 3.12 Factors that affect Currency Value
- 3.13 Summary
- 3.14 Key words
- 3.15 Self Assessment Questions
- 3.16 Suggested Books

3.1 INTRODUCTION :

The foreign exchange market or the forex market, is the largest and most liquid financial market in the world. It is where different currencies are bought and sold, with the exchange rate determining the value of each currency relative to another. The forex market plays a critical role in facilitating international trade and investment, as well as providing opportunities for individuals and institutions to profit from fluctuations in currency values.

The forex market operates 24 hours a day, 5 days a week, with trading volumes exceeding \$6 trillion per day. It is a highly decentralized market, with no single entity controlling the exchange rates or setting the prices of currencies.

What is Foreign Exchange Market?

The Foreign Exchange Market is a global decentralized marketplace where currencies are bought and sold. It is the largest and most liquid financial market in the world, with trading volumes exceeding \$6 trillion per day. The forex market facilitates international trade and investment by enabling businesses to convert one currency into another.

The forex market operates 24 hours a day, 5 days a week, with trading taking place in major financial centers around the world. The market is driven by various factors, including economic data, geopolitical events, and central bank policies. The exchange rate, which is the value of one currency relative to another, is determined by supply and demand forces in the market.

How does Foreign Exchange Market work?

The foreign exchange market works by facilitating the exchange of one currency for another. Market participants buy and sell currencies to facilitate international trade and investment and speculate on currency price movements. The exchange rate, which is the value of one currency relative to another, is determined by supply and demand forces in the market.

Currency values are influenced by a variety of factors, including economic indicators, geopolitical events, and central bank policies. Transactions in the forex market can take place over the counter or through electronic trading platforms, and the market operates 24 hours a day, 5 days a week, across major financial centers around the world.

3.2 WHAT ARE THE DIFFERENT TYPES OF FOREIGN EXCHANGE MARKETS?

There are three main types of foreign exchange markets :

1. Spot Forex Market :

The spot forex market is where currencies are traded for immediate delivery. This means that the exchange of currencies takes place at the current market price, which is determined by supply and demand forces. The spot forex market is the most liquid and actively traded market in the world, with trading taking place 24 hours a day across major financial centers.

2. Forward Forex Market :

The forward forex market is where contracts are used to buy or sell currencies at a future date at a predetermined exchange rate. This allows participants to lock in a future exchange rate, providing protection against currency fluctuations. The forward forex market is used for hedging purposes and is not as actively traded as the spot market.

3. Futures Forex Market :

The futures forex market is a centralized exchange where standardized contracts are traded for the future delivery of a specified currency at a predetermined price. Futures contracts are used for hedging and speculative purposes and are traded on regulated exchanges. The futures forex market is less liquid than the spot market and requires participants to post margin.

What are the Advantages and Disadvantages of Foreign Exchange Markets?

The foreign exchange market has several advantages and disadvantages. Understanding these can help traders make informed decisions about their participation in the market.

3.3 ADVANTAGES OF FOREIGN EXCHANGE MARKETS :

- High liquidity : The forex market is the largest and most liquid market in the world, making it easy to buy and sell currencies quickly.
- Accessibility : The forex market is open 24 hours a day, 5 days a week, and can be accessed by anyone with an internet connection.
- Diverse trading options : Traders can choose from a wide range of currency pairs and trading strategies, providing ample opportunities for profit.
- Low transaction costs : The cost of trading in the forex market is relatively low compared to other financial markets.
- Leverage : Forex trading allows traders to use leverage to increase their trading position, potentially amplifying profits.

- Global market : The forex market is a global market, making it a valuable tool for international businesses to manage their currency risk.
- Transparency : The forex market is highly transparent, with real-time price data available to all market participants.

Disadvantages of Foreign Exchange Markets :

- Volatility : The forex market is highly volatile and can experience sudden and significant price movements, which can lead to large losses for traders.
- Risk of leverage : While leverage can increase potential profits, it can also magnify losses and lead to significant financial risk.
- High competition : The forex market is highly competitive, and traders must compete with other market participants, including large financial institutions.
- Limited regulation : The forex market is not as regulated as other financial markets, which can lead to fraudulent activities and scams.
- Complex market : The forex market can be complex, and traders must have a

good understanding of the market and its various factors that affect currency values.

- Economic and political events : The forex market is highly influenced by economic and political events, which can cause significant volatility and unpredictability.
- High barriers to entry : Trading in the forex market requires a significant amount of knowledge, experience, and capital, making it difficult for inexperienced traders to participate.

3.4 FEATURES OF THE FOREIGN EXCHANGE MARKET :

The foreign exchange market has several key features that set it apart from other financial markets.

1. It is a decentralized market that operates 24 hours a day, 5 days a week, across multiple time zones.
2. It is the largest and most liquid market in the world, with high trading volumes and low transaction costs.
3. The market is influenced by a variety of factors, including economic indicators, geopolitical events, and central bank policies.
4. The market provides opportunities for traders to speculate on the movement of currency values through a range of trading strategies.
5. The market is accessible to a wide range of participants, including individuals, financial institutions, and governments.

3.5 WHO ARE THE PARTICIPANTS IN A FOREIGN EXCHANGE MARKET ?

There are a wide range of participants in the foreign exchange market, including :

- Commercial banks : Banks are the most active participants in the forex market, trading on behalf of their clients and for their own accounts.
- Central banks : Central banks participate in the market to manage their country's monetary policy and stabilize currency values.
- Hedge funds and investment firms : These institutions trade in the forex market to generate returns for their clients.
- Corporations : Multinational corporations use the forex market to manage their currency risk, particularly when conducting international trade.
- Retail traders : Individual traders can participate in the forex market through online brokers, seeking to profit from currency price movements.
- Governments : Governments participate in the forex market to manage their currency values and maintain their country's economic stability.

3.6 WHAT FACTORS INFLUENCE THE FOREIGN EXCHANGE MARKET ?

Several factors influence the foreign exchange market, including :

1. Economic indicators : Economic indicators such as inflation, GDP, and employment data can influence currency values, as they affect a country's economic outlook.
2. Central bank policies : The monetary policies of central banks, including interest rates and quantitative easing measures, can influence currency values.
3. Geopolitical events : Political events such as elections, wars, and trade agreements can cause significant currency volatility.
4. Market sentiment : Market sentiment, including investor confidence and risk appetite, can influence currency values.
5. Natural disasters : Natural disasters can disrupt economic activity and cause currency values to fluctuate.
6. Speculation : Speculative trading activity can also influence currency values, as traders buy or sell currencies based on their expectations of future price movements.

3.7 WHAT IS THE REAL EFFECTIVE EXCHANGE RATE (REER) ?

The Real Effective Exchange Rate (REER) is a measure of a country's currency value relative to a basket of other currencies, adjusted for inflation. It takes into account the relative prices of goods and services between countries and provides a more comprehensive view of a country's currency value than the nominal exchange rate.

The REER is calculated by adjusting the nominal exchange rate using the country's inflation rate and the inflation rates of its trading partners. A high REER indicates that a country's currency is overvalued, while a low REER indicates that it is undervalued.

How Does the Foreign Exchange Market Affect the Economy ?

The foreign exchange market plays a crucial role in the global economy, affecting countries in several ways :

1. International trade : Changes in currency values can affect a country's balance of trade, as exports become more expensive when a country's currency appreciates.
2. Capital flows : The forex market facilitates capital flows between countries, allowing businesses and investors to invest in foreign markets.
3. Monetary policy : The forex market can influence a country's monetary policy, as central banks may adjust interest rates or intervene in the market to maintain currency stability.
4. Economic growth : A stable currency and exchange rate can support economic growth, while currency volatility can harm business and consumer confidence,

potentially leading to economic slowdowns.

3.8 WHAT CAUSES EXCHANGE RATES TO FALL ?

There are several factors that can cause exchange rates to fall :

- Decreased demand: If demand for a country's currency decreases relative to other currencies, its exchange rate may fall.
- Economic factors: Economic indicators such as low inflation or slowing economic growth can lead to a fall in a country's exchange rate.
- Political instability: Political instability, such as political protests or leadership changes, can cause a country's exchange rate to fall.
- Central bank policies: If a country's central bank reduces interest rates or engages in quantitative easing, its currency may weaken.
- Trade imbalances: Persistent trade deficits can cause a country's currency to depreciate as demand for its currency weakens.

3.9 WHAT IS THE MEANING OF FOREIGN EXCHANGE RATE ?

Foreign Exchange Rate, often referred to as Forex Rate or simply Exchange Rate, is the value of one country's currency expressed in terms of another country's currency. In simpler terms, it represents the price at which one [currency](#) can be exchanged for another.

An exchange rate has two components namely, the domestic currency and the foreign currency. Foreign exchange rates are influenced by various factors like economic conditions, interest rates, geopolitical events, and market speculation. The central bank of the country uses many measures and monetary policies to keep the foreign exchange rate in check and ensure that the domestic currency does not slide down.

3.10 WHAT ARE THE TYPES OF FOREIGN EXCHANGE RATE SYSTEMS ?

Fixed Exchange Rate :

In a fixed exchange rate system, the government sets the exchange rate for its currency, linking it to an external standard like gold, silver, another precious metal, or another country's currency. The primary aim is to ensure stability in foreign trade and capital flows.

To maintain the fixed rate, the central bank or government intervenes in the foreign exchange market, purchasing foreign currency when the domestic currency's value rises and selling foreign currency when its value falls. This process, known as pegging, requires the government to hold significant reserves of foreign currencies.

Consequently, the fixed [exchange rate](#) system is also referred to as the Pegged Exchange Rate System. When one currency's value is fixed in terms of another currency or gold, it is termed the Parity Value of the currency.

The **merits of a fixed exchange rate** system are tabled below

- Provides stability in exchange rates, which can promote international trade and investment.
- Helps control inflation as it restricts the central bank's ability to create money excessively.
- Reduces speculative currency trading, as there is less uncertainty about future exchange rate movements
- Facilitates long-term investments since investors can rely on predictable exchange rates.

Flexible Exchange Rate :

In a Flexible Exchange Rate system, a country's currency value is determined by the interplay of demand and supply in the foreign exchange market. This system, also known as the Floating Rate of Exchange or Free Exchange Rate, operates without any government intervention.

The exchange rate fluctuates freely in response to market forces without direct manipulation from the government or central bank. Various entities, including banks, firms, and other institutions, actively engage in buying and selling foreign currencies in the foreign exchange market, leading to constant adjustments in the exchange rate based on changing supply and demand dynamics.

The rate at which the demand for foreign currency equals its supply is termed the Par Rate of Exchange, Normal Rate, or Equilibrium Rate of Foreign Exchange. This is the rate at which the currency value is considered to be in balance, and there is no immediate pressure for further exchange rate adjustments. However, as market conditions change, the exchange rate will continue to fluctuate accordingly in response to shifts in supply and demand.

The merits of using the flexible exchange rate system are highlighted hereunder.

- Allows currencies to adjust automatically to market forces, helping to maintain equilibrium in the balance of payments.
- Gives more flexibility to central banks to pursue independent monetary policies, suitable for their domestic economic conditions.
- Can help correct trade imbalances over time by allowing currencies to find their natural values.

Managed Float Exchange Rate :

The Managed Floating Exchange Rate system, also known as a Hybrid System, combines features of both fixed and flexible rate systems. In this approach, the foreign exchange rate is primarily determined by market forces, allowing it to float freely.

However, the central bank intervenes to stabilize the exchange rate in the event of significant appreciation or depreciation of the domestic currency. Under this system, the central bank acts as a major buyer or seller of foreign exchange to control fluctuations in the exchange

rate. When the exchange rate is high, the central bank sells foreign exchange to bring it down, and vice versa.

This intervention is aimed at protecting the interests of importers and exporters. To carry out this function effectively, the central bank maintains reserves of foreign exchange, ensuring that the exchange rate stays within a targeted range.

The merits of using the managed float exchange rate system are

- Combines features of fixed and floating systems, offering a balance between stability and flexibility in exchange rates.
- Reduces exchange rate risk compared to a pure floating system as central banks may intervene to prevent excessive volatility.
- Provides a relatively stable environment for international trade and investment while accommodating economic changes.

3.11 FACTORS INFLUENCING EXCHANGE RATES :

1. Inflation :

If a country has low inflation rates consistently, its currency value typically rises. This is because the currency's purchasing power becomes higher than the other currencies with which it is compared.

Conversely, higher inflation rates lead to the currency depreciating in value, losing out on purchasing power and value against other currencies.

2. Interest Rates :

If a country has a high-interest rate, lenders have the chance to earn more. This attracts foreign capital looking to earn at higher rates. The result is that the country's foreign exchange rate rises, making its currency stronger.

Interest rates are directly correlated to inflation as well as exchange rates.

A country's central bank will try to influence inflation or exchange rates via the interest rate mechanism. High-interest rates mean a higher cost of borrowing. It could happen that despite an interest rate hike, inflation does not come down in any meaningful sense, which will have less-than-expected effects on the exchange rate.

Conversely, interest rate decreases tend to depress exchange rates.

3. Deficits :

One of the most critical deficit parameters is the current account deficit – the difference between a country's spending and what it earns. A current account deficit means that the country is spending more to buy than what it earns.

Consequently, its foreign currency earnings via exports are not enough; it will need to borrow money from abroad to make up the difference. This high demand for foreign currency lowers the country's exchange rate.

4. Debt :

When a country engages in large-scale infrastructure projects, it generally will not have all the funds for them. So, it borrows funds domestically as well as from abroad.

These projects stimulate the economy; however, the deficit created by the public debt it takes makes it an unattractive investment destination. A large public debt is a recipe for high inflation, i.e., the country's currency gets weaker, and it will need more time to service debt and interest payments, affecting borrowers' returns.

The worst-case scenario? If the country has to default on its loans because it cannot pay them back due to its enormous debt, high inflation, and depressed exchange rates.

5. Import-Export :

Exporting earns a country some money, while importing is spending it. If a country's exports are growing at a higher rate than its imports, it's a good sign for its currency exchange rate.

Higher exports mean increased demand for the country's currency and therefore its value.

Conclusion :

Foreign exchange rates are an important aspect for the governments to manage the overall economic position of the country. Hence, it is given utmost importance in domestic policies as well as in maintaining geopolitical relations. At the micro level, they also form an important aspect of the accounting and reporting provisions of a company and, therefore, have to be adhered to as per the provisions of the Companies Act 2013 as well as the accounting standards issued in this regard from time to time.

Key Takeaways :

- Inflation, interest rates, and forex rates are correlated. Each of these factors can affect the other two.
- Low inflation and high-interest rates can attract foreign funds to a country, strengthening its exchange rate.
- Countries with large public debt can see their exchange rates decrease because they are viewed as unattractive investment destinations. This means the country needs to pay more to service its debt.
- If the country's export growth rate is higher than its imports, it denotes more demand for its currency, thus strengthening its currency and exchange rates.

3.12 FACTORS THAT AFFECT CURRENCY VALUE :

This piece examines the various factors that affect the value of currencies including interest rates, inflation, debt, political stability, and more.

Forex trading involves trading currencies. The best trading platforms offer trades

in dozens of different currencies. If you're new to trading, it's best to start with a small number of currencies in order to minimise risks and keep your trading account manageable.

The Value of a Currency :

What makes a currency strong? The value of a currency, like any other asset, is determined by supply and demand. An increase in demand for a particular currency will increase the value of the currency, while an increase in supply will decrease the currency's value.

The *exchange rate* is the value of one country's currency in relation to another. For example, if USD/JPY is trading at 130, then one US dollar will be exchanged for 130 yen. Exchange rates are determined in the foreign exchange markets and are constantly fluctuating.

What determines the value of a currency? Let's examine some key factors which are important to review in order to trade forex in a smarter way.

Interest Rates :

Interest rates are one of the most important determinants of exchange rates. When the country of a certain currency offers higher interest rates, the value of the currency value will rise, since investors, who are looking for the best rate they can find, can earn a higher return relative to other currencies.

Higher interest rates will attract foreign capital, and as the currency is in higher demand, its value will increase. Conversely, if a country lowers interest rates, the currency value of that country will decrease. Suppose the US Federal Reserve raises interest rates. This makes the US dollar more attractive, because investors will receive higher interest on their US dollar deposits. As more investors purchase US dollars (with other currencies), the value of the dollar will rise.

Inflation :

Inflation is the overall rise in the price of goods and services. If inflation rises, it results in a decrease in money's buying power. Generally speaking, countries with consistently low inflation rates will have currencies that have a higher value than currencies of countries with high inflation.

A useful rule of thumb is that inflation and interest rates have an inverse relationship. Higher inflation will decrease the value of a currency, while higher interest rates will increase its value. Conversely, lower inflation will boost the value of a currency, but lower interest rates makes a currency less attractive to investors and hence lowers its value.

Economic Performance :

Investors looking to invest their assets are seeking safety and certainty. A country with a strong economy will be deemed an attractive location for investment. How do we

determine what is a strong economy? This can be determined by a host of economic indicators, such as GDP, unemployment and debt.

GDP :

Gross Domestic Product (GDP) is the total value of the goods and services produced by the economy. When a country's GDP rises, it means that the economy is expanding. Investors are looking to put their assets in countries with high GDP growth rates. Conversely, a drop in GDP indicates that the economy is in decline, which could result in a decrease in investment.

Unemployment :

Low unemployment is an important indicator of a strong economy, which will increase the demand for that country's currency. If unemployment is on the rise, it is reflective of a weaker economy, and the demand for the currency may drop, resulting in a lower exchange rate. If, for example, the UK released an employment report that showed unemployment had dropped compared to the previous unemployment report, this would be a positive development and would likely send the British pound higher.

Debt :

Nations with large public debts are less attractive to foreign investors. Large debts often result in higher inflation, especially if a government prints more money in order to help pay for the debt. As well, investors may be concerned that the government might default on its obligations. This is the reason that a country's debt rating is an important factor in the exchange rate – the higher the debt rating, the more likely that the country can pay back its debt, which will make the country more attractive to foreign investment and increase the value of the currency.

Political Stability :

In addition to the economic factors listed above, Investors tend to look for countries which offer political stability in which to invest their capital. Political turmoil can result in a loss of confidence in a currency and lead to a flow of capital towards currencies of countries that are considered more stable.

A major political development could also cause a currency to fluctuate. If, for example, the UK and the European Union were to announce that they had reached a post-Brexit agreement, this would increase confidence in the UK and eurozone economies, and both the euro and the British pound would likely rise against the US dollar.

Safe Haven Status :

In times of market turbulence, investors who are looking to reduce their risk will seek assets that act as "safe havens" until the market steadies and investors are ready to take on more risk. The US dollar, Swiss franc and the Japanese yen are all considered safe-haven currencies. These currencies have shown over time that they retain (or increase) their value during times of economic uncertainty, and investors will purchase

safe haven currencies and sell currencies which are more sensitive to risk, thus increasing the value of the safe-havens.

Trading Fluctuating Currencies :

The forex market is made up of currency pairs, which are constantly fluctuating in value. The value of a currency - reflects how strong the currency is in comparison to another currency. To improve your forex trading performance, you must first understand the factors that influence the value of a currency.

Skill can be acquired. There are numerous online resources available for beginners to gain knowledge and know-how when it comes to forex trading.

With the best trading platforms practice is also available through an online demo. Start with a practice account and simulate trades before going live and risking your money.

Floating Rate vs. Fixed Rate: An Overview :

All of the volume traded in the currency markets trades around an exchange rate, the rate at which one currency can be exchanged for another. In other words, it is the value of another country's currency compared to that of your own.

If you are travelling to another country, you need to "buy" the local currency. Just like the price of any asset, the exchange rate is the price at which you can buy that currency. If you are traveling to Egypt, for example, and the exchange rate for U.S. dollars is 1:5.5 Egyptian pounds, this means that for every U.S. dollar, you can buy five and a half Egyptian pounds.

Theoretically, identical assets should sell at the same price in different countries, because the exchange rate must maintain the inherent value of one currency against the other.

Fixed exchange rates mean that two currencies will always be exchanged at the same price while floating exchange rates mean that the prices between each currency can change depending on market factors; primarily supply and demand.

Fixed Rate :

A fixed, or pegged, rate is a rate the government (central bank) sets and maintains as the official exchange rate. A set price will be determined against a major world currency (usually the U.S. dollar, but also other major currencies such as the euro, the yen, or a basket of currencies).

In order to maintain the local exchange rate, the central bank buys and sells its own currency on the foreign exchange market in return for the currency to which it is pegged.

If, for example, it is determined that the value of a single unit of local currency is equal to U.S. \$3, the central bank will have to ensure that it can supply the market with those dollars. In order to maintain the rate, the central bank must keep a high level of foreign reserves.

This is a reserved amount of foreign currency held by the central bank that it can use to release (or absorb) extra funds into (or out of) the market. This ensures an appropriate money supply, appropriate fluctuations in the market (inflation/deflation), and ultimately, the exchange rate. The central bank can also adjust the official exchange rate when necessary.

Floating Rate :

Unlike the fixed rate, a floating exchange rate is determined by the private market through supply and demand. A floating rate is often termed "self-correcting," as any differences in supply and demand will automatically be corrected in the market.

Look at this simplified model: if demand for a currency is low, its value will decrease, thus making imported goods more expensive and stimulating demand for local goods and services. This, in turn, will generate more jobs, causing an auto-correction in the market. A floating exchange rate is constantly changing.

In reality, no currency is wholly fixed or floating. In a fixed regime, market pressures can also influence changes in the exchange rate. Sometimes, when a local currency reflects its true value against its pegged currency, an underground market (which is more reflective of actual supply and demand) may develop.

A central bank will often then be forced to revalue or devalue the official rate so that the rate is in line with the unofficial one, thereby halting the activity of the illegal market.

In a floating regime, the central bank may also intervene when it is necessary to ensure stability and avoid inflation; however, it is less often that the central bank of a floating regime will interfere.

Special Considerations :

Between 1870 and 1914, there was a global fixed exchange rate. This was implemented by the four major industrial powers: Germany, Britain, France, and the U.S. Currencies were linked to gold, meaning that the value of the local currency was fixed at a set exchange rate to gold ounces.

This was known as the gold standard. This allowed for unrestricted capital mobility as well as global stability in currencies and trade; however, with the start of World War I, the gold standard was abandoned.²

In 1944, the "Bretton Woods Conference"—an effort to generate global economic stability and increase global trade—established the basic rules and regulations governing international exchange. As such, an international monetary system, embodied in the International Monetary Fund (IMF), was established to promote foreign trade and to maintain the monetary stability of countries and, therefore, that of the global economy.

It was agreed that currencies would once again be fixed, or pegged, but this time to the U.S. dollar, which in turn was pegged to gold at \$35 per ounce. This meant that the value of a currency was directly linked with the value of the U.S. dollar.³

Federal Reserve History. "Creation of the Bretton Woods System."

So, if you needed to buy Japanese yen, the value of the yen would be expressed in U.S. dollars, whose value, in turn, was determined by the value of gold. If a country needed to readjust the value of its currency, it could approach the IMF to adjust the pegged value of its currency.

The peg was maintained until 1971 when the U.S. dollar could no longer hold the value of the pegged rate of \$35 per ounce of gold.³

From then on, major governments adopted a floating system, and all attempts to move back to a global peg were eventually abandoned in 1985. Since then, no major economies have gone back to a peg, and the use of gold as a peg has been completely abandoned.

Historical Downside of Fixed Rates :

The reasons to peg a currency are linked to stability. Especially in today's developing nations, a country may decide to peg its currency to create a stable atmosphere for foreign investment. With a peg, the investor will always know what their investment's value is and will not have to worry about daily fluctuations.

Fixed regimes, however, can often lead to severe financial crises, since a peg is difficult to maintain in the long run. This was seen in the Mexican (1994), Asian (1997), and Russian (1997) financial crises, where an attempt to maintain a high value of the local currency to the peg resulted in the currencies eventually becoming overvalued.

This meant that the governments could no longer meet the demands to convert the local currency into foreign currency at the pegged rate.

With speculation and panic, investors scrambled to get their money out and convert it into foreign currency before the local currency was devalued against the peg; foreign reserve supplies eventually became depleted.

In Mexico's case, the government was forced to devalue the peso by 35%. In Thailand, the government eventually had to allow the currency to float, and, by the end of 1997, the resulting depreciation of the Thai baht resulted in east Asian currencies losing their value by 35% to 83% against the dollar.

Countries with pegs are often associated with having unsophisticated capital markets and weak regulating institutions. The peg is there to help create stability in such an environment. It takes a stronger system as well as a mature market to maintain a float.

When a country is forced to devalue its currency, it is also required to proceed with some form of economic reform, like implementing greater transparency, in an effort to strengthen its financial institutions.

Variations on Fixed Rates :

Some governments may choose to have a "floating," or "crawling" peg, whereby the government reassesses the value of the peg periodically and then changes the peg rate

accordingly. Usually, this causes devaluation, but it is controlled to avoid market panic.

This method is often used in the transition from a peg to a floating regime, and it allows the government to "save face" by not being forced to devalue in an uncontrollable crisis.

Although the peg has worked in creating global trade and monetary stability, it was used only at a time when all the major economies were a part of it. While a floating regime is not without its flaws, it has proven to be a more efficient means of determining the long-term value of a currency and creating equilibrium in the international market.

3.12 SUMMARY :

The foreign exchange market or the forex market, is the largest and most liquid financial market in the world. It is where different currencies are bought and sold, with the exchange rate determining the value of each currency relative to another. The forex market plays a critical role in facilitating international trade and investment, as well as providing opportunities for individuals and institutions to profit from fluctuations in currency values.

Foreign Exchange Rate, often referred to as Forex Rate or simply Exchange Rate, is the value of one country's currency expressed in terms of another country's currency. In simpler terms, it represents the price at which one [currency](#) can be exchanged for another. An exchange rate has two components namely, the domestic currency and the foreign currency. Foreign exchange rates are influenced by various factors like economic conditions, interest rates, geopolitical events, and market speculation.

The Real Effective Exchange Rate (REER) is a measure of a country's currency value relative to a basket of other currencies, adjusted for inflation. It takes into account the relative prices of goods and services between countries and provides a more comprehensive view of a country's currency value than the nominal exchange rate.

3.13 KEY WORDS:

Beneficiary :

The person or company in whose favor a letter of credit is opened or a draft is drawn. In a documentary letter of credit or acceptance, beneficiary may also be referred to as exporter or seller of goods.

Bid –ask Spread :

The difference between a bid and the ask price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

Bid Price :

A buyer's quote for the purchase of a trading unit from a prospective seller.

Bid Rate :

The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that

party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

Bilateral Trade :

Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

Bill of Exchange :

An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms *bill of exchange* and *draft* are generally used interchangeably.

3.15 SELF ASSESSMENT QUESTIONS :

1. What are the Different Types of Foreign Exchange Markets.
2. Advantages of Foreign Exchange Markets.
3. Features of the Foreign Exchange Market.
4. What Factors Influence the Foreign Exchange Market.
5. What is the Real Effective Exchange Rate (REER).
6. What are the types of Foreign Exchange Rate Systems .

3.16 SUGGESTED READINGS :

1. Foreign exchange management and International finance by Vivek Viswan V. and M.M. Sulphey.
2. Foreign exchange international finance risk management by A. V. Rajwade and H.G. Desai.
3. C. Jeevananddams FOREIGN EXCHANGE practice , concepts & control by Sultan Chand & Sons.

D. Swapna

LESSON – 4

EXCHANGE RATE DETERMINATION

Objectives :

After studying this lesson, the student be able to understand / learn :

- Foreign exchange Rates
- Foreign exchange trading
- Exchange rate mechanism
- Exchange rate determination
- Exchange rate theories

Structure of the Lesson :

- 4.1 Introduction
- 4.2 Foreign Exchange Rates and Quotations
- 4.3 Foreign exchange rate determination
- 4.4 Exchange rates
- 4.5 Theories to determine exchange rates
- 4.6 Arbitrage
- 4.7 Summary
- 4.8 Key words
- 4.9 Self Assessment Questions
- 4.10 Suggested Books

4.1 INTRODUCTION :

In the previous module we have studied Foreign exchange market (forex, FX, or currency market) is a globalised platform or an institutional structure where the currency of one country is converted into that of another country. It is a market in which trade between currencies are made. In other words, it is a market in which national currencies are bought or sold against one another. A foreign exchange market refers to buying foreign currencies with domestic currencies and selling foreign currencies for domestic currencies. Thus it is a market in which the claims to foreign moneys are bought and sold for domestic currency. The foreign exchange market in terms value of transactions, is largest market in the world and works round the clock. BIS Triennial Central Bank Survey reports turnover of \$5.3 trillion per day in April 2013.

4.2 FOREIGN EXCHANGE RATES AND QUOTATIONS :

A foreign exchange rate is the price of a foreign currency. A foreign exchange quotation or quote is a statement of willingness to buy or sell at an announced rate.

1. Inter bank Quotations :

The most common way that professional dealers and brokers state foreign exchange quotations, and the way they appear on all computer trading screens worldwide, is called European terms. The European terms quote shows the number of units of foreign currency needed to purchase one USD :

CAD 1.5770 / USD

An alternative method is called the American terms. The American terms quote shows the number of units of USD needed to purchase one unit of foreign currency :

USD 0.6341 / CAD

Clearly, those two quotations are highly related. Define the price of a USD in CAD to be $S(\text{USD} / \text{CAD})$, and define the price of a CAD in USD to be

$$S(\text{USD} / \text{CAD}) = \text{USD}0.6341 / \text{CAD}$$

Then, it must be that

$$S(\text{CAD} / \text{USD}) = 1 / S(\text{USD} / \text{CAD})$$

$$\text{Because } \text{CAD } 1.5770 / \text{USD} = 1 / \{ \text{USD } 0.6341 / \text{CAD} \}.$$

These rules also apply to forward rates as well. We will denote an outright forward quote using the following notation :

$$F(\text{CAD} / \text{USD})$$

2. Direct and Indirect Quotations :

A direct quote is a home currency price of a unit of foreign currency. An indirect quote is a foreign currency price of a unit of home currency. In the US, a direct quote for the CAD is

USD 0.6341 / CAD

This quote would be an indirect quote in Canada.

3. Bid and Ask Quotations :

Inter bank quotations are given as “bid” and “ask”.

A bid is the exchange rate in one currency at which a dealer will buy another currency. An ask is the exchange rate at which a dealer will sell the other currency. Dealers buy at the bid price and sell at the ask price, profiting from the spread between the bid and ask prices : $\text{bid} < \text{ask}$.

Bid and ask quotations are complicated by the fact that the bid for one currency is the ask for another currency :

$$S^b(\text{USD} / \text{CAD}) = 1 / S^a(\text{CAD} / \text{USD})$$

$$S^a (\text{USD /CAD}) = 1/ S^b (\text{CAD /USD})$$

Foreign exchange trading and SWIFT

In an interbank foreign exchange transaction, no real money changes hand. All transactions are done electronically through SWIFT. Banks undertaking foreign exchange transactions simply transfer bank deposits through SWIFT to settle a transaction. SWIFT is the Society for Worldwide Interbank Financial Telecommunication is a cooperative organization headquartered at Belgium. The Swift network connects around 8300 banks, financial institutions and companies operating 208 countries. Swift provides a standardized messaging service to these members. As and when two counterparties undertake a transaction, SWIFT transports the message to both financial parties in a standard form. As the foreign exchange market is mainly an OTC market, SWIFT message provides some kind of legitimacy to the transactions. The following line captures summarizes the activities at SWIFT.

“SWIFT is solely a carrier of messages. It does not hold funds nor does it manage accounts on behalf of customers, nor does it store financial information on an ongoing basis. As a data carrier, SWIFT transports messages between two financial institutions. This activity involves the secure exchange of proprietary data while ensuring its confidentiality and integrity”. For every participating member, SWIFT assigns a unique code. This code is used to transport messages.

4.3 FOREIGN EXCHANGE RATE DETERMINATION :

Foreign exchange rate :

Exchange rate refers to the rate at which a country's currencies are exchanged for currencies of other country. In other words it is the price of one currency in terms of another currency. For E.g. If the value of 1 US dollar in Indian rupees is 45 then the exchange rate is 1 US \$ = 45. Thus foreign exchange rate indicates the external value of a country's currency. It also shows the purchasing power of a country's currency in terms of currency of another country

Determination of exchange rates :

The rate of exchange being a price of national currency in terms of another, is determined in foreign exchange market in accordance with general principle of the theory of value i.e., by the interaction of forces of demand and supply. Thus the rate of exchange in the foreign exchange market will be determined by interaction between demand for foreign exchange and supply of foreign exchange.

1. Demand for Foreign Exchange :

Foreign exchange is required by citizens or Government to make payments abroad. This results in demand for foreign exchange. These payments are recorded in payment side of BOP. The demand for foreign currency arises due to the following payments

- **Import of Goods :**

Consumer as well as capital goods are imported from other countries. Foreign

exchange is demanded by people who import these goods. Higher the value of Imports, higher is the demand for foreign currency.

- **Import of services :**

Services rendered by other countries which include banking, insurance, transport, communication, educational services, etc. are required to be paid in foreign exchange.

- **Dividend, Interest and Profits :**

In India, many foreign firms have invested in various sectors, which results in outflow of foreign exchange on account of dividend and profits. On other hand Government and Indian firms have also borrowed from foreign countries, which results in payment of Interest.

- **Unilateral Payments :**

Donations, gifts etc. are 'one sided payments without corresponding returns. Such payments create demand for foreign exchange.

- **Export of Capital :**

Repayment of debt, purchase of assets in foreign countries etc. all require foreign exchange. All the above categories of payments abroad result in aggregate demand for foreign exchange. The total demand for foreign currency is inversely related to foreign exchange rate. At a higher exchange rate, the demand for foreign currency may be low.

2. Supply of Foreign Exchange :

Supply of foreign exchange in a country comes from receipts of its exports. The receipts of foreign currency are recorded in the receipt side of BOP. The main sources of supply are :

- **Exports of Goods :**

This constitutes a major source of supply of foreign exchange. Both size and price of exports depends on demand of elasticity for goods. In India, the manufactured items occupy the top position in exports.

- **Exports of Services :**

In recent years this source is gaining importance. Export Services in various fields, tourists coming from other countries, transport, communication, insurance etc. are important services which earn and supply foreign exchange.

- **Dividend, Interest and profits :**

Indian firms have invested in various sectors in foreign countries. Thus there is inflow of foreign exchange on account of dividend and profits. Indian institutions also have lent money abroad, which results in receipt of interest.

- **Unilateral Receipts :**

Payments received in form of remittance from domestics working abroad, donations etc. form a part of foreign exchange supply.

- **Import of Capital :**

Foreign investment – direct and portfolio – repayment of debts by foreigners, all increase the supply of foreign exchange. All the above categories of receipts from abroad result in aggregate supply of foreign exchange. The total supply, like the supply of any other commodity, is directly related to price i.e. the foreign exchange rate. At a higher exchange rate, the supply of foreign currency may be high.

4.4 EXCHANGE RATES :

Transactions in exchange market are carried out at what are termed as exchange rates. In foreign exchange market two types of exchange rate operations take place. They are spot exchange rate and forward exchange rate.

1) Spot Exchange Rate :

When foreign exchange is bought and sold for immediate delivery, it is called spot exchange. It refers to a day or two in which two currencies are involved. The basic principle of spot exchange rate is that it can be analyzed like any other price with the help of demand and supply forces. The exchange rate of dollar is determined by intersection of demand for and supply of dollars in foreign exchange. The demand for dollar is derived from country's demand for imports which are paid in dollars and supply is derived from country's exports which are sold in dollars. The exchange rate determined by market forces would change as these forces change in market. The primary price makers buy (Bid) or sell (ask) the currencies in the market and the rates continuously change in a free market depending on demand and supply. The primary dealer (bank) quotes two-way rates i.e., buy and sell rate.

(Bid) Buy Rate 1 US \$ = ` 45.50

(Ask) Sell Rate 1 US \$ = ` 45.75

The bank is ready to buy 1 US \$ at Rs. 45.50 and sell at Rs. 45.75. The difference of Rs.0.25 is the profit margin of dealer.

2) Forward Exchange Rate :

Here foreign exchange is bought or sold for future delivery i.e., for the period of 30, 60 or 90 days: There are transactions for 180 and 360 days also. Thus, forward market deals in contract for future delivery. The price for such transactions is fixed at the time of contract; it is called a forward rate. Forward exchange rate differs from spot exchange rate as the former may either be at a premium or discount. If the forward rate is above the present spot rate, the foreign exchange rate is said to be at a premium. If the forward rate is below the present spot rate, the foreign exchange rate is said to be at a discount. Thus foreign exchange rate may be at forward premium or at forward discount. For e.g. an Indian importer may enter

into an agreement to purchase US \$ 10,000 sixty days from today at 1 US \$ = Rs. 48. No amount is paid at the time of agreement, except for usual security margin money of about 10% of the total amount. 60 days from today, the importer will get 10,000 US \$ in exchange for Rs. 4,80,000 irrespective of the Spot exchange rate prevailing on that date.

Factors Influencing Forward Exchange Rate :

- i) Interest rates.
- ii) Degree of speculation in foreign exchange market.
- iii) Inflation rate.
- iv) Foreign investor's confidence in domestic country.
- v) Economic situation in the country.
- vi) Political situation in the country.
- vii) Balance of payments position.

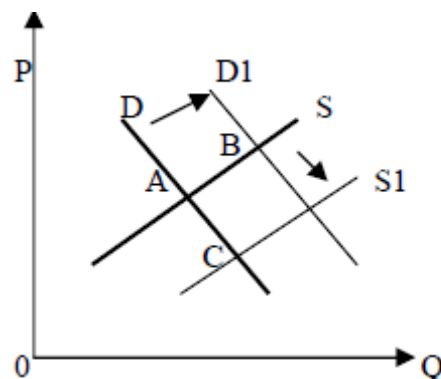
4.5 THEORIES TO DETERMINE EXCHANGE RATES :

Many theories there have been written in respect to the main determinant of future exchange rates. Although the majority of these theories give adequate reasons in order to explain what actually determines the rates between the currencies. Here below, we will refer to the main theories regarding the determinants of the exchange rates:

1. Supply and Demand :

The exchange rate, just like commodities, determines its price responding to the forces of supply and demand. Therefore, if for some reason people increase their demand (shift of the curve from D to D1) for a specific currency, then the price will rise from A to B, provided the supply remains stable. On the contrary, if the supply is increased (shift of the curve from S to S1), the price will decline from A to C, provided the demand remains stable (figure A). Any excess supply (above the equilibrium point) or excess demand (below the equilibrium point) will increase or decrease temporarily foreign currency reserves accordingly. Finally, such disequilibrium situations will be eliminated through the pricing, e.g. the market itself.

Figure A : Supply and Demand for foreign currency



P : shows the exchange rate,

Q : shows the amount of currency demanded and supplied

A, B, C : Show the equilibrium exchange rate.

2. Purchasing Power Parity (PPP) :

By definition the PPP states that using a unit of a currency, let us say one euro, which is the purchasing power that can purchase the same goods worldwide. The theory is based on the 'law of one price', which argues that should a euro price of a good be multiplied by the exchange rate (€/US\$) then it will result in an equal price of the good in US dollars. In other words, if we assume that the exchange rate between the € and US \$ states at 1/1.2, then goods that cost € 10 in the EU should cost US\$ 12 in the United States. Otherwise, arbitrage profits will occur. However, it is finally the market that through supply and demand will force accordingly the euro and US dollar prices to the equilibrium point. Thus, the law of one price will be reinstated, as well as the purchase power parity between the euro and US dollar. Inflation differentials between countries will also be eliminated in terms of their effect on the prices of the goods because the PPP will adjust to equal the ratio of their price levels. More specifically, as stated in their book (Lumby S. & Jones C. 1999) "the currency of the country with the higher rate of inflation will depreciate against the other country's currency by approximately the inflation differential". In conclusion, it can be argued that the theory, although it describes in a sufficient way the determination of the exchange rates, is not of good value, mainly because of the following two disadvantages. Firstly, not all goods are traded internationally (for example, buildings) and secondly, the transportation cost should represent a small amount of the good's worth.

3. The Balance of Payments (BOP) Approach :

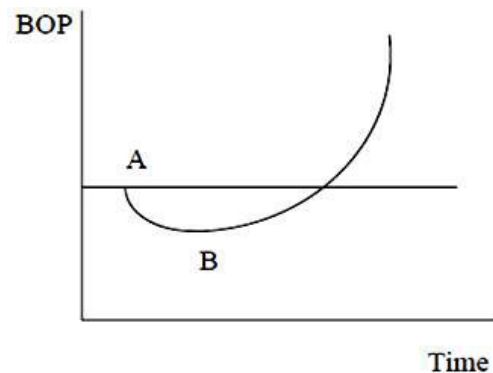
The balance of payments approach is another method that explains what the factors are that determine the supply and demand curves of a country's currency. As it is known from macroeconomics, the balance of payments is a method of recording all the international monetary transactions of a country during a specific period of time. The transactions recorded are divided into three categories: the current account transactions, the capital account transactions, and the central bank transactions. The aforementioned categories can show a deficit or a surplus, but theoretically the overall payments (the BOP as a whole) should be zero – which rarely happens. As stated earlier, a currency's price depreciation or appreciation (the change in the value of money), directly affects the volume of a country's imports and exports and, consequently, a likely fluctuation in the exchange rates can add to BOP discrepancies. For example, a likely depreciation will increase the value of exports in home currency terms (the larger the exports demand elasticity the greater the increase).

Conversely, the imports will become 'more expensive' and their value will be reduced in home currency (the larger the imports demand elasticity the greater the decrease).

The J curve effect illustrates that in the short-term a depreciation of the currency can initially worsen (from A to B) the current account balance before it improves its position (figure B). This is due to the low price elasticity of demand for imports and exports in the

immediate outcome of an exchange rate change.

Figure B : The J curve effect



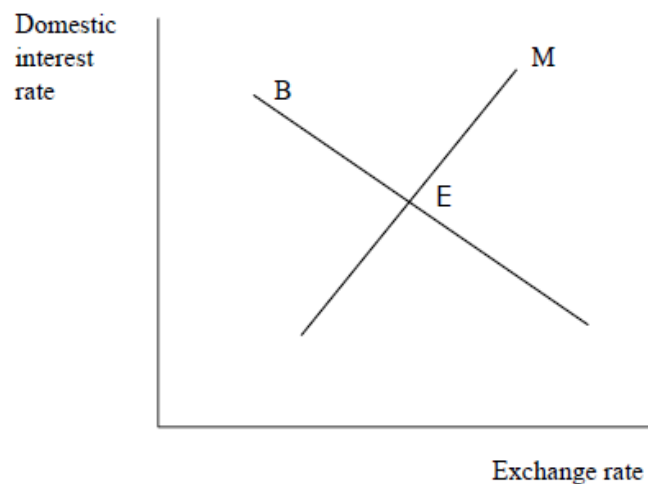
4. The Monetary Approach :

In this approach attention is given to the stock of currencies in comparison to the willingness of people to hold these stocks. According to the monetary theory, exchange rates adjust to ensure that the quantity of money in each currency supplied is equal to the quantity demanded. Both Quantity Theory of Money (QTM) and Purchasing Power Parity (PPP) have been used in support of the aforementioned theory. The QTM states that there is a direct relationship between the quantity of money and the level of prices of goods and services sold. In other words, more money equals more inflation.

5. The Portfolio Balance Approach :

The portfolio balance approach takes into consideration the diversification of investors' portfolio assets. Diversification is a technique that attempts to reduce risk by investing both among various financial instruments and across national borders, to mention just a few. For example, here below we consider a combination of domestic and foreign money and domestic and foreign bonds, the implications of which are illustrated in the following figure C.

Figure C : Portfolio balance approach



Both the M and the B lines show combinations of domestic interest rates and exchange rates. The upward line M is in agreement with the equilibrium in the money market and the downward line B is in agreement with the equilibrium in the bond market. Point E, which is the intersection of M with B, represents the combination of interest rate with the exchange rate that gives equilibrium to both the money and bond markets. What the theory argues is that an increase in the money supply will lead to a depreciation of the exchange rate. The extent of the depreciation depends upon the slope of the curves M and B. For example, if we consider an increase in the domestic money supply, we will anticipate that a lower interest rate and /or a higher exchange rate can only absorb the excess supply, which in turn will result in the reduction of bonds. To this end, line M will move to the right and line B will move to the left.

4.6 ARBITRAGE :

Arbitrage is the act of simultaneously buying a currency in one market and selling it in another to make a profit by taking advantage of exchange rate differences in two markets. If the arbitrages are confined to two markets only it is said “two-point” arbitrage. If they extend to three or more markets they are known as “three-point” or “multi-point” arbitrage. Those who deal with arbitrage are called arbitrageurs. A Spot sale of a currency when combined with a forward repurchase in a single transaction is called “Currency Swap”. The Swap rate is the difference between spot and forward exchange rates in currency swap. Arbitrage opportunities may exist in a foreign exchange market. Suppose the rate of exchange is 1 US \$ = ` . 50 in US market and 1 US \$ = ` . 55 in Indian Markets, then an arbitrageur can buy dollars in US market and sell it in Indian market and get a profit of 5 per dollar. In today’s modern well connected and advanced markets, arbitrageurs (which are mainly banks) can spot it quickly and exploit the opportunity. Such opportunities vanish over a period of time and equilibrium is again maintained.

For e.g.

Bank A ` / \$ = 50.50 / 50.55

Bank B ` / \$ = 50.40 / 50.45

The above rates are very close. The arbitrageur may take advantage and he can purchase \$ 1,00,000 from Bank B at 50.45 / a dollar and sell to it to Bank A at 50.50, thus making a profit of 0.05. The total profit would be $(1,00,000 \times 0.05) = 0.5,000$. The profit is earned without any risk and blocking of capital.

Arbitrage and Interest rate :

Interest arbitrage refers to differences in interest rates in domestic market and in overseas markets. If interest rates are higher in overseas market than in domestic market, an investor may invest in overseas market to take the advantage of interest differential. Interest arbitrage may be covered and uncovered.

1) Uncovered Arbitrage :

In this system, arbitrageurs would take a risk to earn profit by investing in a high

interest bearing risk free securities in a foreign market. His earnings would be according to his calculations if the currency of foreign market where he invested does not depreciate. If depreciation is equal to the difference in interest rate, the investor would not incur loss. However, if depreciation is more than interest rate, then the arbitrageur will incur loss.

2) Covered Arbitrage :

International investors would like to avoid the foreign exchange risk, thus interest arbitrage is usually covered. The investor converts the domestic currency for foreign currency at the current spot rate for the purpose of investment. At the same time, investor sells forward the amount of foreign currency which he is investing plus the interest that he will earn so as to coincide with maturity of foreign investment. The covered interest arbitrage refers to spot purchase of foreign currency to make investment and offsetting simultaneous forward sale of foreign currency to cover foreign exchange risk. When treasury bills mature, the investor will get the domestic currency equivalent of foreign investment plus interest without a foreign exchange risk.

4.7 SUMMARY :

The foreign exchange market is the mechanism, by which a person or firm transfers purchasing power from one country to another, obtains or provides credit for international trade transactions, and minimizes exposure to foreign exchange risk. A foreign exchange transaction is an agreement between a buyer and a seller that a given amount of one currency is to be delivered at a specified rate for some other currency. A foreign exchange rate is the price of a foreign currency. A foreign exchange quotation or quote is a statement of willingness to buy or sell at an announced rate. The foreign exchange market consists of two tiers: the interbank or wholesale market, and the client or retail market. Participants include banks and non bank foreign exchange dealers, individuals and firms conducting commercial and investment transactions, speculators and arbitrageurs, central banks and treasuries, and foreign exchange brokers. Transactions are effectuated either on a spot basis or on a forward or swap basis. A spot transaction is for an (almost) immediate value date while a forward transaction is for a value date somewhere in the future. Quotations can be classified either as European and American terms or as direct and indirect quotes. A cross rate is an exchange rate between two currencies, calculated from their common relationship with a third currency. Arbitrage is the act of simultaneously buying a currency in one market and selling it in another to make a profit by taking advantage of exchange rate differences in two markets.

4.8 KEY WORDS :

Blocked Currency :

A currency that is prohibited by law from being converted into another foreign currency.

Blocked Exchange :

Exchange that cannot be freely converted into other currencies.

Brady Plan :

Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

Break-even Exchange Rate :

The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency, which has not been covered in the forward market, so that there will be no advantage to any party from interest rate differentials.

Buyer's Option Contract :

When the buyer has the right to settle a forward contract at their option any time within a specified period.

Buying Rates :

Rates at which foreign exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

4.9 SELF ASSESSMENT QUESTIONS :

1. Foreign Exchange Rates and Quotations.
2. Foreign exchange rate determination.
3. Exchange rates.
4. Theories to determine exchange rates
5. Arbitrage.

4.10 SUGGESTED READINGS :

1. Sundaram, Anant K. and J. Stewart Black, The International Business Environment: Text and Cases, Prentice Hall of India Pvt. Ltd., New Delhi.
2. Cherunilam Francis, International Business: Text and Cases, Prentice Hall of India Pvt. Ltd., New Delhi.
3. Foreign Exchange Market, Jain, Yadav & Peyrard, Macmillan publishers India ltd. New Delhi.
4. International Business: Competing in the Global Marketplace by Charles W.L.Hill
5. International Business: The Challenges of Global Competition by Donald Ball and Michael Geringer.

D. Swapna

LESSON – 5

INTERNATIONAL FINANCIAL INSTITUTIONS

Objectives :

After studying this lesson, the student be able to learn :

- International Financial Institutions
- world bank
- International Finance Corporation

Structure of the Lesson :

- 5.1 International Financial Institutions
- 5.2 International Finance Corporation
- 5.3 Difference between IFC and the World Bank
- 5.4 Summary
- 5.5 Key words
- 5.6 Self Assessment Questions
- 5.7 Suggested Books

5.1 INTERNATIONAL FINANCIAL INSTITUTIONS :

International Financial Institutions: An Overview IFIs are institutions that provide financial support and professional advice for economic and social development activities in developing countries and promote international economic cooperation and stability. The term The information for this chapter is based mostly on publicly available materials on the Web sites of the International Monetary Fund, the World Bank, and the regional development banks. Information about the global programs is based on the Annual Global Monitoring Reports. These contributions are gratefully acknowledged.

International financial institution typically refers to the International Monetary Fund (IMF) and the five multilateral development banks (MDBs): the World Bank Group, the African Development Bank, the Asian Development Bank, the Inter-American Development Bank, and the European Bank for Reconstruction and Development. The last four of these each focus on a single world region and hence are often called regional development banks. IMF and the World Bank, in contrast, are global in their scope; they are also specialized agencies in the UN system but are governed independently of it. All IFIs admit only sovereign countries as owner-members, but all are characterized by a broad country membership, including both borrowing developing countries and developed donor countries; membership in the regional development banks is not limited to countries from the region but

includes countries from around the world. Each IFI has its own independent legal and operational status, but because a considerable number of countries have membership in several IFIs, a high level of cooperation is maintained among them. Broadly speaking, IMF provides temporary financial assistance to member countries to help ease balance of payments adjustment. MDBs provide financing for development to developing countries through the following:

Long-term loans (with maturities of up to 20 years) based on market interest rates. To obtain the financial resources for these loans, MDBs borrow on the international capital markets and re-lend to borrowing governments in developing countries.

Very-long-term loans (often termed credits, with maturities of 30 to 40 years) at interest rates well below market rates. These are funded through direct contributions by governments in the donor countries.

Grant financing is also offered by some MDBs, mostly for technical assistance, advisory services, or project preparation. All IFIs are active in supporting programs that are global in scope, in addition to their primary role of financing and providing technical assistance to programs at the country level. Their global activities are discussed later in the chapter. Several other publicly owned international banks and funds also lend to developing countries, and these are often grouped together as other multilateral financial institutions rather than as IFIs. They usually have a relatively narrow ownership or membership structure or focus on particular sectors or activities. Among these are the European Investment Bank, the International Fund for Agricultural Development, the Islamic Development Bank.

The Nordic Development Fund and the Nordic Investment Bank, and the Organization of the Petroleum Exporting Countries Fund for International Development. A number of sub regional banks established for development purposes are also classified as multilateral banks rather than as IFIs, as they are owned by a group of countries (typically borrowers and not donors). Among these are the Corporación Andina de Fomento (Andean Development Corporation), the Caribbean Development Bank, the Central American Bank for Economic Integration, the East African Development Bank, and the West African Development Bank. Some other international institutions, such as the Bank for International Settlements, the Financial Stability Forum, and the Basel Committee, also perform important roles in the international financial system but are not involved in lending. These, too, are not counted among IFIs and are not discussed in this chapter, which discusses IMF and MDBs only.

The International Monetary Fund IMF was established by international treaty in 1945 as the central institution of the international monetary system—the system of currency trading and exchange rates that enables business to take place between countries with different currencies. IMF aims to prevent crises in the system by encouraging countries to adopt sound economic policies and monitoring their adherence to such policies; it is also—as its name suggests—a fund that can be tapped by members needing temporary financing to address balance of payments problems. More specifically, IMF's statutory purposes include promoting the balanced expansion of world trade, the stability of exchange rates, the

avoidance of competitive currency devaluations, and the orderly correction of balance of payments problems.

To serve these purposes, IMF engages in three types of activities :

- (a) it monitors economic and financial developments and policies, both in its member countries and at the global level, and offers policy advice to its members based on its more than 50 years of experience;
- (b) it lends to member countries experiencing balance of payments problems, not just to provide temporary financing but also to support economic adjustment and reforms aimed at correcting the underlying problems; and
- (c) it provides the governments and central banks of its member countries with technical assistance and training in its areas of expertise. Headquartered in Washington, D.C., IMF is governed by its almost-global membership of 184 countries.

IMF is also the principal forum for discussing not only national economic policies in a global context but also issues important to the stability of the international monetary and financial system. These include countries' choice of exchange rate arrangements, the risks of destabilizing international capital flows, and the design of internationally recognized standards and codes for policies and institutions.

The World Bank Group Founded in 1945 at the same international conference as IMF, the World Bank at first was involved mainly in the reconstruction of countries devastated by World War II. As those countries recovered, the Bank turned its primary focus to the second task envisioned for it, namely, the economic development of the world's non-industrialized countries, with the goal of lifting the world out of poverty.

The World Bank is organized much like a cooperative, whose shareholders are the same 184 countries that make up IMF's membership. The shareholding countries are represented by a Board of Governors, which is the Bank's ultimate policy making body. As a rule, the governors are member countries' ministers of finance or of development. Because they meet only annually, the governors delegate much of the Bank's decision making to 24 executive directors, who work on site at the Bank. The governors have also established a Development Committee at the ministerial level. The committee's task is to facilitate intergovernmental consensus building on development issues, as well as to advise the boards of governors of both the Bank and the IMF on critical development issues and on the financial resources required to promote development.

The World Bank Group, which is headquartered in Washington, D.C., is made up of five institutions :

- the International Bank for Reconstruction and Development (IBRD),
- the International Development Association (IDA),
- the International Finance Corporation (IFC),

- the Multilateral Investment Guarantee Agency (MIGA),
- and the International Centre for Settlement of Investment Disputes (ICSID).

Each institution plays a different but important role in the group's corporate mission of reducing global poverty and improving living standards in the developing world. Together, they provide low-interest loans, interest-free credits, and grants to governments and the private sector in developing countries for investments in education, health, infrastructure, communications, and many other purposes, as well as services in support of those investments.

- IBRD focuses on middle-income countries and creditworthy low-income countries, whereas IDA focuses on the poorest countries in the world.
- IBRD lends only to governments, financing these loans primarily by selling triple-A-rated bonds in the world's financial markets.
- Although IBRD earns a small margin on this lending, the greater proportion of its income comes from lending out its own capital.

This capital consists of reserves built up over the years and money paid in from the World Bank's shareholders. This income also pays the World Bank's operating expenses, and part of it has been contributed to IDA and debt relief. IDA is the world's largest source of interest-free loans and grant assistance to the governments of the poorest countries. Its funds are replenished every 3 years by its 40 donor country members. Additional funds are generated through repayments of principal on its 35- to 40-year no-interest loans; these funds are then available for re-lending. IDA lending amounts vary from year to year but generally account for about 40 percent of total World Bank Group lending. IFC focuses on financing private sector projects, in which it may take an equity stake in addition to lending. MIGA promotes foreign direct investment in developing countries by insuring investors against political or noncommercial risks in those countries. ICSID provides a forum for mediating disputes between investors and governments and advises governments in their efforts to attract investment. The Inter-American Development Bank The Inter-American Development Bank (IDB) was established as a development institution in 1959, which makes it the oldest of the regional development banks. It is owned by its 47 member countries, which include 26 Latin American and Caribbean states, the United States, Canada, 16 European countries, Israel, the Republic of Korea, and Japan. It is headquartered in Washington, D.C. Within its region, IDB is the main source of multilateral financing for economic, social, and institutional development projects in both the public and the private sectors, as well as for trade and regional integration programs. IDB's main goals are to promote poverty reduction and social equity, as well as environmentally sustainable economic growth. To attain these goals, IDB focuses its work on four priority areas :

- Fostering competitiveness through support for policies and programs that increase a country's potential for development in an open global economy
- Modernizing the state by strengthening the efficiency and transparency of public institutions

- Investing in social programs that expand opportunities for the poor
- Promoting regional economic integration by forging links among countries to develop larger markets for their goods and services.
- IDB supports regional initiatives by producing information and knowledge for policy discussion and funding technical cooperation to strengthen regional integration.
- It provides technical support to governments on trade and integration issues and conducts public outreach activities to promote such integration.

The Asian Development Bank The Asian Development Bank (ADB) is owned by its 65 members, 47 from the region and 18 from other parts of the globe. Its highest policy making body is its Board of Governors, which meets annually and consists of one representative from each member. The governors elect the 12 members of the Board of Directors. ADB was founded in 1966 and is headquartered in Manila. ADB's vision is a region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their citizens through policy dialogue, loans, technical assistance, grants, guarantees, and equity investments. ADB's operations are financed by bonds, recycled repayments on its loans, and contributions from members. About 70 percent of its cumulative lending comes from its ordinary capital resources, but ADB also provides loans from several special funds. Among these is the Asian Development Fund, which provides concessional loans to the least-developed member countries. ADB also manages several trust funds and channels grants provided by bilateral donors to their ultimate recipients.

The African Development Bank The African Development Bank (AfDB) is engaged in promoting the economic development and social progress of its shareholder countries in Africa. Established in 1964, with headquarters in Abidjan, Cote d'Ivoire (but temporarily located in Tunis), AfDB is owned by 53 African countries and by 24 countries in the Americas, Europe, and Asia. AfDB's principal functions include the following:

- Making loans and equity investments for the economic and social advancement of the regional member countries
- Providing technical assistance for the preparation and execution of development projects and programs
- Promoting the investment of public and private capital for development purposes
- Responding to requests for assistance in coordinating the development policies and plans of the regional member countries.

In its operations, AfDB is also required to give special attention to national and multinational projects and programs that promote regional integration. AfDB gets its financial resources from subscribed capital; reserves, funds raised through borrowings, and accumulated net income. Its capital is subscribed such that the regional member countries hold two-thirds of the total and the non-regional members one-third. AfDB's highest policy

making body is its Board of Governors, which consists of one governor for each member country. The Board of Governors delegates many of its powers to the Board of Directors, which is composed of 18 executive directors: 12 representing the regional members and 6 representing the non-regional members. Under AfDB's founding agreement, its president must be a national of one of the regional members. AfDB lends on a non-concessional basis at a variable lending rate calculated on the basis of the cost of its borrowing. The other terms include a commitment charge of 1 percent and maturities of up to 20 years, including a 5-year grace period. AfDB also provides development finance on concessional terms to its low-income member countries that are unable to borrow on the above non-concessional terms. Money for such loans comes from the 24 non-regional shareholders in the form of grant contributions.

The European Bank for Reconstruction and Development :

The European Bank for Reconstruction and Development (EBRD) was established in 1991, when communism was crumbling in central and eastern Europe and these countries needed support to nurture a new private sector in a democratic environment. EBRD's charter is unique among MDBs in that it stipulates that EBRD may work only in countries that are committed to democratic principles. EBRD, which is headquartered in London, is owned by 60 countries and 2 intergovernmental institutions, the European Union and the European Investment Bank. EBRD's share capital is provided by its members. EBRD does not directly use shareholders' capital to finance its loans. Instead, its triple-A creditworthiness rating enables it to borrow funds in the international capital markets by issuing bonds and other debt instruments at highly favorable market rates. Although its shareholders are in the public sector, EBRD invests mainly in private enterprises, usually together with commercial partners.

Today, EBRD uses its investment tools to help build market economies and democracies in 27 countries from central Europe to central Asia. It provides project financing for banks, industries, and individual businesses, in the form of both new ventures and investments in existing companies. It also works with publicly owned companies to support privatization, restructuring of state-owned firms, and improvements in municipal services. EBRD uses its close relationship with governments in the region to promote policies that will bolster the business environment. International Financial Institutions and Global and Regional Issues All IFIs have two major product lines that help address global and regional issues: their country programs and their global and regional programs.² By definition, the country programs support the development strategies and investment projects of individual countries, but taken together, these programs contribute to advancing the well-being of the country's region and of the world as a whole. The global and regional programs provide financial resources that address global and regional issues directly and increase the supply of global public goods. They also promote international cooperation. A good overview of the activities of IFIs at the country, regional, and global levels can be found in the annual Global Monitoring Report series jointly produced since 2004 by the staff members of the World Bank and IMF. Although the primary purpose of these reports is to assess the implementation of policies and actions aimed at achieving the Millennium Development Goals, each report

also contains a chapter on IFIs, which summarizes their contributions on global issues through their global and regional programs. The rest of this section draws heavily on the 2004 and 2005 reports.

The International Monetary Fund IMF plays a central role in addressing those global issues related to promoting a stable and open global economic and financial environment (see chapter 3 of this volume).

First, it does so through its surveillance of the economic policies of those countries that, because of their size or their critical role in international trade or finance, is important to the health of the global economic system. The consultations with industrial countries that IMF conducts under Article IV of its Articles of Agreement are a vehicle for promoting appropriate policies, such as curbing domestic imbalances that may pose risks for the global economy. IMF is also becoming increasingly active in multilateral surveillance, highlighting both macroeconomic and financial risks as they emerge at the global level. IMF is planning to make its surveillance more effective through more-incisive analysis of specific weaknesses and distortions in the global financial system that raise the risk of crisis or contagion or hinder adjustment to globalization. It will also promote international dialogue within the international community on multilateral actions necessary to ensure global financial stability.

Second, IMF provides financial support to member countries experiencing protracted balance of payments difficulties. Such lending helps stabilize the affected economy while also safeguarding global financial stability. Stabilization loans are extended at market interest rates for high and middle income countries and on concessional terms for low-income countries.

The World Bank :

A critical part of the World Bank's work is devoted to analysis and advocacy in the global arena, especially with respect to the policies and actions of developed countries on trade, aid, and debt relief, given their importance in addressing these global issues and reducing poverty. The Bank's support for global programs began three decades ago, with the establishment of the Consultative Group on International Agricultural Research (CGIAR), for which the Bank serves as both convener and donor, as well as a lender to developing countries for complementary activities. CGIAR, which brings together leading agricultural research institutes from around the world, has had some notable successes in creating global public goods such as the high-yielding varieties of crops that are the backbone of the Green Revolution. As the only global institution among MDBs, the World Bank has increased its support for global programs rapidly in recent years; 70 different programs involving many of the global issues covered in this book are now under way. A major expansion of the Bank's work on global issues began in the late 1990s, when the Bank increased its orientation toward global partnerships and associated program support activities. This change in policy reflected the Bank's recognition of the rapid pace of globalization and the sharply increased attention to global policy issues within the development community. Many of these programs feature partnerships focused on the delivery of global and regional public goods, including the provision of seed money.

In September 2000, the Development Committee endorsed the Bank's priorities in supporting global public goods; those priorities focus on five areas :

- public health,
- protection of the global commons,
- financial stability,
- trade and
- knowledge.

The Regional Development Banks The regional development banks are also actively involved in global and regional programs covering financial stability, trade, the environment, post conflict assistance, and knowledge; all but EBRD are also involved in the control of infectious diseases. In many cases, the regional banks' focus is on provision of regional public goods (RPGs) or on regional aspects of global public goods; in this regard, they complement the World Bank's global and regional efforts. The regional banks are also involved in helping their regional members build capacity to meet members' obligations under recent global agreements. IDB has five priority areas in the provision of regional and global public goods: financial sector assessments, regional integration, curbing of infectious diseases, promotion of environmental services, and support for research in agriculture and regional policy dialogue. IDB has prepared a new policy framework for its support for RPGs, including a financing facility geared to providing grant financing for what it calls early-stage RPGs, where the greatest need is for dialogue among countries; later-stage RPGs, where more institutional resources to manage the emerging program are needed; and the initial stages of club RPGs, which will likely be financially self-sustaining once they are up and running. For AfDB, critical regional issues include post conflict assistance and public health measures, especially in the face of the HIV/AIDS epidemic. For ADB, key issues are the environment, health, and knowledge, with a particular focus on those issues where spillover effects exist within the region or its sub regions. Finally, for EBRD, nuclear safety is an area of special focus. It has taken the lead internationally in supporting countries in transition from socialism in the decommissioning of nuclear capacity, along with the resolution of other environmental liabilities from the socialist era. Another area of focus is financial stability, especially the adoption by EBRD's regional members of the financial standards and codes underpinning market economies. Taken together, MDBs support a number of regional and sub regional programs and initiatives in collaboration with other partners. These regional programs include a mix of RPG programs, including regional infrastructure projects, and multi country programs.

Examples include the following :

AfDB is supporting the New Partnership for Africa's Development, the African Union, the Global Environment Facility (especially on the development of an Environmental Action Plan for Africa), and the Africa Regional Coordination Unit for the UN Convention to Combat **Desertification**.

AfDB is supporting the Greater Mekong Sub region Program, which promotes cross-

country cooperation in a number of sectors through investments in infrastructure, policy initiatives, and institutional mechanisms. ADB is also supporting regional programs for the Pacific Islands; sub regional economic cooperation in Central Asia and South Asia; and cooperation in the Indonesia-Malaysia-Thailand growth triangle and among the countries of Brunei, Indonesia, Malaysia, and the Philippines. Particularly noteworthy is ADB's leadership on tsunami related work, including its organization of a recent high-level conference and the support it has pledged for an interim tsunami warning system.

IDB's approach to regional issues has focused on facilitating cross fertilization of ideas on policy issues. Its Regional Policy Dialogue provides a forum for policy makers to discuss issues of common concern in its seven network areas: education, natural disasters, environment, central banks and finance ministries, poverty and social protection, public policy management, and transparency.

An example of collaboration between regional development banks on RPGs is the joint sponsorship by ADB and IDB of the recent Tokyo Forum on the Operational Dimensions of Supplying Regional Public Goods through Regional Development Assistance.

EBRD supports a number of regional programs for private sector development, including for trade facilitation and small and mediumsize enterprise development. In addition, a growing number of EBRD projects cover more than one country: examples include regional equity funds, energy trade, and projects in which sponsors from one country invest in another.

The World Bank supports a large number of regional programs and initiatives in cooperation with other MDBs and other relevant partners. Examples include the Trade and Transport Facilitation in Southeast Europe Program, which promotes more efficient and less costly trade flows and provides customs standards compatible with the European Union; the Latin American regional initiative on infrastructure, in cooperation with IDB; and the strategic framework for IDA assistance to Africa, in cooperation with AfDB and other partners.

Reform of the International Financial Institutions :

IFIs' unique comparative advantage and the contributions they have made toward addressing global issues are well recognized. Yet there is a rising expectation on the part of almost all stakeholders—developed and developing country shareholders, academics and think tanks, civil society organizations, and business leaders—that IFIs need to do still more in this domain. However, a number of concerns about IFIs raise questions about the role they can play in global issues management.³ Many suggestions have been put forward for reform of IFIs. IFIs themselves agree that reform is needed if their shareholders expect them to play an increasing role in regional and global development issues. The suggested reforms can be categorized under the headings of legitimacy, effectiveness, conditionality, and financial capacity and sustainability.

Legitimacy :

Legitimacy concerns relate to the extent to which IFIs are perceived as impartial

advisers, given that their ownership structure and their policy making powers are skewed in favor of the rich nations. Many in developing countries— officials and citizens alike—as well as international nongovernmental organizations (NGOs) and researchers believe that the developed countries, particularly the United States and the European countries, have an undue influence on IFIs' policies, policy advice, and allocation of funds. Their influence is so great, in this view, that IFIs' advice cannot be trusted to be impartial but, rather, is infected by political and ideological bias. Those who hold this view also criticize the way the heads of IFIs are chosen: by convention, the head of IMF has always been a European, the head of the World Bank an American, the head of the EBRD a European, and the head of ADB a Japanese. (However, the head of AfDB is always an African, and the head of IDB a Latin American.) The critics argue that leadership selections should be made on the basis of merit and in public hearings, not on the basis of national origin.

Given their global nature and influence, concerns over legitimacy are most acute in the case of IMF and the World Bank, and, in response, proposals for reform of these institutions have been tabled for consideration by their shareholders. IMF's medium-term strategy paper proposes the reallocation of existing shareholdings (called quotas) so as to improve the share of developing countries. Other proposals would give more votes to developing countries with large and growing shares of the global economy (such as Brazil, China, India, and South Africa) and to smaller nations (particularly in Africa) that represent a significant share of the work of the two institutions.⁴ At the Spring 2006 meetings of IMF and the World Bank, some promising breakthroughs were made when the International Monetary and Financial Committee of the Board of Governors of IMF agreed on the need for fundamental reform and called on IMF's managing director to present concrete proposals for agreement at the annual meetings in September 2006.

5.2 INTERNATIONAL FINANCE CORPORATION :

The International Finance Corporation (IFC) is the private sector arm of the World Bank Group. IFC advances economic development and reduces poverty by investing in projects and private sector firms in developing countries. IFC focuses on investing, providing advice and mobilizing finance for developing countries.

IFC does this through :

- loans, equity, trade finance, structured finance, syndication
- advisory services (advice, problem-solving, training)
- asset management (mobilizing and managing third-party capital for investments in developing markets)

IFC's 3.0 strategy is split into two pillars. The first focuses on IFC's role "Upstream", creating markets and increasingly getting involved earlier in the project development cycle to seed investment opportunities, and in some cases working to create markets where none existed. This approach creates the conditions for bankable projects in developing countries.

The second pillar is to mobilize more private capital for development purposes, particularly in low-income countries and those affected by fragility and conflict.

Climate is a strategic focus for IFC, and the World Bank Group. IFC is committed to growing its climate-related investments to an annual average of 35 percent of its own-account long-term commitment volume between 2021 and 2025 and, working with financial institutions to finance projects that will support mitigation and adaptation.

IFC is also committed to gender equality and reducing gaps between men and women in the private sector, including financial support for women entrepreneurs and women-led SMEs.

In FY22, IFC committed a record \$32.8B to private companies and financial institutions in developing countries. This includes \$4.4B in climate financing and \$9.7B in trade finance, IFC's highest level ever. Of this amount, 75% was invested in International Development Association (IDA) countries and conflict-afflicted situations.

Private sector financing :

IFC offers a wide variety of financial products for private sector projects in developing countries, but it will not completely fund a new project. IFC can provide up to 50% of capital – which is a standard practice across most Development Finance Institutions (DFIs). It is therefore advisable that the project developer have relationships with other funders where IFC would play a catalytic role. Equity investments by the IFC are also limited, particularly for infrastructure projects.

IFC provides loans, equity, trade and supply chain finance, syndications, derivative finance, structure finance, local currency products, blended finance and asset management to both the private and public sector.

To be eligible for IFC funding, a project must meet certain criteria, including environmental and social safeguards. A company or entrepreneur seeking to establish a new venture or expand an existing enterprise can approach IFC directly by submitting an [investment proposal](#). *Note however that the IFC won't fund new ventures outside of its limited VC funding, which is largely through intermediaries.* After this initial contact and a preliminary review, IFC may proceed by requesting a detailed feasibility study or business plan to determine whether or not to appraise the project. IFC's [project/investment cycle](#) illustrates the stages a business idea goes through as it becomes an IFC-financed project.

Eligibility for funding includes: being a private sector entity that is located in a developing country that is a member of IFC; project is technically sound and projected to be profitable; project is beneficial to the local economy; project is environmentally and socially sound; and project satisfies IFC and host country standards.

IFC does not lend directly to micro, small, and medium-sized enterprises, or individual entrepreneurs, but many of the IFC's investment clients are financial intermediaries that then lend to smaller businesses.

Advisory services :

Providing advice is a critical part of IFC's strategy to create markets and mobilize

private investment. This work creates the conditions that will attract private capital, thus enabling the private sector to grow. IFC's strategy is to link the Advisory Services program to the needs identified in World Bank Group Country Partnership Frameworks and Sector Strategies.

IFC provides advice and market insights to private investors and partners, in order to mobilize more private capital. IFC also advises investors and partners on good practices and standards to increase competitiveness and productivity. In addition, IFC advises governments on reforms that encourage private investment and how to structure public-private partnerships to improve people's access to high quality infrastructure and basic services.

In FY22, IFC advisory portfolio totaled US\$1.4B, and included program expenditures of US\$251 million, with a strong focus on IFC's priority areas: IDA eligible countries (51%), fragile and conflict-affected situations (21%) and climate change (25%). IFC's PPP transaction advisory work mobilized \$3.56B of private capital.

Firms interested in pursuing IFC consulting services, including advisory and investment projects, should review the World Bank Procurement Portal [RFx Now](#). While registration is not required for bidding, firms and individuals must register before signing a contract. Note that procurement is a small part of IFC's business as private sector financing remains its main source of revenue.

5.3 WHAT IS THE DIFFERENCE BETWEEN IFC AND THE WORLD BANK ?

IFC is a member of the World Bank Group, which consists of five closely associated institutions that play an important role in eradicating poverty and improving lives. IFC promotes economic and social development through working directly with the private sector.

Working with business partners and other development finance institutions (DFIs), IFC invests in sustainable private enterprises and projects in developing countries. This direct lending to businesses is the primary difference between IFC and World Bank, which lends to sovereign governments.

IFC also offers advisory services to support private sector development. Most of these activities are funded in partnership with donor countries, and many involve close collaboration with the World Bank.

The Trade Commissioner Service (TCS) helps Canadian businesses of all sizes succeed in international markets with export advisory services, funding and accelerator programs. With a presence in more than 160 cities worldwide, the TCS can help you go global.

5.4 SUMMARY :

International Financial Institutions are institutions that provide financial support and professional advice for economic and social development activities in developing countries and promote international economic cooperation and stability. The term information for this chapter is based mostly on publicly available materials on the Web sites of the International Monetary Fund, the World Bank, and the regional development banks. Information about the

global programs is based on the Annual Global Monitoring Reports. These contributions are gratefully acknowledged.

International financial institution typically refers to the International Monetary Fund (IMF) and the five multilateral development banks (MDBs) : the World Bank Group, the African Development Bank, the Asian Development Bank, the Inter-American Development Bank, and the European Bank for Reconstruction and Development. The last four of these each focus on a single world region and hence are often called regional development banks. IMF and the World Bank, in contrast, are global in their scope; they are also specialized agencies in the UN system but are governed independently of it. All IFIs admit only sovereign countries as owner-members, but all are characterized by a broad country membership, including both borrowing developing countries and developed donor countries; membership in the regional development banks is not limited to countries from the region but includes countries from around the world. Each IFI has its own independent legal and operational status, but because a considerable number of countries have membership in several IFIs, a high level of cooperation is maintained among them.

5.5 KEY WORDS :

Clearinghouse :

A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

Clearinghouse Funds :

Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

Closing a Commitment :

Allowing a covered foreign- exchange position to expire on maturity or reversing it before maturity by a swap operation.

Combined Transport Document :

A through bill of lading that applies to more than one mode of transport.

Commodity Credit Corporation :

An agency of the U.S. Department of Agriculture that promotes the export of U.S. surplus agricultural commodities. It provides the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

Consortium Banks :

A group of banks forming a joint alliance to enter a new market, in order to reduce the capital requirements and risks involved in new ventures. While they were popular in the 1970s, they have since fallen into disfavor.

5.6 SELF ASSESSMENT QUESTIONS :

1. Write About International Finance Institutions.
2. What is the difference between IFC and World Bank?
3. Explain about International Financial Corporation.
4. What is ADB?
5. Write about WTO.

5.7 SUGGESTED READINGS :

1. World Bank, IMF and WTO: Role In Global Economy (Finance Series).
2. Reform Of the international Institutions The IMF, World Bank And The WTO.

Venna Sakunthala

LESSON – 6
**INTERNATIONAL DEVELOPMENT
ASSOCIATION & WTO**

Objectives :

After studying this lesson, the student be able to learn :

- International Development Association
- world trade organization
- Pease clause
- International Bank for Reconstruction and Development (IBRD)

Structure of the Lesson :

- 6.1 What is IDA
 - 6.1.1 How is IDA funded
 - 6.1.2 What does the IDA20 program include
 - 6.1.3 IDA20 will be supported by five special themes
 - 6.1.4 IDA20 will deepen recovery efforts by focusing on four cross-cutting issues
 - 6.1.5 As part of the package, IDA20 expects to deliver the following results
 - 6.1.6 What are some recent examples of IDA's work
- 6.2 Meaning of WTO
 - 6.2.1 History of WTO
 - 6.2.2 Functions of the World Trade Organization (WTO)
 - 6.2.3 Ministerial Conferences of WTO
 - 6.2.4 Dispute Settlement of the World Trade Organization
- 6.3 Background and Issues related to the Peace Clause
- 6.4 International Bank for Reconstruction and Development (IBRD)
- 6.5 Summary
- 6.6 Key words
- 6.7 Self Assessment Questions
- 6.8 Suggested Books

6.1 WHAT IS IDA ?

The World Bank's International Development Association (IDA) is one of the largest and most effective platforms for fighting extreme poverty in the world's lowest income countries.

- IDA works in 74 countries in Africa, East Asia & Pacific, South Asia, Europe & Central Asia, Latin America & Caribbean, and Middle East & North Africa.
- IDA aims to reduce poverty by providing financing and policy advice for programs that boost economic growth, build resilience, and improve the lives of poor people around the world.
- More than half of active IDA countries already receive all, or half, of their IDA resources on grant terms, which carry no repayments at all. Grants are targeted to low-income countries at higher risk of debt distress.
- Over the past 62 years, IDA has provided about \$458 billion for investments in 114 countries. IDA also has a strong track record in supporting countries through multiple crises.

6.1.1 How is IDA funded ?

- IDA partners and representatives from borrower countries come together every three years to replenish IDA funds and review IDA's policies. The replenishment consists of contributions from IDA donors, the World Bank, and financing raised from the capital markets.
- Since its founding in 1960, IDA has had 20 replenishment cycles. The current 20th cycle, known as IDA20, was replenished in December 2021. It took place one year earlier than scheduled to meet the unprecedented need brought about by the COVID-19 pandemic in developing countries.
- The \$93 billion IDA20 package was made possible by donor contributions from 52 high- and middle-income countries totaling \$23.5 billion, with additional financing raised in the capital markets, repayments, and the World Bank's own contributions.

6.1.2 What does the IDA20 program include ?

- IDA is a multi-issue institution and supports a range of development activities that pave the way toward equality, economic growth, job creation, higher incomes, and better living conditions.
- To help IDA countries address multiple crises and restore their trajectories to the 2030 development agenda, IDA20 will focus on Building Back Better from the Crisis: Towards a Green, Resilient and Inclusive Future. The IDA20 cycle runs from July 1, 2022, to June 30, 2025.

6.1.3 IDA20 will be supported by five special themes :

- Human Capital: Address the current crises and lay the foundations for an

inclusive recovery. This theme will continue to help countries manage the pandemic through vaccination programs deployment, scaling up safety nets, and building strong and pandemic-ready health systems.

- **Climate:** Raise the ambition to build back better and greener; scale up investments in renewable energy, resilience, and mitigation, while tackling issues like nature and biodiversity.
- **Gender:** Scale up efforts to close social and economic gaps between women and men, boys and girls. It will address issues like economic inclusion, gender-based violence, childcare, and reinforcing women's land rights.
- **Fragility, Conflict, and Violence (FCV):** Address drivers of FCV, support policy reforms for refugees, and scale-up regional initiatives in the Sahel, Lake Chad, and Horn of Africa.
- **Jobs and Economic Transformation:** Enable better jobs for more people through a green, resilient, and inclusive recovery. IDA20 will continue to address macroeconomic instability, support reforms and public investments, and focus on quality infrastructure, renewable energy, and inclusive urban development.

6.1.4 IDA20 will deepen recovery efforts by focusing on four cross-cutting issues :

- **Crisis Preparedness:** Strengthen national systems that can be adapted quickly, and shock preparedness investments to increase country readiness (e.g., shock-responsive safety nets).
- **Debt Sustainability and Transparency:** The Sustainable Development Finance Policy will continue to be key to support countries on debt sustainability, transparency, and management.
- **Governance and Institutions:** Strengthen public institutions to create a conducive environment for a sustainable recovery. Reinforce domestic resource mobilization, digital development, and combat illicit financial flows.
- **Technology:** Speed up digital transformation with the focus on digital infrastructure, skills, financial services, and businesses. Also address the risks of digital exclusion and support the creation of reliable, cyber secure data systems.

6.1.5 As part of the package, IDA20 expects to deliver the following results :

- essential health, nutrition, and population services for up to 430 million people,
- immunizations for up to 200 million children,
- social safety net programs to up to 375 million people,
- new/improved electricity service to up to 50 million people,
- access to clean cooking for 20 million people, and

- Improved access to water sources to up to 20 million people.

6.1.6 What are some recent examples of IDA's work ?

Here are some recent examples of how IDA is empowering countries towards a resilient recovery :

- Across Benin, Malawi, Cote D'Ivoire in Africa, and across South Asia, IDA is working with partners like the World Health Organization to finance vaccine purchase and deployment, and address hesitancy.
- In West Africa, an Ebola-era disease surveillance project has prepared countries to face the COVID-19 health crisis.
- In Tonga, IDA's emergency funding allowed the government to respond to the eruption and Tsunami in January 2022. The project strengthened Tonga's resilience to natural and climate-related risks by facilitating a significant reform of disaster risk management legislation.
- In the Sahel, where climate change is compounding the impacts of COVID-19— IDA is setting up monitoring initiatives, strengthening existing early warning systems, and providing targeted responses to support the agro-pastoral sectors.
- In Yemen, IDA provides critical facilities backed by solar systems to more than 3.2 million people – 51 percent female – including water, educational services, and health care.
- In Bangladesh, IDA helped restart the immunization of children under 12 months after the lockdown due to the COVID-19 outbreak in 2020. It enabled the country to vaccinate 28,585 children in 2020 and 25,864 in 2021 in the camps for the displaced Rohingya people.
- Across Burkina Faso, Chad, Mali, and Niger, IDA's response helped two million people benefit through cash transfers and food vouchers for basic food needs. Some 30,000 vulnerable farmers received digital coupons to access seeds and fertilizers, and 73,500 people, of which 32,500 were women, were provided temporary jobs through land restoration activities.

6.2 MEANING OF WTO :

- WTO – World Trade Organisation, was established in 1995 as the heir organisation to the GATT (General Agreement on Trade and Tariff). GATT was founded in 1948 with 23 nations as the global (international) trade organisation to serve all multilateral trade agreements by giving fair chances to all nations in the international exchange for trading prospects. WTO is required to build a rule-based trading government in which countries cannot place unreasonable constraints on trade.
- In addition, its mission is to increase stock and trade of services, to assure maximum utilisation of world resources and to preserve the environment. The

WTO deals include trade in commodities as well as services to promote international trade (bilateral and multilateral) through the elimination of the tax as well as non-tariff obstacles and implementing greater marketplace access to all member nations.

- As an influential member of WTO, India is at the lead of building fair global laws, statutes and shields and supporting the concerns of the developing system. India has fulfilled its promises towards the liberalisation of trade, made in the WTO, by eliminating quantitative limitations on imports and decreasing tariff charges.

We can look at WTO in several ways. WTO happens to be an organization responsible for liberalizing trade. It's a forum to negotiate trade agreements for various governments. It's a place where trade disputes are settled. It operates a system of trade rules.

- One of the most important features is that it is a forum where results come out after serious negotiations.
- Essentially, the WTO is a place where governments who are members go, in order to sort out the trade problems they face with each other.
- The first step is to talk. The WTO was born out of negotiations, and everything the WTO does is the result of negotiations.
- The bulk of the WTO's current work comes from the 1986-94 negotiations called the Uruguay Round.

The negotiations have helped to liberalize trade where countries have faced trade barriers and wanted them to be lowered. But the WTO is not just about liberalizing trade, and in some cases, its rules are such that trade barriers get support— for example, to protect consumers.

6.2.1 History of WTO :

The WTO started functioning on 1 January 1995, but its trading system is half a century older. Since 1948, the General Agreement on Tariffs and Trade (GATT) had given the rules for the system. (The second WTO ministerial meeting, held in Geneva in May 1998, included a celebration of the 50th anniversary of the system.)

- It did not take long for the General Agreement to give birth to an unofficial, extant international organization, also known informally as GATT.
- Over the years, GATT evolved through several rounds of negotiations.
- The General Agreement on Tariffs and Trade (GATT) had its last round in 1986 and it lasted till 1994.
- This was known as the Uruguay Round and it led to the formulation of the World Trade Organization (WTO).

While GATT mostly dealt with trade in goods, the WTO and its agreements could not

only cover goods but also trade in services and other intellectual properties like trade creations, designs, and inventions.

The WTO has 164 members and 23 observer governments. Afghanistan became the 164th member in July 2016. In addition to states, the European Union, and each EU country in its own right is a member.

6.2.2 Functions of the World Trade Organization (WTO) :

The WTO's overriding objective is to help trade flow smoothly, freely, fairly, and predictably. It does this by:

- Administering WTO trade agreements
- Conducting forum for trade negotiations
- Handling trade disputes
- Monitoring national trade policies
- Providing technical assistance and training for developing countries
- Cooperation with other international organizations

6.2.3 Ministerial Conferences of WTO :

| Ministerial Conferences | Place | Year | Description |
|-------------------------|---------------------|------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| MC1 | Singapore | 1996 | Ministers of finance, trade, foreign, and agriculture from more than 120 countries participated and the following issues were in discussion. <ul style="list-style-type: none"> • <i>trade and investment</i> • <i>trade facilitation</i> • <i>transparency in government procurement</i> • <i>trade and competition</i> These are known as the Singapore Issues. |
| MC2 | Geneva, Switzerland | 1998 | Discussions on the implementation of Singapore Issues. Further discussions for the next round related to Export subsidies, market access, etc. |
| MC3 | Seattle, USA | 1999 | The Uruguay Round was discussed. Further discussions on agricultural and services mandated at the last Ministerial. |

| | | | |
|-----|---------------------|------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| | | | The Ministerial Conference ended without a conclusion though. |
| MC4 | Doha, Qatar | 2001 | The <u>Doha Round</u> was discussed. |
| MC5 | Cancún, Mexico | 2003 | Discussions on the progress of the Doha Development Agenda and other negotiations from the last Ministerial. |
| MC6 | Hong Kong | 2005 | Discussions on aiming to conclude the Doha Round by 2006. Adoption of the ‘Swiss Formula’ to cut down tariffs on non-agricultural goods (<i>NAMA</i>) by both developed and developing countries with different coefficients. |
| MC7 | Geneva, Switzerland | 2009 | This meeting didn’t revolve around the Doha Round. Ministers discussed various other ideas for further development. The theme of MC7 was ‘ <i>The WTO, the Multilateral Trading System and the Current Global Economic Environment</i> ’ |
| MC8 | Geneva, Switzerland | 2011 | Discussions on multiple topics for least developed nations and trade policy reviews. WTO approved Montenegro, Russian Federation, and Samoa accessions. Doha Round was discussed to make the mandate more effective, operational, and precise. |
| MC9 | Bali, Indonesia | 2013 | The ‘Bali Package’ was adopted by the WTO that aimed at the following points: <ul style="list-style-type: none"> • Boosting trade in the least developed countries (LDCs) • Higher food security provisions for developing countries • Streamlining trade <p>The Bali Package is a selection of issues from the broader Doha Round negotiations.</p> <p>Yemen became a part of WTO.</p> |

| | | | |
|------|----------------------------|------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| MC10 | Nairobi, Kenya | 2015 | Discussion on agriculture, cotton, and issues of LDCs. The Nairobi Package was adopted by WTO that delivered beneficial commitments to WTO's poorest members. |
| MC11 | Buenos Aires, Argentina | 2017 | Discussions on e-commerce duties, fisheries subsidies, and other commitments to negotiations in all sectors. |
| MC12 | Nur-Sultan, Kazakhstan | 2021 | Postponed due to pandemic situation. |

Doha Declaration :

The Doha Declaration is the November 2001 declaration that came out of the 4th Ministerial Conference of the WTO, that took place in Doha, Qatar.

- This declaration gives the mandate for negotiations on an array of topics including issues concerning the implementation of the previous agreements.
- This is called the Doha Declaration on the TRIPS Agreement and Public Health.
- There were disagreements between developed and developing countries.
- The major bones of contention were agriculture, non-tariff trade barriers, industrial tariffs, services, and trade remedies.
- The Bali Ministerial Declaration was achieved in 2013 which is the first agreement under the Doha Round, and also the first unanimous agreement under WTO.

6.2.4 Dispute Settlement of the World Trade Organization :

- WTO is an international body that also deals in Dispute Settlements.
- The member country will approach the WTO's dispute settlement body when a country fails to comply with WTO rules.
- All the members are encouraged to settle the disputes through consultation or a panel if the consultation fails.
- The constituted panel will circulate the verdict of the dispute settlement amongst WTO members who can decide to reject the ruling.
- If the ruling is approved, the member country that violated the rules must change rules in line with the WTO Agreement.
- In the case of failure to do so, the complaining country and the violating country may determine a mutually-acceptable compensation, failing which, the complaining country may retaliate suitably.

World Trade Organization (WTO) Agreements :An Overview of Latest Developments :

India and her role in various international organisations is an important topic for the civil services exam. The World Trade Organisation (WTO) is a very important intergovernmental organisation that deals with international trade and commerce.

India and WTO :

India has been a member of the WTO since January 1995 and also had been a member of the WTO's forerunner General Agreement on Tariffs and Trade (GATT) since July 1948. As a developing country, India has played a significant role in the proceedings of the WTO, especially in voicing its own concerns and also of the entire developing world.

In the Doha WTO conference that took place in 2001, India emerged as the most outspoken of advocates for the developing bloc. The meeting was declared a success since the delegates of 142 countries agreed to a new round of trade talks, including topics such as environment, competition and investment.

There are many implications for the Indian economy as a result of the many agreements signed as part of the WTO. They are discussed below:

Reduction of Tariff and Non-Tariff Barriers :

The agreement proposes an overall reduction of tariffs on manufactured products and the phasing out of the quantitative restrictions over a period of time. The important implication is that the firms that have a competitive advantage would be able to survive in the long run.

Trade-Related Investment Measures (TRIMS) :

This agreement forbids the host country to discriminate against investments from abroad vis-a-vis domestic investment i.e. agreement requires investment to be freely allowed by nations.

Trade-Related Intellectual Property Rights (TRIPS) :

Intellectual property rights seek to protect and provide legal recognition to the creator of the intangible illegal use of his creation. It includes patents, copyrights, geographical indications, trademarks, industrial circuits, designs and trade secrets. Since the law governing these aspects vary vastly across countries, the agreement stipulates a basic homogeneity of the law so that no infringement of rights occurred. This required some changes in the domestic laws of countries including India. As a result, India amended the Copyright Act, the Patents Act, and the Trade and Merchandise Act. The pharmaceutical and biotechnology industries are expected to be hit the hardest. Another impact on India is expected to be in the transfer of technology from abroad.

Agreement on Agriculture (AOA) :

This agreement deals with giving market access, reducing export subsidies and government subsidies on agricultural products. Read about the Agreement on Agriculture in detail in the link

Agreement on Sanitary and Phyto-sanitary measures (SPM) :

This deals with restricting exports of any country that do not comply with the international standards of germs/bacteria, etc. This is particularly related to industries such as marine food, food processing and other packed food.

Multi-Fibre Agreement (MFA) :

This agreement is no longer applied. It was valid until 2004 only. It had essentially placed quotas on the amount of textile and clothing exports from developing to developed countries. The developed countries, including the USA and the EU, had this in place to protect their own domestic producers. As a result of this agreement being dismantled, a huge opportunity has opened up for developing nations such as India. To take advantage of this opportunity, India should have preparedness in terms of standardisation, modernisation, customisation and cost-efficiency to satisfy the demands of foreign customers.

6.3 INDIA AND THE WORLD TRADE ORGANIZATION – LATEST DEVELOPMENTS :

There are 4 important recent developments related to India and the World Trade Organisation (WTO). These 4 are listed below

1. Ban of Chinese Mobile Apps
2. Issues related to the Peace Clause
3. Information and Communication Technology (ICT) Tariff Case
4. Fisheries Subsidies

6.3.1 Ban on Chinese Mobile Apps – China Claims Violation of WTO Rules :

After India banned 59 mobile apps of China, they have claimed that India has violated World Trade Organization (WTO) rules. Even if China complains, WTO may most likely favour Indian decision due to the following reasons.

- There is no bilateral agreement between India and China related to Smartphone apps.
- As per the rules of the World Trade Organisation (WTO), a country can take action against companies if it is a threat to the national security and sovereignty of the nation.
- China has blocked many global giants from entering its market on various pretexts.

6.3.2 Background and Issues related to the Peace Clause :

Recently there was an issue concerned with the invoking of the Peace Clause by India at the World Trade Organisation (WTO). The below-given questions and answers will give a comprehensive understanding of the issue faced by India at the World Trade Organization (WTO).

What is a Peace Clause ?

High subsidies are seen to be distorting global trade. The peace clause protects a developing country's food procurement programmes against action from WTO members in case subsidy ceilings are breached.

Why did India invoke the Peace Clause at the World Trade Organisation (WTO) ?

In the month of April 2020, India informed the World Trade Organisation (WTO) that the value of India's rice production was \$ 43.67 billion in 2018-19 and India had given subsidies worth \$ 5 billion.

What is the issue related to India invoking the Peace Clause ?

India was the first country to invoke the peace clause for breaching the subsidy limit for rice for the marketing year 2018-19. The limit is pegged at 10% of the value of food production (called de minimis) in the case of India and other developing countries.

Which Countries questioned India on invoking the World Trade Organisation (WTO) Peace Clause ?

European Union (E.U.), United States of America (USA), Japan, Canada, Brazil and Paraguay have questioned India for invoking the World Trade Organization (WTO) peace clause for exceeding the ceiling on the support it can offer its farmers for rice. The European Union E.U has asked India for all the information on the products covered by the public stockholding programme to assure that only rice support exceeded the limits.

What were the reasons given by India, in support of its breaching the subsidy limits and invoking the peace clause ?

- Rice stocks sold in the domestic market were not allowed for exports thus preventing the risk of distorting the global market.
- An adequate buffer stock of food grains helps deal with fluctuations in production and meets unforeseen exigencies and natural calamities.

What is the next course of action for India ?

India has to hold consultations with other WTO members in line with the Bali ministerial decision of 2013 on public stockholding for food security purposes.

6.3.3 Information and Communication Technology (ICT) Tariff Case :

- The World Trade Organisation (WTO) has decided to set up a dispute panel against India.
- The panel is being set up on the request of Japan and Taiwan.
- The dispute panels of the World Trade Organisation (WTO) would determine whether India's customs duties on imports of certain information and communications technology (ICT) products infringe WTO norms or not.
- Japan and Taiwan filed a case against India in WTO over the import duties

imposed on certain electronic goods, parts of telephone sets, telephones for cellular networks; conversion and transmission or regeneration of voice, machines for the reception, images or other data.

- India has stated that these ICT products are part of WTO's Information Technology Products (ITA-2) agreement. India is a part of ITA-1, signed in 1997.

6.3.4 Dispute Resolution for Harmful Fisheries Subsidies :

- India has sought a clear dispute settlement mechanism in the global agreement to end harmful fisheries subsidies
- WTO members are negotiating to finalise disciplines to eliminate subsidies for illegal, unreported and unregulated (IUU) fishing, and to prohibit certain forms of fisheries subsidies that contribute to overcapacity and overfishing.
- India wants to avoid undue haste and conclude the negotiations by next ministerial conference in June 2021.

There are other issues also like the Agreement on Countervailing Duties, Anti-dumping Duties, etc. which affect India. Candidates can go through the videos on India, WTO and Dispute Settlement & Agricultural Subsidies and TRIPS Waiver for better clarification for exam preparation.

6.4 WHAT IS THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD) ?

The IBRD is one of five member institutions that collectively form the World Bank Group. Established in 1944, the World Bank Group was created with the aim of providing financial and technical assistance to developing countries for a wide range of development projects. IBRD, specifically, focuses on middle-income and creditworthy low-income countries.

The Origins of IBRD :

The International Bank for Reconstruction and Development (IBRD) was established alongside its sister institution, the International Monetary Fund (IMF), during the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire, in 1944. The primary motivation behind its creation was to aid the reconstruction of Europe and Asia after the devastation of World War II.

IBRD's initial focus was to provide long-term loans to war-ravaged nations to rebuild their infrastructure, industries, and economies. However, over the years, its mission expanded to encompass a broader spectrum of development activities.

Headquarters of IBRD :

The headquarters of IBRD is located in Washington, D.C., USA. This strategic location facilitates its interaction with numerous international partners, financial institutions, and policymakers. It serves as a hub for collaboration, knowledge sharing, and coordination

of global development efforts.

Functions of IBRD :

The primary functions of IBRD encompass :

- Providing Loans: IBRD extends financial loans to member countries for a myriad of development projects, such as infrastructure development, education, healthcare, and environmental sustainability. These loans come with favorable terms, including extended repayment periods and low-interest rates.
- Offering Expertise: Beyond financial support, IBRD brings together a wealth of knowledge and expertise, providing technical assistance and policy advice to member countries. This advisory role is instrumental in helping nations design and implement projects effectively.
- Facilitating Capacity Building: The institution aids in strengthening the institutional capacities of borrowing nations, enhancing their ability to plan, manage, and execute development projects efficiently. Capacity building is crucial for the sustainable success of initiatives.
- Promoting Sustainable Development: IBRD prioritizes projects that align with sustainable development goals, emphasizing environmental and social sustainability. This commitment ensures that development efforts have a positive and lasting impact.

Structure of IBRD :

The governance structure of IBRD comprises key components –

Board of Governors :

The highest decision-making body is composed of one governor from each member country (typically the country's finance minister).

Board of Executive Directors :

Responsible for day-to-day operations, consisting of executive directors representing member countries or groups of countries.

President of IBRD :

The President, appointed by the Board of Executive Directors, is responsible for the overall management and administration of IBRD.

Leadership and Governance :

IBRD's governance framework ensures transparency, accountability, and representation of member countries in its decision-making processes. The institution operates with a commitment to the best interests of global development.

Objectives of IBRD :

The overarching objectives of IBRD are –

- Economic Development: To reduce poverty and support economic development in member countries. IBRD's financial resources contribute to improving living standards and creating opportunities for sustainable growth.
- Infrastructure: To promote the construction and improvement of infrastructure crucial for economic growth. This includes investments in transportation, energy, water supply, and telecommunications.
- Technical Assistance: To provide technical expertise and knowledge to facilitate development projects. IBRD offers policy advice, conducts research, and shares best practices to empower nations in their development endeavors.
- Global Integration: To foster global integration and cooperation for sustainable development. IBRD's initiatives aim to strengthen economic ties between nations, promote trade, and enhance collaboration on regional and global challenges.

Features of IBRD :

IBRD is characterized by the following features –

- Market Borrowing: It raises most of its funds by borrowing from international capital markets, thanks to its high credit rating. This allows IBRD to provide member countries with loans at favorable terms.
- Loan Terms: IBRD provides loans with long repayment periods, often spanning several decades, and low-interest rates. These terms make it easier for borrowing nations to invest in large-scale development projects.
- Selective Lending: It operates on a selective lending policy, focusing on projects that align with its development goals. This approach ensures that resources are directed toward initiatives that have a meaningful impact on development outcomes.
- Commitment to Sustainability: IBRD places a strong emphasis on environmental and social sustainability. Projects supported by the institution are expected to adhere to rigorous sustainability standards, minimizing adverse environmental and social impacts.

Services Provided by IBRD :

The following are some of the services provided by IBRD –

Financial Services :

- The IBRD provides flexible loans with maturities of up to 30 years and custom-tailored repayment scheduling.
- The IBRD offers loans in local currencies.
- The IBRD, in collaboration with the International Finance Corporation, offers financing to subnational entities with or without sovereign guarantees.

- The IBRD operates a Deferred Drawdown Option. It is a line of credit with features similar to its flexible loan program for borrowers requiring quick financing.

Credit Enhancement and Guarantee Products :

- The IBRD offers a variety of credit enhancement and guarantee products. This includes policy-based guarantees, partial credit guarantees, and partial risk guarantees.
- The IBRD's Enclave Partial Risk Guarantee covers private projects in IDA member countries against sovereign governments' failures to fulfill contractual obligations.

Financial Risk Management Products :

- The IBRD provides an array of financial risk management products. This includes foreign exchange swaps, currency conversions, interest rate swaps, interest rate caps and floors, and commodity swaps.

Catastrophe Protection :

- The IBRD offers a Catastrophe Deferred Drawdown Option to provide financing after a natural disaster or declared state of emergency.
- The IBRD issues catastrophe bonds to transfer catastrophic risks from borrowers to investors.

Conclusion :

The International Bank for Reconstruction and Development, as part of the World Bank Group, plays a pivotal role in promoting global development and addressing critical challenges faced by countries around the world. Through its financial assistance, technical expertise, and commitment to sustainable development, IBRD stands as a beacon of hope for nations striving for progress and prosperity.

6.5 SUMMARY :

The World Bank's International Development Association (IDA) is one of the largest and most effective platforms for fighting extreme poverty in the world's lowest income countries. We can look at WTO in several ways. WTO happens to be an organization responsible for liberalizing trade. It's a forum to negotiate trade agreements for various governments. It's a place where trade disputes are settled. It operates a system of trade rules. The negotiations have helped to liberalize trade where countries have faced trade barriers and wanted them to be lowered. But the WTO is not just about liberalizing trade, and in some cases, its rules are such that trade barriers get support.

The IBRD is one of five member institutions that collectively form the World Bank Group. Established in 1944, the World Bank Group was created with the aim of providing financial and technical assistance to developing countries for a wide range of development

projects. IBRD, specifically, focuses on middle – income and creditworthy low – income countries. The International Bank for Reconstruction and Development, as part of the World Bank Group, plays a pivotal role in promoting global development and addressing critical challenges faced by countries around the world. Through its financial assistance, technical expertise, and commitment to sustainable development, IBRD stands as a beacon of hope for nations striving for progress and prosperity.

6.6 KEY WORDS :

Consular Documents :

Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

Consular Invoice :

Detailed statement regarding the character of goods shipped which is duly certified by the consul at the port of shipment. Required by certain countries, including the U.S., its principal function is to record accurately the types of goods and their quantity, grade and value for import duty, balance of payments, and other statistical purposes.

Convertibility :

Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

Credit Risk :

The possibility that the buyer or seller of a foreign exchange or some other traded instrument may be unable to meet their obligation at maturity.

Cross-border Exposure :

The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

6.7 SELF ASSESSMENT QUESTIONS :

1. Write about IDA.
2. What are the Functions of the world trade organization (WTO)?
3. What is the international Bank for Reconstruction and Development (IBRD)?

6.8 SUGGESTED READINGS :

1. IMF (International Monetary Fund) 1995 , Balance of Payments Compilation Guide, 1st Edition, Washington DC.
2. IMF (International Monetary Fund) 2001, Balance of Payments Statistics Yearbook, Washington DC.
3. IMF (International Monetary Fund) 2001, International Finance Statistics Yearbook, Washington, DC

LESSON – 7
**SOURCES OF DEMAND OR OUTFLOW
OF FOREIGN EXCHANGE**

Objectives :

After studying this lesson, the student be able to learn :

- Outflow of foreign exchange
- Foreign Exchange Earning
- NRI Remittance

Structure of the Lesson :

- 7.1 Three sources of demand or outflow of foreign exchange
- 7.2 Foreign Exchange
- 7.3 Foreign Exchange earning requirements and Monitoring
- 7.4 Invisible Export Earnings
- 7.5 Role of NRI Remittance
- 7.6 Summary
- 7.7 Key words
- 7.8 Self Assessment Questions
- 7.9 Suggested Books

7.1 THREE SOURCES OF DEMAND OR OUTFLOW OF FOREIGN EXCHANGE :

1) Imports :

It requires foreign exchange because payments for imports are made in foreign exchange only.

2) Foreign Investment :

Investment in rest of the world is an important business activity. We need foreign currency in which investment is to be made.

3) Direct purchase Abroad :

Foreign exchange is needed to make direct purchases of goods and services from abroad.

Three sources of supply of foreign exchange are :

1) Exports :

Exports of goods and services are an important source of supply of foreign exchange.

2) Grants and donations from rest of the world :

A significant amount of foreign exchange flows from rich to poor countries by way of grants and donations.

3) Loans form rest of the world :

It refers to the borrowings from rest of the world. It contributes to the supply of foreign exchange.

7.2 WHAT IS FOREIGN EXCHANGE ?

Foreign exchange refers to foreign currency. *For example*, for an Indian resident, the Indian rupee (₹) is a domestic currency that can be used as a medium of exchange in India. But the Indian rupee (₹) cannot be used as a medium of exchange outside India. The currency used in other countries is treated as foreign currency for India. Therefore, in the case of international transactions, the domestic currency is converted into foreign currency. *For example*, if a person visits New York for vacation, he/she cannot use the Indian rupee (₹) in New York for economic transactions. The person has to convert the Indian rupee into US Dollars (\$), only then he/she can stay there. For that reason, it is important to know at what price domestic currency can be converted into foreign currency. This price is known as the Exchange Rate. The market in which domestic currency is traded for others is the “Foreign Exchange Market”.

Foreign Exchange Rate :

“The rate at which the domestic currency can be exchanged for the foreign currency is known as Foreign Exchange Rate“. In simple terms, the foreign exchange rate is the price paid in the domestic currency (₹) for buying a unit of foreign currency. It links the currencies of different countries and enables the comparison of international prices. *For example*, to buy a unit of \$(dollar), if you have to pay ₹ 60, then the exchange rate is ₹ 60 per dollar. It can be written in the form; of $\$1 = ₹ 60$.

Demand and Supply for Foreign Exchange :

Demand for Foreign Exchange :

The demand for foreign exchange arises when a person has to make a payment in foreign currency. In simple terms, it indicates the outflow of foreign currency. It is demanded by Indian residents for the following reasons :

1. **Import of Goods and Services :** In the case of the Import of goods and services from a foreign country the payment is made by the importer (the person who imports goods and services) in foreign currency; thus, creating a demand for foreign exchange in India’s Foreign Exchange Market.

2. **Unilateral Transfers Sent Abroad** : These are the transfers made by the person for free. It includes the transfer of gifts and grants sent by the government or a person to other countries. These are called unilateral transfers because they are not made to get something in return and because of this reason, foreign exchange is required. *For example*, If a foreigner is working in India. It means that he is earning income in Indian Rupees. Now, if the foreigner wants to send money to his family, he will have to get the currency exchanged, resulting in an increasing demand for foreign exchange.
3. **Tourism** : To pay for expenses incurred during international tours, tourists require a foreign exchange, which creates demand for it. Foreign tourists will create a demand for foreign exchange in India's foreign exchange markets.
4. **Investments** : When investments are made by India in other countries foreign exchange is required. Therefore, demand for foreign exchange is created while making investments abroad.
5. **Lending Abroad** : If India provides loans to foreign countries, India will demand foreign exchange.
6. **Repayment of Interest and Loans** : If loans along with interest are paid to foreign lenders, there is a need for foreign exchange. It results in an increase in the demand for foreign exchange.
7. **Purchase of assets abroad** : There is a demand for foreign exchange to make payments for the purchase of assets like land, shares, bonds, etc., abroad.
8. **Speculation** : When people earn money from the appreciation of currency it is called speculation. For this purpose, they need foreign exchange. *For example*, If an Indian resident through analysis expects the price of the US Dollar to be high in the future, he/she will buy more US Dollars today. The main goal of speculation is to earn profits when the dollar becomes expensive.

Reasons for Rising Demand for Foreign Currency :

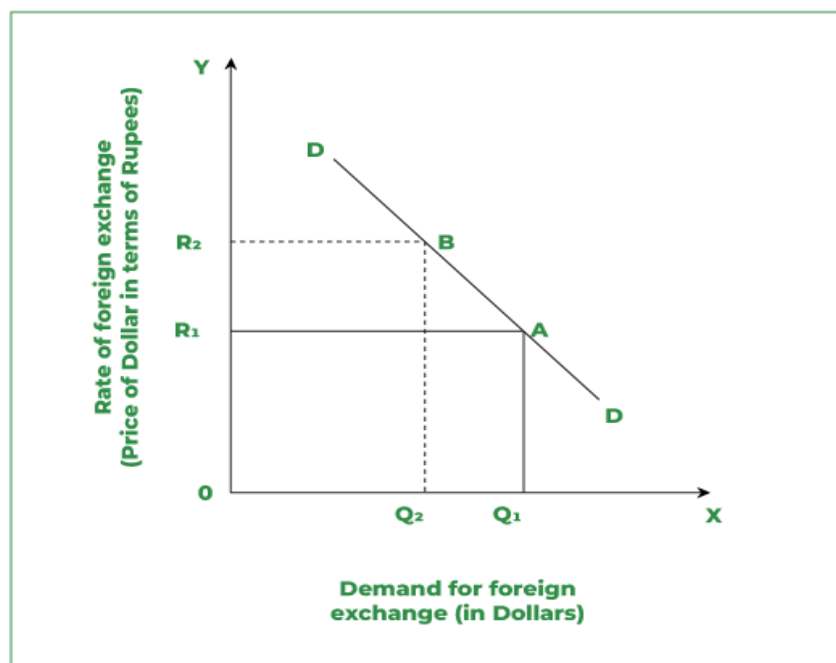
The demand for foreign exchange rises in the following situations :

1. The demand for foreign currency rises because of the appreciation of domestic currency (it can also be said that there is a depreciation in the price of foreign currency). Appreciation of domestic currency refers to an increase in the value of the domestic currency in comparison to foreign currency. *For example*, if the price of \$1 (US Dollar) falls from ₹ 64 to ₹ 60, then it means that more goods will be purchased with the same rupees. This indicates that imports from the USA will increase, as American goods become cheaper in India. It will ultimately increase the demand for US Dollars in India.
2. When the price of foreign currency falls, its demand for speculative purposes rises as now it is available at a low price.

3. A fall in the exchange rate of \$1= ₹ 64 to \$1= ₹ 60, increases the level of investment abroad.
4. Tourism to that foreign country increases as travelling abroad has now become relatively cheaper.

Demand Curve of foreign exchange :

There is an inverse relationship between the rate of foreign exchange and demand for foreign exchange. It means the higher the rate, the lesser will be the demand for foreign exchange and vice-versa. Due to this reason, the demand curve slopes downwards. The relationship between the rate of foreign exchange and the quantity demanded for foreign exchange can be illustrated graphically with the help of a downward-sloping curve, as shown in Figure 1.



In the graph, the exchange rate is shown on the Y axis, and demand for foreign exchange is shown on the X axis. The demand curve DD shows the negative relation between the rate of exchange rate and demand for foreign exchange. The DD demand curve (negative sloping) shows that at a lower rate of exchange OR_1 more foreign exchange is demanded OQ_1 , whereas at a higher rate of exchange, i.e., OR_2 less foreign exchange is demanded OQ_2 .

Supply of Foreign Exchange :

The supply of foreign exchange involves receipts of foreign exchange. Thus it indicates the inflow of foreign currency into the domestic country. The major sources of supply of foreign exchange are stated below :

1. Exports : Whenever the foreigner purchases goods and services from a domestic country (India), the payment is made by the foreigner in foreign

exchange. Thus, in the case of Exports of goods and services, there is an increase in the supply of foreign exchange in India's foreign exchange market.

2. **One-sided/Unilateral Transfers from Abroad** : These are the transfers made by the person for free. It includes the transfer of gifts and grants sent by the government or a person to other countries. These are called unilateral transfers because these are not made to get something in return. Thus for unilateral transfers, foreign exchange is required. If Indians are working in a foreign country. It means they earn income abroad. When they send back the income earned to their homeland for their families in India, it results in an increase in the supply of foreign exchange in India's foreign exchange market.
3. **Tourism** : To pay for expenses incurred during international tours, tourists require foreign exchange. If foreign tourists come to India, then they need our Indian Rupee for their stay. They supply foreign exchange in return for the Indian Rupee which will in return increase the supply of foreign exchange in India.
4. **Foreign Direct Investments(FDI) in India** : FDI refers to the investment made to get direct control of the domestic market. When investments are made by Multinational Companies (like Pizza Hut, and Dominos). In India, there is a flow of foreign exchange.
5. **Foreign Portfolio Investments(FPI) by Foreign Investors** : FPI refers to the investment made to earn profit in the domestic market. These are made in form of shares, debentures, bonds, etc. Any purchase in the Indian stock exchange by foreign investors results in the flow of foreign exchange in the Indian share market.
6. **Deposits by Non-Resident Indians(NRI)** : Foreign exchange flows in the Indian foreign exchange market due to deposits by Non-Resident Indians(NRI) in India.
7. **Speculation**: Supply of foreign exchange arises when people earn money from the foreign exchange by speculating.

Reasons for Rising Supply of Foreign Currency :

The supply of foreign currency rises in the following situations :

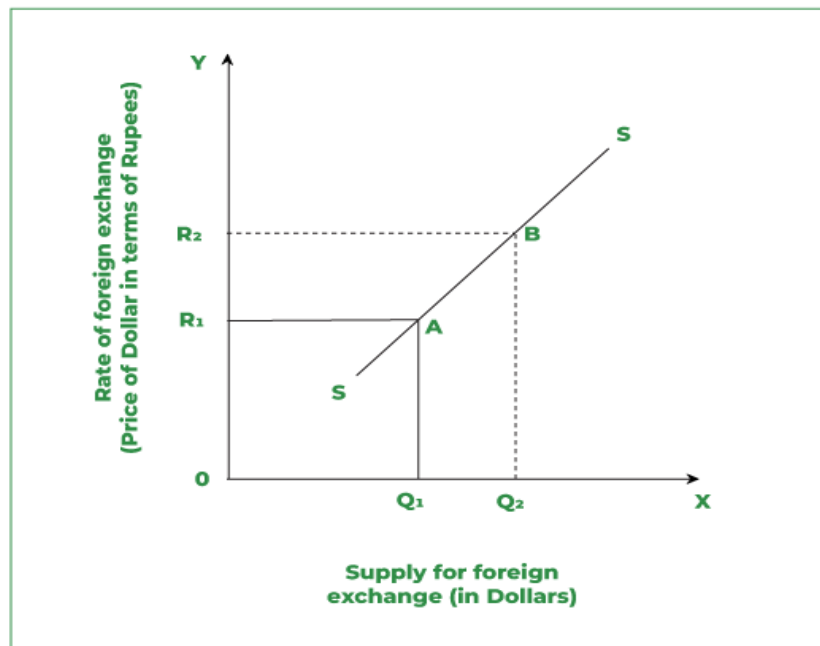
1. The supply of foreign currency rises because of the depreciation of domestic currency (it can also be said that there is an appreciation in the price of foreign currency). Depreciation of the domestic currency refers to the decrease in the value of the domestic currency in comparison to foreign currency. *For example*, if the price of \$1 (US Dollar) rises from ₹ 60 to ₹ 64, then it means that more goods will be purchased in rupees with the same dollar. This indicates that exports to the USA will increase, as Indian goods become

cheaper in the USA. It will ultimately increase the supply of US Dollars in India.

2. When the price of foreign currency increases, the tendency for speculative gains in the domestic country rises. Thus it increases the supply of foreign exchange.
3. A rise in the exchange rate of $\$1 = ₹ 60$ to $\$1 = ₹ 64$, increases the purchases by the non-resident in India.
4. Tourism in the domestic country increases as travelling in India has now become relatively cheaper.
5. There is an increase in the level of investment from a foreign country as the purchasing power of the foreign currency in the domestic country rises.

Supply Curve of Foreign Exchange :

There is a positive relationship between the rate of foreign exchange and demand for foreign exchange. This means the higher the rate of foreign exchange, the higher will be the supply of foreign exchange and vice-versa. Thus supply curve slopes upwards. The relationship between the rate of foreign exchange and the quantity supplied of foreign exchange can be illustrated graphically with the help of an upward-sloping curve as shown in Figure 2.



In the graph, the exchange rate is shown on the Y axis, and the supply of foreign exchange is shown on the X axis. The supply curve SS shows the direct (positive) relation between the rate of exchange rate and the supply of foreign exchange. The supply curve (positive sloping) shows that when the rate of foreign exchange rises from OR_1 to OR_2 , then the supply of foreign exchange rises from OQ_1 to OQ_2 .

7.3 FOREIGN EXCHANGE EARNING REQUIREMENTS AND MONITORING :

Net Foreign Exchange Earnings : The Unit shall achieve Positive Net Foreign Exchange to be calculated cumulatively for a period of five years from the commencement of production according to the following formula, namely :

$$\text{Positive Net Foreign Exchange} = A - B > 0$$

where

A – is Free on Board value of exports, including exports to Nepal and Bhutan against freely convertible currency, by the Unit and the value of following supplies of their products, namely :

- (a) supply of goods against Advance License or Duty Free Replenishment Certificate under the Duty Exemption or Remission Scheme or Diamond Imprest License under the Foreign Trade Policy;
- (b) supply of capital goods to holders of license under the Export Promotion Capital Goods scheme under the Foreign Trade Policy;
- (c) supply of goods to projects financed by multilateral or bilateral agencies or funds as notified by the Department of Economic Affairs, Ministry of Finance under International Competitive Bidding in accordance with the procedures of those agencies or funds, where the legal agreements provide for tender evaluation without including the customs duty;
- (d) supply of capital goods, including those in unassembled or disassembled condition as well as plants, machinery, accessories, tools, dies and such goods which are used for installation purposes till the stage of production and spares to the extent of ten per cent. of the free on rail value to fertilizer plants;
- (e) supply of goods to any project or purpose in respect of which the Ministry of Finance, by a notification, permits the import of such goods at zero customs duty;
- (f) supply of goods to the power projects and refineries not covered in
- (e) above;
- (g) supply to projects funded by United Nations Agencies;
- (h) supply of goods to nuclear power projects through competitive bidding as opposed to International Competitive Bidding;
- (i) supply made to bonded warehouses set up under the Foreign Trade Policy or under section 65 of the Customs Act and free trade and warehousing zones, where payment is received in foreign exchange;
- (j) supply against special entitlements of duty free import of goods under the Foreign Trade Policy;
- (k) export of services by services units including services rendered within Special

Economic Zone or services rendered in the Domestic Tariff Area and paid for in free foreign exchange or such services rendered in Indian Rupees which are otherwise considered as having been paid for in free foreign exchange by the Reserve Bank of India;

- (l) supply of Information Technology Agreement items and notified zero duty telecom or electronic items, namely, Color Display Tubes for monitors and Deflection components for colour monitors or any other items as may be notified by the Central Government;
- (m) supply to other units and Developers in the same or other Special Economic Zone or Export Oriented Unit or Electronic Hardware Technology Park or Software Technology Park Units or Bio-technology Park Unit provided that such goods and services are permissible for import or procurement by such units and Developers;
- (n) supply of goods to Domestic Tariff Area against payment in foreign exchange from the Exchange Earners Foreign Currency account of the Domestic Tariff Area buyer or Free Foreign Exchange received from overseas;
- (o) supply of goods against free foreign exchange by a Free Trade and Warehousing Zone Unit;

Explanation : For the purposes of this sub-rule, the supplies under clause (m) shall be against procurement certificate, as applicable and the supplies under clauses (d) to (h) and (j) shall be as per the terms and conditions of the respective duty exemption notified by the Central Government, in the Ministry of Finance; and

B : consist of sum of the following –

- (a) sum total of the Cost Insurance and Freight value of all imported inputs used for authorized operations during the relevant period and the Cost Insurance and Freight value of all imported capital goods including goods purchased on high seas basis even though paid for in Indian Rupees and the value of all payments made in foreign exchange by way of export commission, royalty, fees, dividends, interest on external commercial borrowings during the first five year period or any other charges;
- (b) value of goods obtained from other Unit or Export Oriented Unit or Electronic Hardware Technology Park or Software Technology Park Unit or Bio-technology Park Unit or from bonded warehouses or procured from international exhibitions held in India or precious metals procured from nominated agencies;
- (c) the Cost Insurance Freight value of the goods and services, including pro- rata Cost Insurance Freight of capital goods, imported duty free or leased from a leasing company or received free of cost and or on loan basis or on transfer for the period they remain with Unit;
- (d) for annual calculation of Net Foreign Exchange, value of imported capital goods

and lump sum payment of foreign technical know-how fee shall be amortized at the rate of ten per cent. every year from the first year to tenth year.

Explanation : For the purposes of this sub-rule "Inputs" mean raw materials, intermediates, components, consumables, parts and packing materials.

Monitoring of performance :

- (1) Performance of the Unit shall be monitored by the Approval Committee as per the guidelines given in Annexure appended to these rules.
- (2) In case the Approval Committee come to the conclusion that a Unit has not achieved positive Net Foreign Exchange Earning or failed to abide by any of the terms and conditions of the Letter of Approval or Bond-cum-Legal Undertaking, without prejudice to the action that may be taken under any other law for the time being in force, the said Unit shall be liable for penal action under the provisions of the Foreign Trade (Development and Regulation) Act, 1992.

7.4 INVISIBLE EXPORT EARNINGS :

Introduction :

Invisible export is the part of international trade that does not involve the transfer of goods or tangible objects, which mostly include service sectors like banking, advertising, copyrights, insurance, consultancy etc. invisible export also known as invisible trade is basically associated with the person's own skill and knowledge is what is 'sold' rather than a piece of software or books.

Invisible trade is composed of invisible imports and invisible exports. Since nothing tangible is transferred, the importer is defined as the person, group or country that receives the service. The exporter is defined as the supplier of the service. The net total of a country's invisible imports and invisible exports is called the invisible balance of trade and is a part of the country's balance of trade. For countries that rely on service exports or on tourism, the invisible balance is particularly important.

Export Performance of the Indian service Industry :

An analysis of the consultancy contracts secured by Indian project in the foreign market has been carried out by Exim Bank of India. As per the analysis, done during 1995-96 to 2000-01 indicates that consultancy contracts were secured largely in West Asia which accounted for 39% number wise and 46% value wise followed by South East Asia and Pacific & South Asia.

South East Asia constituted 22% both by number and by value whereas South Asia was 18% number wise and 16% value wise. According to the 2002 data of the Federation of Indian Export Organizations (FIEO), India's share in global trade in services was about 1.3%. India's share of consultancy exports is about 0.5% of global trade in services.

Government Initiatives :

In the recent years the Government of India has take some important step for the

improvement of service based export. The Foreign Trade Policy, 2004 – 09 is one of them, which has announced the setting up of Services Export Promotion Council for promoting the Indian service sector in the foreign market. Government of India has also introduced Market Development Assistance (MDA), Market Access Initiative (MAI) scheme, proactive EXIM Policy and EXIM Bank schemes. Government also provides exemption on service tax for export of consultancy services. However due to lack of clarity in the provisions in the present notification, consultancy export may be affected.

Strengths and Weaknesses of Indian Consulting Industry :

- The major strengths of Indian invisible export or invisible trade include professional competence, low cost structure, diverse capabilities, high adaptability and quick learning capability of Indian consultants.
- The major weaknesses of Indian invisible trade or invisible export include low quality assurance, low local presence overseas, low equity base, lack of market intelligence and low level of R&D.

7.5 ROLE OF NRI REMITTANCE :

NRIs are people who used to live in India but now live in other countries. They help India by sending money back to their families, which in return strengthen the Indian economy. This money increases the foreign currency and makes sure the economy is stable. In the year 2022, NRIs sent a lot of money back to India, which was more than what the World Bank expected.

This happening increased India's inward gross remittance, which spiked up to \$107.5 billion during the FY 2022 as per the RBI Governor Shaktikata Das. The inward remittance upped the projected amount by the Word Bank, which was \$7.5 billion.

India's forex reserves have crossed \$600 billion again due to stabilizing exchange rates and high remittance flows after a year in June 2021, which fund imports, pay off external debt, and strengthen the currency. The reserves had reached a high of \$642 billion in Sep 2021 before falling below \$600 billion in May 2022 due to the pressure on the rupee following the Ukraine invasion. It helped the government to release its external debt amount, strengthening Indian currency.

Remittance Strengthening Microeconomic :

When people who live abroad send money back to their families in India, it helps India's economy. This is called remittance, and it makes up about 3% of India's economy. Remittances are important because they help India when it's facing economic problems from other countries. They're the second-biggest source of money coming into India from outside, after services exports. Recently, India's trade situation has gotten better because the difference between the number of goods it exports and imports has gone down, and more people than expected are sending money back home.

The amount of money India spends on buying goods and services from other countries is more than the amount it earns by selling goods and services to other countries.

This is called the current account deficit. But in the last few months, this deficit has gone down because India is exporting more services and importing fewer goods. Due to this, India's foreign exchange reserves have increased to more than \$600 billion from \$524.5 billion on October 21, 2022. Remittances, or money sent back by Indians living abroad, have played an important role in this. By adding to India's foreign exchange reserves, remittances have helped India protect its currency from big ups and downs.

Why is Remittance Increasing ?

India received \$89.4 billion in remittances in 2021, making it the world's largest recipient. The World Bank expects that India's remittances will reach \$100 billion in 2022, growing at a 12% faster rate than 7.5% in 2021. The recent increase in remittances is due to a change in the profile of Non-Resident Indians (NRIs) and a shift in the countries they send money.

According to a World Bank report, the United States is now the top country from where remittances to India are sent, surpassing the United Arab Emirates. This is because Indian migrants have been getting better jobs in countries like the US, the UK, and some in East Asia, instead of low-skilled jobs in countries like Gulf Cooperation Council (GCC). This shift has helped increase the amount of money sent back home to India.

From 2016 to 2020, the proportion of remittances sent by NRIs from countries like the US, UK, and Singapore has increased significantly (from 26 percent to over 36 percent), while the proportion of remittances from countries in the Gulf Cooperation Council (GCC) like Saudi Arabia, the United Arab Emirates, Kuwait, Oman, and Qatar has decreased. This indicates that more remittances are now being sent by NRIs who are better off financially.

More and more NRIs in the US are climbing the social ladder, and as they do, they are sending more money back to India. A lot of Indians who have been living in the US for over 10 years have earned higher degrees, which help them move into higher-income groups.

The Indian people living in the US are well-educated and highly skilled, with many of them having a graduate degree. In contrast, the number of US-born residents with a graduate degree is much lower, i.e. 13% of the US-born residents. Additionally, most Indians (82% of all Indians & 77% of foreign-born Indians) in the US have at least a high school degree and are fluent in English.

When Indians in the US have higher education, they earn more money, which leads to more money being sent back home as remittances. Indians in the US have higher education levels and earn more than the average American. This has led to an increase in remittances from high-salaried jobs, particularly in the service sector. In 2019, the median household income for Indians in the US was nearly \$120,000, which is way more than \$70,000 for all Americans.

More Indian students are opting to study in developed countries, which will further increase the upward mobility of Indian diaspora in the US. As their income grows, particularly in developed countries, remittances are likely to increase.

The UPI linkage with Singapore's PayNow allows for lightning-fast and inexpensive

cross-border funds transfers through mobile apps. Typically, the cost of international money transfers is almost 5%, but this new system can reduce it to less than half, which will likely increase India's inward remittances. It's an efficient way to transfer money from abroad to India, and it can be duplicated in many other countries if it proves successful.

7.6 SUMMARY :

Foreign exchange refers to foreign currency. *For example*, for an Indian resident, the Indian rupee (₹) is a domestic currency that can be used as a medium of exchange in India. But the Indian rupee (₹) cannot be used as a medium of exchange outside India. The currency used in other countries is treated as foreign currency for India. Therefore, in the case of international transactions, the domestic currency is converted into foreign currency. *For example*, if a person visits New York for vacation, he/she cannot use the Indian rupee (₹) in New York for economic transactions. The person has to convert the Indian rupee into US Dollars (\$), only then he/she can stay there. For that reason, it is important to know at what price domestic currency can be converted into foreign currency. This price is known as the Exchange Rate. The market in which domestic currency is traded for others is the "Foreign Exchange Market".

NRIs are people who used to live in India but now live in other countries. They help India by sending money back to their families, which in return strengthen the Indian economy. This money increases the foreign currency and makes sure the economy is stable. In the year 2022, NRIs sent a lot of money back to India, which was more than what the World Bank expected. When people who live abroad send money back to their families in India, it helps India's economy. This is called remittance, and it makes up about 3% of India's economy. Remittances are important because they help India when it's facing economic problems from other countries.

7.7 KEY WORDS :

Current Account :

Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers. Includes trade, travel, military spending and other short-term financial flows. Short- and long-term capital flows are excluded, as they are included in the capital account balance. A surplus or deficit in the current account is commonly referred to as a trade deficit or surplus.

Customs Union :

An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

Date Draft :

A draft drawn to mature on a fixed date, irrespective of acceptance.

Demand Draft :

Draft payable immediately upon presentation to the drawee. Also called a *sight* or *presentation* draft

Documentary Credit :

A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of the merchandise, against delivery of documents specified in the credit.

Documentary Draft :

A draft with documents attached delivered to the drawee when it accepts or pays the draft, and which ordinarily controls title to the merchandise.

7.6 SELF ASSESSMENT QUESTIONS :

1. Three sources of demand or outflow of foreign exchange.
2. Foreign Exchange.
3. Foreign Exchange Earning Requirements And Monitoring.
4. Invisible Export Earnings.
5. Role of NRI Remittance.

7.10 SUGGESTED READINGS :

1. Lipsey, Robert E. (2001) "Foreign Direct Investment and the operations of multinational firms: concepts, history, and data", Working paper 8665, National Bureau of Economic Research, Cambridge (USA).
2. OECD (Organisation for Economic Cooperation and Development) 1996, Benchmark Definition of Foreign Direct Investment, 3rd Edition, Paris

Venna Sakunthala

LESSON – 8

Foreign Direct Investment

Objectives :

After studying this lesson, the student be able to :

- Foreign Direct Investment (FDI)
- Foreign Institutional Investment
- Income-tax Act, 1961

Structure of the Lesson :

- 8.1 Introduction
 - 8.1.1 Foreign Direct Investment (FDI)
 - 8.1.2 Direct investment classification, components and sectorial breakdown
 - 8.1.3 Valuation of FDI flows and stocks and relations between both of them
 - 8.1.4 Financial system FDI: an estimation for Spain
- 8.2 Foreign Institutional Investment
 - 8.2.1 Preferential allotment by listed Indian Companies to FIIs
- 8.3 Income-tax Act, 1961
- 8.4 Summary
- 8.5 Key words
- 8.6 Self Assessment Questions
- 8.7 Suggested Readings

8.1 INTRODUCTION :

Foreign Direct Investment (FDI) from the viewpoint of the Balance of Payments and the International Investment Position (IIP) share a same conceptual framework given by the International Monetary Fund (IMF). The Balance of Payments is a statistical statement that systematically summarises, for a specific time span, the economic transactions of an economy with the rest of the world (transactions between residents and non-residents) and the IIP compiles for a specific date, such as the end of a year, the value of the stock of each financial asset and liability as defined in the standard components of the Balance of Payments.

We will not deal in this note with other relevant statistical concepts for operations overseas, particularly for financial institutions, such as exposure (foreign claims, international claims, etc.), which belong to the realm of the BIS statistics.³

Sections 2, 3 and 4 give an overview of FDI definitions, concepts and recommendations adopted by the IMF's *Balance of Payments Manual* (5th Edition, 1993) and by the OECD's *Benchmark Definition of Foreign Direct Investment* (3rd Edition, 1996). Both provide operational guidance and detailed international standards for recording flows and stocks related to FDI. Section 5 gives a quick overview of trends in FDI inward flows and stocks for the period 1980-2001. Section 6 reports on onward FDI flows for Spain, with particular attention to the financial sector. Finally a brief description of the main available sources of FDI is found in an annex.

8.1.1 What is Foreign Direct Investment (FDI) :

According to the IMF and OECD definitions, *direct investment* reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise). The "lasting interest" implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter. Direct investment involves both the initial transaction establishing the relationship between the investor and the enterprise and all subsequent capital transactions between them and among affiliated enterprises⁴, both incorporated and unincorporated. It should be noted that capital transactions which do not give rise to any settlement, e.g. an interchange of share among affiliated companies, must also be recorded in the Balance of Payments and in the IIP.

The fifth Edition of the IMF's Balance of Payment Manual defines the owner of 10% or more of a company's capital as a *direct investor*. This guideline is not a fast rule, as it acknowledges that smaller percentage may entail a controlling interest in the company (and, conversely, that a share of more than 10% may not signify control). But the IMF recommends using this percentage as the basic dividing line between direct investment and portfolio investment in the form of shareholdings. Thus, when a non-resident who previously had no equity in a resident enterprise purchases 10% or more of the shares of that enterprise from a resident, the price of equity holdings acquired should be recorded as direct investment. From this moment, any further capital transactions between these two companies should be recorded as a direct investment. When a non-resident holds less than 10% of the shares of an enterprise as portfolio investment, and subsequently acquires additional shares resulting in a direct investment (10% or more), only the purchase of additional shares is recorded as direct investment in the Balance of Payments. The holdings that were acquired previously should not be reclassified from portfolio to direct investment in the Balance of Payments but the total holdings should be reclassified in the IIP.

Concerning the terms direct investor and direct investment enterprise, the IMF and the OECD define them as follows. A *direct investor* may be an individual, an incorporated or unincorporated private or public enterprise, a government, a group of related individuals, or a group of related incorporated and/or unincorporated enterprises which have a direct investment enterprise, operating in a country other than the country of residence of the direct investor. A *direct investment enterprise* is an incorporated or unincorporated enterprise in which a foreign investor owns 10% or more of the ordinary shares or voting power of an

incorporated enterprise or the equivalent of an unincorporated enterprise. Direct investment enterprises may be subsidiaries, associates or branches. A *subsidiary* is an incorporated enterprise in which the foreign investor controls directly or indirectly (through another subsidiary) more than 50% of the shareholders' voting power. An *associate* is an enterprise where the direct investor and its subsidiaries control between 10% and 50% of the voting shares. A *branch* is a wholly or jointly owned unincorporated enterprise.

It should be noted that the choice between setting up either a subsidiary/associate or a branch in a foreign country is dependent, among other factors, upon the existing regulations in the host country (and sometimes in its own country, too). National regulations are often more restrictive for subsidiaries than for branches but this is not always the case.

It should be mentioned that in the case of affiliated banks (depository institutions) and affiliated financial intermediaries such as securities dealers, transactions recorded under direct investment are those associated with permanent debt (loan capital representing a permanent interest) and equity (share capital) investment or, in the case of branches, fixed assets. Deposits, loans and other claims and liabilities related to usual banking transactions of depository institutions and of other financial intermediaries are classified, as appropriate, under portfolio investment or "other investment", but never as direct investment. The stock of foreign assets and liabilities of banks and other financial intermediaries should be treated in a parallel manner.

The OECD recommends in its *Benchmark definition* that for the existence of a direct investment relationship the "full consolidated system" should be followed. In other words, it means that when there is a cascade of participations, the percentage of the parent company in any affiliated companies should be calculated assuming the 100% of the subsidiaries and the corresponding percentage of the associates. This criterion does not correspond with the consolidation concept in the accounting statement.

From an accounting standpoint, bank branches are wholly considered as being an integral part of their parent company and, therefore, do not have separate accounts. However, the requirement for affiliated companies to be included in banks' consolidated financial statements is twofold: (i) they themselves must carry out a financial activity; and (ii) at least 20% of their capital must be owned by their parent bank, together with the latter's exerting an effective control over them. Non-compliance with any of these requisites entails that the affiliated company is not consolidated, although it should be valued according to the "equity method" in its parent bank's financial statements⁵. In accordance with these consolidation rules, a bank will not include in its consolidated statements the assets and liabilities of all its associates, despite the fact that such associates may obviously be direct investment enterprises from a BOP/IIP viewpoint (cf. 10% cutoff point explained above).

8.1.2 Direct investment classification, components and sectorial breakdown :

The classification of direct investment is based firstly on the *direction* of investment both for assets or liabilities; secondly, on the investment instrument used (shares, loans, etc.); and thirdly on the sector breakdown.

As for the direction, it can be looked at it from the home and the host perspectives.

From the home one, financing of any type extended by the resident parent company to its non-resident affiliated would be included as *direct investment abroad*. By contrast, financing of any type extended by non-resident subsidiaries, associates or branches to their resident parent company are classified as a decrease in *direct investment abroad*, rather than as a *foreign direct investment*. From the host one, the financing extended by non-resident parent companies to their resident subsidiaries, associates or branches would be recorded, in the country of residence of the affiliated companies, under *foreign direct investment*, and the financing extended by resident subsidiaries, associates and branches to their non-resident parent company would be classified as a decrease in *foreign direct investment* rather than as a *direct investment abroad*. This directional principle does not apply if the parent company and its subsidiaries, associates or branches have cross-holdings in each other's share capital of more than 10%.

As for the instruments, direct investment capital comprises the capital provided (either directly or through other related enterprises) by a direct investor to a direct investment enterprise and the capital received by a direct investor from a direct investment enterprise. Direct investment capital transactions are made up of three basic components: (i) Equity capital: comprising equity in branches, all shares in subsidiaries and associates (except non-participating, preferred shares that are treated as debt securities and are included under other direct investment capital) and other capital contributions such as provisions of machinery, etc. (ii) Reinvested earnings: consisting of the direct investor's share (in proportion to direct equity participation) of earnings not distributed, as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor. If such earnings are not identified, all branches' earnings are considered, by convention, to be distributed. (iii) Other direct investment capital (or inter company debt transactions): covering the borrowing and lending of funds, including debt securities and trade credits, between direct investors and direct investment enterprises and between two direct investment enterprises that share the same direct investor. As it has been mentioned before, deposits and loans between affiliated deposit institutions are recorded as *other investment* rather than as *direct investment*.

Finally, there are several sector breakdowns of FDI flows and of IIP. The IMF has chosen a breakdown by four institutional sectors (see table 1 below), defined according to the sector to which the resident party belongs. However, reporting on this sector breakdown is not compulsory in the Fifth IMF Manual. In national statistics, some countries (among which Spain) publish their FDI data providing this breakdown. Nevertheless, in practice the only relevant breakdown is *Banks* and *Other sectors* and it is blurred by the fact that national banks often invest in foreign enterprises via resident non-banking holding companies. Such transactions would be recorded as being carried out by *other sectors* rather than by *Banks*, thus distorting both categories.

By contrast to the classification according to the institutional sector, the OECD *Benchmark definition* favours an "industrial" breakdown (see table 1 below), which includes nine economic sectors. The OECD specifically recommends, for the purpose of this classification, that FDI carried out via a resident holding company be classified according to

the industrial sector to which the parent company belongs. Under this criterion, when the parent company is a bank, FDI transactions carried out by a non-banking holding company would be attributed to the *Banks*.

Table 8.1

| Institutional sector (IMF) | Economic or industry sector (OECD) |
|----------------------------|----------------------------------------------------------|
| 1. Monetary Authority | 1. Agriculture, hunting, forestry and fishing |
| 2. Banks | 2. Mining and quarrying |
| 3. General Government | 3. Manufacturing |
| 4. Other resident sector | 4. Electricity, gas and water |
| | 5. Construction |
| | 6. Wholesale and retail trade and restaurants and hotels |
| | 7. Transport, storage and communications |
| | 8. Financing, real state and business services |
| | 9. Community, social and personal services |

8.1.3 Valuation of FDI flows and stocks and relations between both of them :

The Balance of Payments and the International Investment Position are compiled under the same framework of methodological rules laid down in the Fifth edition of the IMF Balance of Payments Manual. According to this, FDI transactions should be recorded in the Balance of Payments at the accrued value, i.e. “*transactions are recorded when economic value is created, transformed, exchanged, transferred, or extinguished*”. Thus, the flows recorded do not necessarily coincide with the liquid proceeds and payments generated. In practice, it is very difficult to apply the accrued principle to all transactions and many of them are therefore recorded at the time when the proceeds or payments are generated.

Moreover, the IMF recommends the using of market price as the basis for valuation of flows and stocks, although this means different approaches for both types of data: (i) For flows, market price refers to the actual price agreed upon by transactors on the date of the transaction and should not reflect changes induced by fluctuations in exchange rates or in the market price of the financial assets of liabilities in question. (ii) For stocks, the market price at the time of the compilation of the stocks is recommended. Nevertheless, it is recognized that in practice, book values from the balance sheets of direct investment enterprises (or investors) often are used at a proxy of the market value of the stock of direct investments, when the company has no a market price. These balance sheets values, if recorded on the basis of current market value, would be in general accordance with the principle. If based on historical cost or on an interim but not current revaluation, such balance sheet values would not conform to the principle. But this practice reflects the fact that enterprise balance sheet values represent the only source of valuation of assets and liabilities readily available in most countries.

The difference between the stock at the beginning of the year and its value at year-end must be equal to the flow recorded in the Balance of Payments, which reflects the transactions on these assets or liabilities that actually took place; plus the change in the value of the stock induced by swings in the exchange rate; plus the change caused by alterations in the price of the related assets or liabilities; and plus other changes in the volume of financial assets and liabilities (as summarized below) :

| |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| $\begin{aligned} \text{Position at the end of the period} &= \text{Position at the beginning of the period} \\ &+ \text{FDI flows} \\ &+ \text{price changes} \\ &+ \text{exchange rate changes} \\ &+ \text{other adjustments.} \end{aligned}$ |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

With regard to the “other adjustments” although some of them may be explained by the use of different sources to compile both statistics, main conceptual ones are reclassifications in the IIP (but not in the Balance of Payments) e.g. portfolio to direct investment as previously explained in the second section.

As for the international comparison of data, despite a common international methodological framework, discrepancies between countries do occur. In fact, the worldwide discrepancy between outward and inward direct investment flows should be zero, if all flows were recorded fully and consistently by both sides. Nevertheless, according to *Lipsey (2001)* “the asymmetries have been no higher than 8% in any year from 1993 to 1999, as contrasted with 40 or 50% for portfolio investment”.

Discrepancies are mainly due to the use of different criteria for valuation or for geographical allocation of transactions. The increasing complexity of enterprise groups poses a further challenge to the correct application of the directional principle for accurately assessing FDI. Similarly, it is rather difficult to consistently capture loans granted to or received from related enterprises and they are often incorrectly considered as “other investment”, rather than as “direct investment”. This problem does not arise, however, in the case of loans between banks since they are not considered as “direct investment”. Additional circumstances resulting in discrepancies between countries are, among others: the lack of information on reinvested earnings, the use of a percentage-ownership threshold different from the recommended 10% level for identifying an investment as direct, and the use of different reporting systems and exemption threshold by countries for collecting and aggregating data on international transactions. Most countries use a combination of sources to compile their balance of payments and international investment position statistics. Data collection may be based on the compulsory reporting of individual transactions or on aggregates, or alternatively data may be collected by the statistical agency from an intermediary (such as a dealer that handles security transactions for clients) or directly from the transactor by means of mandatory surveys.

FDI Data :

Data on FDI flows and stocks are offered by several sources, the most important of

which are explained in the Annex. Within them, however, only the OECD and EUROSTAT provide a sector breakdown of FDI flows and stocks (they use the 9 group industrial or economic classification shown in table 1 above). Since both institutions do only cover a very limited number of world countries, the total direct investment received by the financial sector of any given country cannot be wholly assessed.

Due to this significant restriction, we focus on showing the trend of total FDI flows and stocks. We use both data published by the UNCTAD with those published by the IMF, to assess the extent of the discrepancies. Note that the former provides a break down into two different categories (FDI figures for developed and for developing countries) so the IMF FDI data has been harmonised with this breakdown (by adding up individual countries' figures according to the geographical classification of the World Economic Outlook, WEO).

Therefore, a preliminary reason for discrepancies may be the criterion for classifying some countries as “developed” or “developing” that differs between the UNCTAD and the WEO.

The charts on the next page give a picture of FDI flows and stocks from 1980 until 2001, by comparing IMF and UNCTAD data.

In rough terms, both sets of data reveal a similar pattern for all countries, albeit significant differences in magnitude, especially with regard to stocks and with regard to developing countries. More specifically, the following statistical issues can be observed :

- (i) Concerning flows, the differences between both sources are more relevant in the case of developing countries, especially for the year 2000 but they are relatively limited (UNCTAD data reach a peak of USD 264 billion, while IMF data initiate a downward trend).
- (ii) Concerning stocks, differences are larger, especially for developing countries. The main reason is the lack of information for many developing countries in the IMF data. For developed countries the differences between IMF and UNCTAD data are more significant from 1994 onwards, IMF data henceforth always being higher than UNCTAD data.

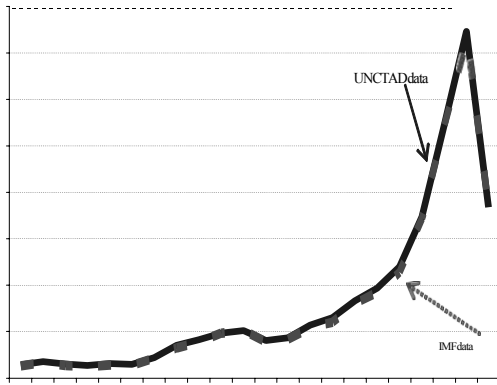
As for the general trends, it is interesting to note a couple of things :

- (i) Even if flows to emerging countries have grown, the bulk of them continue to go to industrial countries.
- (ii) The large reduction in FDI flows to emerging countries in 2001 in the UNCTAD statistics is much milder in the IMF ones and is not perceived in the stock data.
- (iii) Total stock, as well as the stock received by industrial countries, seems to have reached a plateau in IMF statistics but not in the UNCTAD ones.

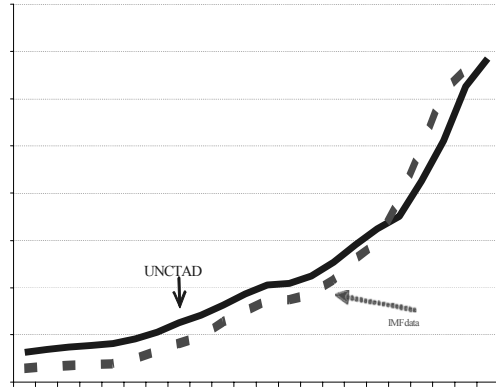
Inward Foreign Direct Investment: Flows and Stocks Data (1980–2001)

Comparison between IMF and UNCTAD data

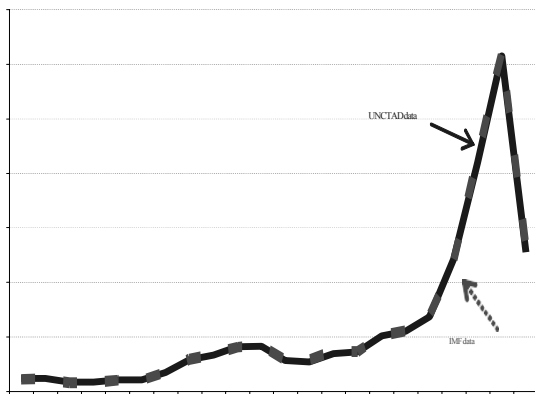
Flows. All countries
Billion \$



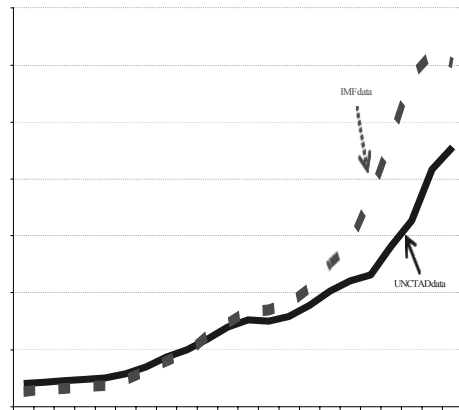
Stocks. All countries
Billion \$



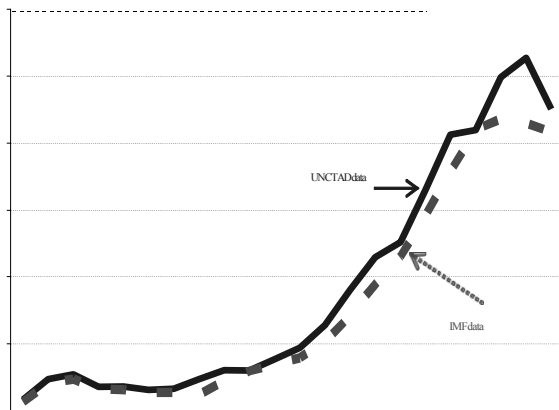
Flows. Developed countries
Billion \$



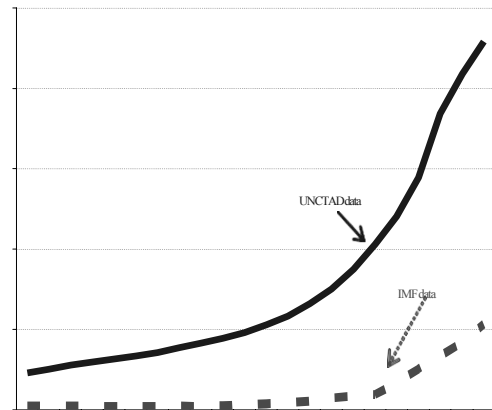
Stocks. Developed countries
Billion \$



Flows. Developing countries
Billion \$



Stocks. Developing countries
Billion \$



8.1.4 Financial system FDI :

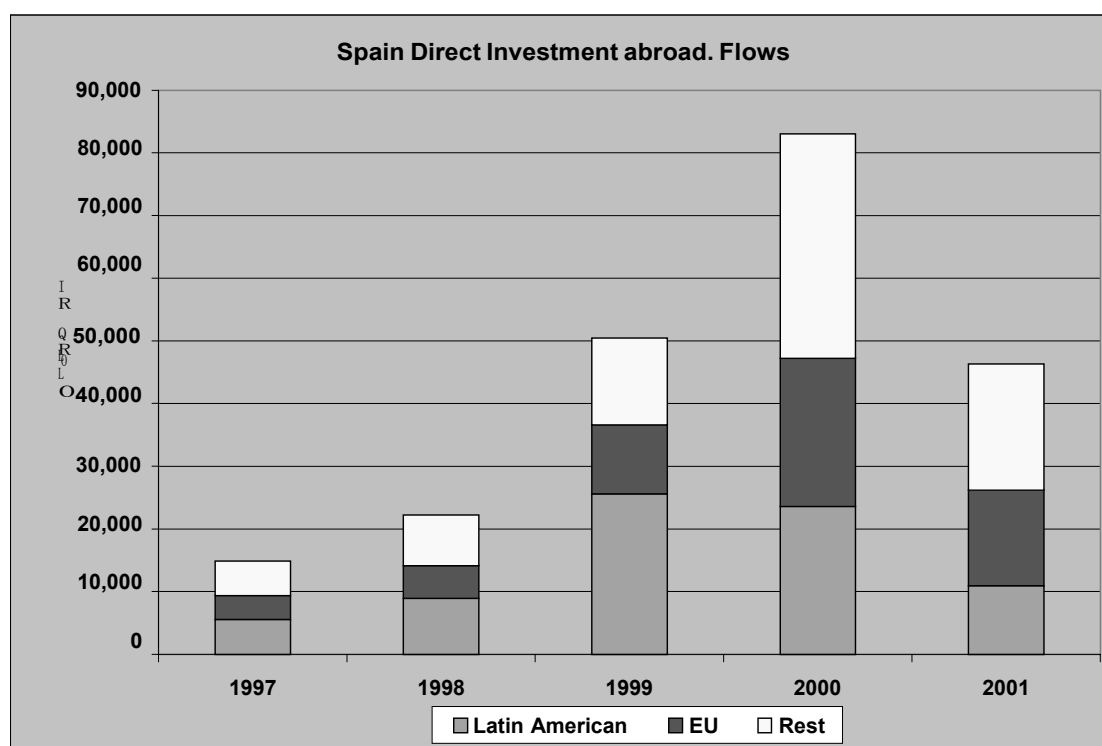
An estimation for Spain :

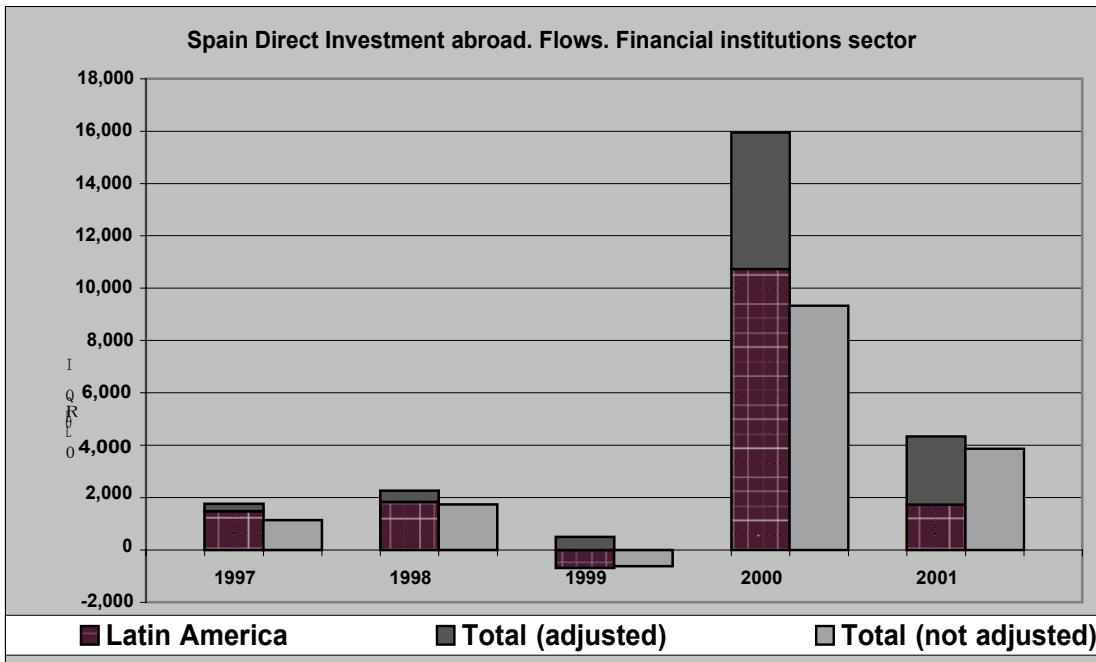
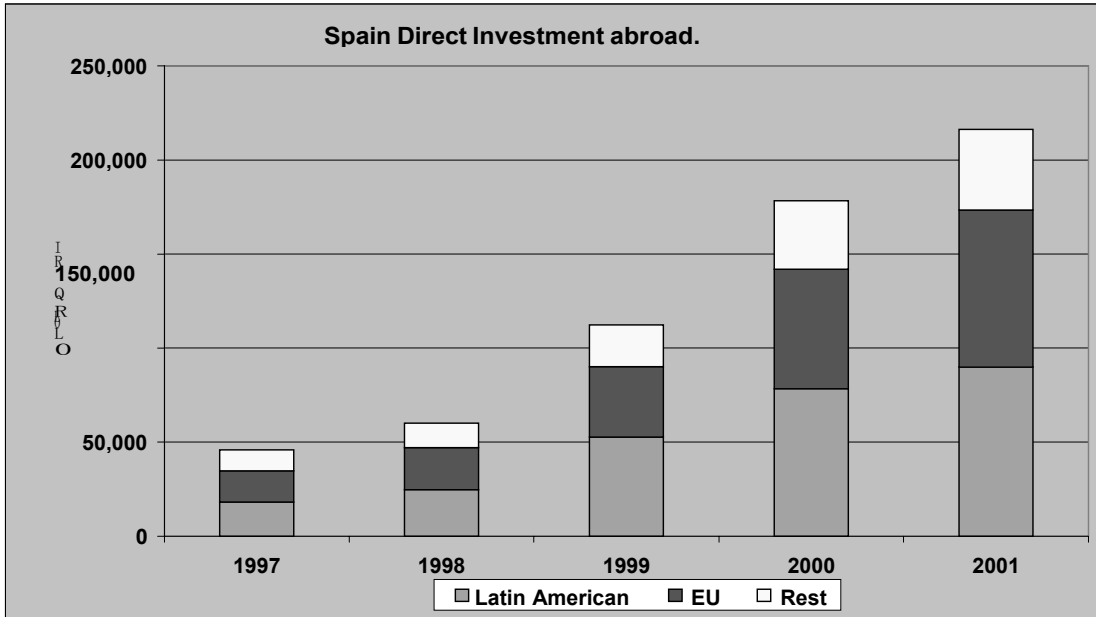
According to the OECD recommendations, Spain has reclassified, in the data provided to this International Organization, the economic sector of resident holding companies that are owned by resident companies, in the Balance of Payments data for the period 1999 to 2001. Moreover, main transactions for the years 1997 and 1998 have also been reclassified in the charts included below. The resident holding companies has been classified according to the economic sector to which the parent company belongs.

The preliminary results of this reclassification is that Spain direct investment abroad of the *Financial Institutions* was undervalued by about 56% for the period studied (see the comparison between the two columns of the last graph below). Likewise, the direct investment abroad of *other sectors* was overvalued in the same percentage. It shows that it is very common that Spain banks invest in foreign enterprises via resident non-banking holding companies, instead of operating themselves. Thus, it is very important to reclassify the economic sector in order to obtain more accurate figures.

The following charts give an overview of Spain's direct investment abroad both for stocks and flows, distinguishing between three geographical areas: Latin America, European Union and the rest of the world. The first two show that stocks have continued to grow although flows have decelerated in 2001. This is a similar trend to the one depicted in the previous graphs for total FDI inflows and stock.

The last graph shows that the Spanish financial system direct investment flows abroad, are quite large, particularly in 2000 but also in 2001, especially after having included the transactions carried out by resident holding companies, which were not in the original series as previously explained.





8.2 FOREIGN INSTITUTIONAL INVESTMENT :

Who is a Foreign Institutional Investor ?

A foreign Institutional Investor (an "FII") as an institution established or incorporated outside India which proposes to make investment in India in securities of companies incorporated in India ("Indian Companies")¹.

Registration with the SEBI :

FII's seeking to invest in Indian Companies are required to be registered with the Securities and Exchange Board of India (the "SEBI"). Such FII's would have to comply with

the provisions of the Guidelines for Foreign Institutional Investors² and the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 (the "SEBI Regulations"). An FII seeking registration would have to apply to the SEBI on Form A. The application form along with the enclosures have to be submitted to the SEBI in duplicate. The application includes an application to the Reserve Bank of India (the "RBI") for the required permission under the Foreign Exchange Regulation Act, 1973. The SEBI provides a single window clearance for all such applications. The application on Form A is required to be accompanied by the following documents :

- Copies of memorandum of association and articles of association of the FII.
- Brochures of the FII and its parent/group company.
- Copy of the investment management agreements or any other agreements authorizing the FII to invest on behalf of its sub-accounts/clients.
- Audited financial statements and annual reports for the last five years.
- Documents to support registration or regulation by a Securities Commission and/or Self-Regulatory Organization, or any other appropriate regulatory authority recognized by the SEBI.
- Copy of the Custodian Agreement with a custodian in India.

Criteria :

- FIIs seeking a license from the SEBI are required to be registered with a recognized foreign securities regulatory authority (recognized by the SEBI) or foreign tax authority.
- They must have a five-year track record of good performance. Based on the performance of the FII, the SEBI may consider a period less than five years. If the FII is a newly organized entity, the SEBI may consider the track record of its parent/group company.
- If the FII proposes to invest directly in Indian portfolio companies it would have to be broad-based (*i.e.* it would be required to have at least fifty shareholders each holding not more than 5% of the corpus of the FII). The SEBI however considers the broad-based criteria on a look-through basis (*i.e.* if an investor in the FII holds more than 5% of that FII's corpus then such investor must itself be broad-based).

If the SEBI is satisfied that the applicant has complied with all the requirements, it will issue its "in-principle" approval. However, prior to issuing the "in-principle" approval, the SEBI will request the FII applicant to send it a name of the compliance office who will be responsible for ensuring that the FII company adhere to the guidelines. Furthermore, before issuing its "in-principle" approval, the SEBI will verify with the securities regulatory authority of the applicant's home country whether the applicant has a clean track record. On receiving an assurance that the applicant has a clean track record, the SEBI issues its "in-principle" approval to the applicant.

Fees :

The SEBI charges a registration fee of US\$ 10,000 (payable only by way of cheque or demand draft payable at “Mumbai, India”) for registering FIIs with it. The registration is valid for a period of five years and can be renewed for a further period of five years on an additional payment of US\$ 10,000. Once the applicant receives the SEBI’s “in-principle” approval, it would have to remit the registration fees to the SEBI. The SEBI will issue its final approval only after it receives the amount of the registration fees.

Sub-accounts :

FIIs can also invest on behalf of their sub-accounts. In such cases, the sub-account would be required to register as a sub-account of an FII already registered with the SEBI. Currently no separate registration fee is payable by sub-accounts. The broad-based condition detailed hereinabove would also apply to the sub-accounts investing in Indian Companies. An entity already registered as a sub-account of an FII registered with the SEBI cannot be registered as a sub-account of another FII registered with the SEBI. The application, on Form A would have to be made by the FII on behalf of its sub-account and it would have to be accompanied by the following documents:

- Copies of memorandum of association and articles of association of the sub-account.
- Copy of the investment management agreement or any other agreements authorizing the FII registered with the SEBI to invest on behalf of the sub-account.
- Documents to support registration or regulation by a regulatory authority of the jurisdiction in which it is located.
- Copy of the Custodian Agreement with a custodian in India.

However, the SEBI is in the process of issuing a notification to the effect that the FII must give an undertaking to the SEBI (at the time of getting registered with the SEBI), that it would pay a fee of USD 1,000 to the SEBI for every sub-account that that FII wishes to register with the SEBI. Also, the notification is likely to state that henceforth, if an FII wishes to apply to the SEBI for registration of an entity as its sub-account with the SEBI, then the FII would be required to give an undertaking to the SEBI stating that the sub-account complies with the SEBI’s broad-based criteria and submit a registration fee of USD 1,000 together with the completed application on Form A. It is understood that the SEBI would then immediately register the entity as a sub-account of the FII with any further delay.

Investment restrictions :

FIIs registered with the SEBI can invest up to 30% of their own corpus in debt securities of Indian Companies. They can also invest in unlisted securities of Indian Companies and in the units of mutual funds organized in India. The aggregate non-resident Indian and persons of Indian origin (together referred to as “NRIs”), Overseas Corporate

Body (owned to the extent of 60% or more by NRIs) ("OCB"), and FII investment in any Indian Company cannot exceed 24% of its paid-up share capital. The 24% limit may be increased to 30% if the board of directors of the investee Indian Company passes a resolution and the shareholders of the investee Indian Company pass a special resolution approving such investment up to 30%. An FII together with its sub-accounts cannot invest in more than 10% of an investee Indian Company. The 10% investment in an Indian Company would however apply separately to the FII and each of its sub-account, if the FII is unrelated to its sub-accounts (*i.e.* the sub-account does not belong to the FII's group). This implies that an FII can hold up to 10% in an Indian Company and its sub-accounts can each hold up to 10% in the same Indian Company subject to the overall limit of 30% aggregate NRI, OCB and FII investment in that Indian Company.

FII's registered as debt funds with the SEBI can invest their entire corpus in debt securities of Indian Companies. They can also invest in dated government securities. The SEBI is also permitting FII's not registered as debt funds to invest in government securities, including treasury bills.

Bank account and custodian :

FII's are also permitted, as a part of their registration, to open a bank account in India. Furthermore, it is mandatory for FII's registered with the SEBI to appoint a custodian in India³. FII's can purchase and sell securities of Indian Companies only through its custodian and the deals should be routed only *via* the stock exchange. The custodian is also required to monitor the investment limits (detailed above) on each portfolio and to report on a daily basis to on Form LEC(FII) to the central office of the RBI at Mumbai.

8.2.1 Preferential allotment by listed Indian Companies to FII's :

FII investments by way of preferential allotments will be permitted up to 15% of the equity of a listed Indian Company subject to the condition that the aggregate FII/NRI/OCB investment does not exceed 24% (where certain conditions detailed above are complied with, the 24% ceiling may be raised to 30%) of the equity of the said Indian Company⁴. There is a lock-in period of 5 years on all investments made by FII's on a preferential allotment basis⁵.

Proprietary funds :

FII's can also use their proprietary funds for investing in Indian Companies. In such cases, the broad-based criteria are relaxed.

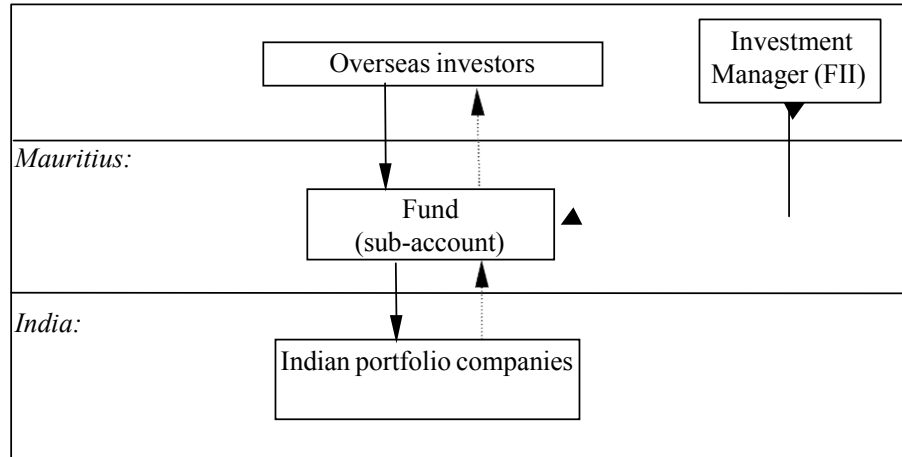
Forward cover :

FII's are also permitted the take forward cover on their equity⁶ and debt exposure to hedge against currency fluctuations⁷.

Structuring of Mauritian based funds :

Funds set up in Mauritius ("Funds") are generally not registered with a securities regulatory authority. Furthermore, the SEBI does not recognize the Mauritius Offshore Business Activities Authority (the "MOBAA") as a regulatory authority and therefore, it may not be possible for the Funds to directly obtain an FII license. However, an existing

investment management company (the “Investment Manager”) of the Fund organized outside of Mauritius and registered with a recognized regulatory authority can register itself as an FII with the SEBI. The Fund can then register as a sub-account of the Investment Manager with the SEBI. The structure chart is depicted below.



8.3 INCOME-TAX ACT, 1961 :

- Interest earned by an entity (registered as an FII or sub-account of a registered FII) from India from its investments in listed debt securities of Indian Companies (whether or not incurred in foreign currency) will be taxed at the rate of 20% under section 115AD of the Income-tax Act, 1961 (the “ITA”).
- Interest income of an entity (registered as an FII or sub-account of a registered FII) from debt (whether listed or unlisted) incurred in foreign currency would be taxed at the rate of 20% under section 115A of the ITA.
- Other interest income earned by an entity (registered as an FII or sub-account of a registered FII) from unlisted debt not incurred in foreign currency would be taxed at the rate of 48%.
- Long-term capital gains⁸ earned by an entity (registered as an FII or sub-account of a registered FII) from sale of listed debt securities of Indian Companies would be taxed at the rate of 10% and short-term capital gains⁹ would be taxed at 30% in terms of section 115AD of the ITA.
- Long-term capital gains earned by an entity (registered as an FII or sub-account of a registered FII) from sale of unlisted securities of Indian Companies would be taxed at the rate of 20% and short-term capital gains would be taxed at 48% under the ITA.
- Dividends earned by an entity (registered as an FII or sub-account of a registered FII) would not be subject to any withholding tax in India¹⁰.

India – Mauritius tax treaty :

- Capital gains earned by the Fund (organized in Mauritius) registered as a sub-

account of an FII from its investments in Indian Companies would be tax exempt subject to the condition that it does not have a permanent establishment in India.

- Interest income earned by the Fund (organized in Mauritius) registered as a sub-account of an FII from India from debt (whether listed or unlisted) incurred in foreign currency would be taxed at the rate of 20%.
- Interest income earned by the Fund (organized in Mauritius) registered as a sub-account of an FII from all investments in listed debt securities of Indian Companies (whether or not incurred in foreign currency) would be taxed at the rate of 20%.
- Interest income earned by the Fund (organized in Mauritius) registered as a sub-account of an FII other than that mentioned above would be taxed at the rate of 35% under the India-Mauritius tax treaty.
- Dividends earned by the Fund would not be subject to any withholding tax in India¹¹.

Conclusion :

The Fund could be organized in a jurisdiction with which India has a favorable tax treaty and claim reduction of or exemption from tax in India. India-Mauritius tax treaty offers the benefit of complete exemption from capital gains tax in India. However, it does not offer any concessions on the withholding tax on interest. The India-U.A.E. tax treaty and India-Cyprus tax treaty also offer similar capital gains tax exemption in India. The India-U.A.E. tax treaty reduces the withholding tax on interest to 12.5% and India-Cyprus tax treaty reduces this rate to 10%.

Besides the tax concessions, Funds should also consider some other factors before selecting a particular jurisdiction. U.A.E. is not considered politically very stable. In case of Cyprus, the fund regime is not yet in place although it is considerably used for setting up holding companies. Also, Cyprus has a tainted reputation as a 'tax haven'. Given these factors, Mauritius still emerges as the most favorable jurisdictions for setting up an offshore fund for investment in India. Since the India-Mauritius tax treaty does not offer any significant advantages in respect of interest income, it may be preferable to structure investments through the mutual fund route (discussed hereinabove), thereby falling within Article 22 of the India-Mauritius tax treaty and claiming exemption from withholding tax on income from units of the mutual fund in India.

8.4 SUMMARY :

Foreign Direct Investment (FDI) from the viewpoint of the Balance of Payments and the International Investment Position (IIP) share a same conceptual framework given by the International Monetary Fund (IMF). The Balance of Payments is a statistical statement that systematically summarises, for a specific time span, the economic transactions of an economy with the rest of the world (transactions between residents and non-residents) and the IIP

compiles for a specific date, such as the end of a year, the value of the stock of each financial asset and liability as defined in the standard components of the Balance of Payments.

The classification of direct investment is based firstly on the *direction* of investment both for assets or liabilities; secondly, on the investment instrument used (shares, loans, etc.); and thirdly on the sector breakdown. Finally, there are several sector breakdowns of FDI flows and of IIP. The IMF has chosen a breakdown by four institutional sectors (see table 1 below), defined according to the sector to which the resident party belongs. However, reporting on this sector breakdown is not compulsory in the Fifth IMF Manual. In national statistics, some countries (among which Spain) publish their FDI data providing this breakdown. Nevertheless, in practice the only relevant breakdown is Banks and Other sectors and it is blurred by the fact that national banks often invest in foreign enterprises via resident non-banking holding companies. Such transactions would be recorded as being carried out by other sectors rather than by Banks, thus distorting both categories.

8.5 KEY WORDS :

Documents :

Shipping and other papers attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

Documents Against Acceptance (D/A) :

Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against their acceptance of the draft.

Documents Against Payment (D/P) :

Instructions given by an exporter to their bank that the documents attached to a draft for collection are deliverable to the drawee only against their payment of the draft.

Eligible Acceptance :

A bankers acceptance that meets Federal Reserve requirements related to its financing purpose and term.

Embargo :

A partial or total prohibition on trade initiated by the government of one country against another for political or economic reasons.

Eurobank :

A bank that regularly accepts foreign currency denominated deposits and makes foreign currency loans.

8.6 SELF ASSESSMENT QUESTIONS :

1. Foreign Direct Investment (FDI).
2. Direct investment classification, components and sectorial breakdown.

3. Foreign Institutional Investment.

8.7 SUGGESTED READINGS :

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LESSON – 9

EXTERNAL COMMERCIAL BORROWINGS

Objectives :

After studying this lesson, the student be able to :

- External Commercial Borrowings
- Global Depository Receipt (GDR)

Structure of the Lesson :

- 9.1 External Commercial Borrowings
 - 9.1.1 Available Routes for Raising ECB
 - 9.1.2 All – In – Cost
 - 9.1.3 End – Use
 - 9.1.4 Individual Limits
 - 9.1.5 Currency of Borrowing
 - 9.1.6 Hedging Requirements
 - 9.1.7 Issue of Corporate or Personal Guarantee
 - 9.1.8 Issuance of Guarantee, Etc. by Indian Banks and Financial Institutions
 - 9.1.9 Parking of ECB Proceeds
- 9.2 Global Depository Receipt (GDR)
- 9.3 Summary
- 9.4 Key words
- 9.5 Self Assessment Questions
- 9.6 Suggested Readings

9.1 EXTERNAL COMMERCIAL BORROWINGS :

The following write up on External Commercial Borrowings (ECB) is based on RBI Master Direction No. 5/2015-16 dated 1-1-2016 (updated to 31/12/2016). Candidates are advised to refer to the Master Directions for additional details.

ECBs are commercial loans raised by eligible resident entities from recognised non-resident entities and should conform to parameters such as minimum maturity, permitted and non-permitted end-uses, maximum all-in-cost ceiling, etc.

The framework for raising loans through ECB, comprises of the following three tracks :

Track – I :

Medium term foreign currency denominated ECB with minimum average maturity of 3/5 years.

Track – II :

Long term foreign currency denominated ECB with minimum average maturity of 10 years.

Track – III :

Indian Rupee (INR) denominated ECB with minimum average maturity of 3/5 years.

The ECB Framework enables permitted resident entities to borrow from recognized non- resident entities in the following forms:

- i. Loans including bank loans;
- ii. Securitized instruments (e.g. floating rate notes and fixed rate bonds, non-convertible, optionally convertible or partially convertible preference shares / debentures);
- iii. Buyers' credit;
- iv. Suppliers' credit;
- v. Foreign Currency Convertible Bonds (FCCBs);
- vi. Financial Lease; and
- vii. Foreign Currency Exchangeable Bonds (FCEBs)

9.1.1 Available Routes For Raising ECB :

ECBs can be raised either under the automatic route or under the approval route.

For the automatic route, the cases are examined by the Authorised Dealer Category-I (AD Category-I) banks.

Under the approval route, the prospective borrowers are required to send their requests to the RBI through their ADs for examination.

While the regulatory provisions are mostly similar, there are some differences in the form of amount of borrowing, eligibility of borrowers, permissible end-uses, etc. under the two routes. While the first six forms of borrowing, mentioned above, can be raised both under the automatic and approval routes, FCEBs can be issued only under the approval route.

Minimum Average Maturity Period :

The minimum average maturities for the three tracks are as follows :

| TRACK – I | TRACK – II | TRACK – III |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------|-------------------|
| i. 3 years for ECB upto USD 50 million or its equivalent. ii. 5 years for ECB beyond USD 50 million or its equivalent. iii. 5 years for eligible borrowers under Financial Lease, irrespective of the amount of borrowing. iv. 5 years for Foreign Currency Convertible Bonds (FCCBs)/ Foreign Currency Exchangeable Bonds(FCEBs) irrespective of the amount of borrowing. The call and put option, if any, for FCCBs shall not be exercisable prior to 5 years | 10 years irrespective of the amount. | Same as Track – I |

9.1.2 All – In – Cost :

The All – In – Cost requirements for the three tracks will be as under :

Track – I :

- i. The all-in-cost ceiling is prescribed through a spread over the benchmark as under :
 - a. For ECB with minimum average maturity period of 3 to 5 years - 300 basis points per annum over 6 month LIBOR or applicable bench mark for the respective currency.
 - b. For ECB with average maturity period of more than 5 years – 450 basis points per annum over 6 month LIBOR or applicable bench mark for the respective currency.
- ii. Penal interest, if any, for default or breach of covenants should not be more than 2 per cent over and above the contracted rate of interest.

Track – II :

- i. The maximum spread over the benchmark will be 500 basis points per annum.
- ii. Remaining conditions will be as given under Track – I.

Track – III :

The All – In – Cost should be in line with the market conditions.

9.1.3 End – Use :

The end-use prescriptions for ECB raised under the three tracks are given in the following table :

| TRACK – I | TRACK – II | TRACK – III |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>i. ECB proceeds can be utilised for capital expenditure in the form of :</p> <p>a. Import of capital goods including payment towards import of services, technical know-how and license fees, provided the same are part of these capital goods;</p> <p>b. Local sourcing of capital goods;</p> <p>c. New projects;</p> <p>d. Modernisation / expansion of existing units;</p> <p>e. Overseas direct investment in Joint ventures (JV)/ Wholly owned subsidiaries (WOS);</p> <p>f. Acquisition of shares of public sector undertakings at any stage of disinvestment under the disinvestment programme of the Government of India;</p> <p>g. Refinancing of existing trade credit raised for import of capital goods;</p> <p>h. Payment of capital goods already shipped / imported but unpaid;</p> <p>i. Refinancing of existing ECB provided the residual maturity is not reduced.</p> | <p>i. The ECB proceeds can be used for all purposes excluding the following :</p> <p>a. Real estate activities</p> <p>b. Investing in capital market</p> <p>c. Using the proceeds for equity investment domestically;</p> <p>d. On-lending to other entities with any of the above objectives ;</p> <p>e. Purchase of land.</p> | <p>i. NBFCs can use ECB proceeds only for :</p> <p>a. On-lending for any activities, including infrastructure sector as permitted by the concerned regulatory department of RBI;</p> <p>b. Providing hypothecated loans to domestic entities for acquisition of capital goods / equipment; and</p> <p>c. providing capital goods / equipment to domestic entities by way of lease and hire – purchases</p> <p>ii. Developers of SEZs / NMIZs can raise ECB only for providing infrastructure facilities within SEZ / NMIZ.</p> <p>iii. NBFCs – MFI, other eligible MFIs, NGOs and not for profit companies registered under the Companies Act, 1956 / 2013 can raise ECB only for on-lending to self-help groups or for micro-credit or for bonafide micro finance activity including capacity building.</p> |

| | | |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>ii. SIDBI can raise ECB only for the purpose of on- lending to the borrowers in the Micro, Small and Medium Enterprises (MSME sector),</p> <p>iii. Units of SEZs can raise ECB only for their own requirements⁵.</p> <p>iv. Shipping and airlines companies can raise ECB only for import of vessels and aircrafts respectively⁵</p> <p>v. ECB proceeds can be used for general corporate purpose (including working capital) provided the ECB is raised from the direct / indirect equity holder or from a group company for a minimum average maturity of 5 years.</p> <p>vi. NBFC-IFCs and NBFCs- AFCs can raise ECB only for financing infrastructure.</p> <p>vii. Holding Companies and CICs shall use ECB proceeds only for on- lending to infrastructure Special Purpose Vehicles (SPVs).</p> <p>viii. ECBs for the following purposes will be considered only under the approval route⁵ :</p> <p>a. Import of second hand goods as per the Director General of Foreign Trade (DGFT) guidelines;</p> <p>b. On-lending by Exim Bank.</p> | | <p>iv. For other eligible entities under this track, the ECB proceeds can be used for all purposes excluding the following:</p> <p>a. Real estate activities</p> <p>b. Investing in capital market</p> <p>c. Using the proceeds for equity investment domestically.</p> <p>d. On-lending to other entities with any of the above objectives;</p> <p>e. Purchase of land.</p> |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

9.1.4 Individual Limits :

The individual limits refer to the amount of ECB which can be raised in a financial year under the automatic route.

- i. The individual limits of ECB that can be raised by eligible entities under the automatic route per financial year for all the three tracks are as under :
 - a. Up to USD 750 million or equivalent for the companies in infrastructure and manufacturing sectors, Non-Banking Financial Companies - Infrastructure Finance Companies (NBFC-IFCs), NBFCs-Asset Finance Companies (NBFC-AFCs), Holding Companies and Core Investment Companies ;
 - b. Up to USD 200 million or equivalent for companies in software development sector ;
 - c. Up to USD 100 million or equivalent for entities engaged in micro finance activities ; and,
 - d. Up to USD 500 million or equivalent for remaining entities.
- ii. ECB proposals beyond aforesaid limits will come under the approval route.

For computation of individual limits under Track III, exchange rate prevailing on the date of agreement should be taken into account.

9.1.5 Currency of Borrowing :

ECB can be raised in any freely convertible foreign currency as well as in Indian Rupees.

Change of currency of ECB from one convertible foreign currency to any other convertible foreign currency as well as to INR is freely permitted. Change of currency from INR to any foreign currency is, however, not permitted.

9.1.6 Hedging Requirements :

Eligible borrowers shall have a board approved risk management policy and shall keep their ECB exposure hedged 100 per cent at all times.

Security for raising ECB :

AD Category I banks are permitted to allow creation of charge on immovable assets, movable assets, financial securities and issue of corporate and/ or personal guarantees in favour of overseas lender / security trustee, to secure the ECB to be raised / raised by the borrower, subject to satisfying themselves that :

- i. the underlying ECB is in compliance with the extant ECB guidelines,
- ii. there exists a security clause in the Loan Agreement requiring the ECB borrower to create charge, in favour of overseas lender / security trustee, on immovable assets / movable assets / financial securities / issuance of corporate

and / or personal guarantee, and

- iii. No objection certificate, as applicable, from the existing lenders in India has been obtained.

9.1.7 Issue of Corporate or Personal Guarantee :

The arrangement shall be subject to the following :

- i. A copy of Board Resolution for the issue of corporate guarantee for the company issuing such guarantee, specifying name of the officials authorised to execute such guarantees on behalf of the company or in individual capacity should be obtained.
- ii. Specific requests from individuals to issue personal guarantee indicating details of the ECB should be obtained.
- iii. Such security shall be subject to provisions contained in the Foreign Exchange Management (Guarantees) Regulations, 2000.
- iv. ECB can be credit enhanced / guaranteed / insured by overseas party/ parties only if it / they fulfill the criteria of recognised lender under extant ECB guidelines.

9.1.8 Issuance of Guarantee etc., by Indian Banks and Financial Institutions :

Issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by Indian banks, All India Financial Institutions and NBFCs relating to ECB is not permitted.

Further, financial intermediaries (viz. Indian banks, All India Financial Institutions, or NBFCs) shall not invest in FCCBs in any manner whatsoever.

9.1.9 Parking of ECB Proceeds :

ECB proceeds are permitted to be parked abroad as well as domestically.

Loan Registration Number (LRN) :

Any draw-down in respect of an ECB as well as payment of any fees / charges for raising an ECB should happen only after obtaining the LRN from RBI. To obtain the LRN, borrowers are required to submit duly certified Form 83, which also contains terms and conditions of the ECB, in duplicate to the designated AD Category I bank. In turn, the AD Category I bank will forward one copy to the Director, Balance of Payments Statistics Division, Department of Statistics and Information Management (DSIM), Reserve Bank of India.

Prepayment of ECB :

Prepayment of ECB may be allowed by AD Category I banks subject to compliance with the stipulated minimum average maturity as applicable to the contracted loan under these guidelines.

Refinancing of Existing ECB :

A designated AD Category I bank may allow refinancing of existing ECB by raising fresh ECB provided the outstanding maturity of the original borrowing is not reduced and all-in- cost of fresh ECB is lower than the existing ECB. Further, refinancing of ECBs raised under the previous ECB framework may also be permitted, subject to additionally ensuring that the borrower is eligible to raise ECB under the extant framework. Raising of fresh ECB to part refinance the existing ECB is also permitted subject to same conditions.

Borrowing by Entities Under Investigation :

All entities against which investigation / adjudication / appeal by the law enforcing agencies for violation of any of the provisions of the Regulations under FEMA pending, may raise ECBs as per the applicable norms, if they are otherwise eligible, notwithstanding the pending investigations / adjudications / appeals, without prejudice to the outcome of such investigations / adjudications / appeals. The borrowing entity shall inform about pendency of such investigation / adjudication / appeal to the AD Cat-I bank / RBI as the case may be. Accordingly, in case of all applications where the borrowing entity has indicated about the pending investigations / adjudications / appeals, the AD Category I Banks / Reserve Bank while approving the proposal shall intimate the agencies concerned by endorsing a copy of the approval letter.

ECB Facility for Low Cost Affordable Housing Projects :

The terms and conditions for the ECB facility for low cost affordable housing projects are as follows :

- i. For the purpose of ECB, a low cost affordable housing project is as defined in the extant foreign direct investment policy
- ii. ECB proceeds shall not be utilized for acquisition of land.

Developers / builders registered as companies may raise ECB for low cost affordable housing projects provided they have minimum 3 years' experience in undertaking residential projects, have good track record in terms of quality and delivery and the project and all necessary clearances from various bodies including Revenue Department with respect to land usage/environment clearance, etc., are available on record. They should also not have defaulted in any of their financial commitments to banks/ financial institutions or any other agencies and the project should not be a matter of litigation.

- iii. The ECB should be swapped into Rupees for the entire maturity on fully hedged basis.
- iv. Housing Finance Companies (HFCs) registered with the National Housing Bank (NHB) and operating in accordance with the regulatory directions and guidelines issued by NHB are eligible to avail of ECB for financing low cost affordable housing units. The minimum Net Owned Funds (NOF) of HFCs for the past three financial years should not be less than INR 300 crore. Borrowing through

ECB should be within overall borrowing limit of 16 times of their Net Owned Fund (NOF) and the net non-performing assets (NNPA) should not exceed 2.5% of the net advances. The maximum loan amount sanctioned to the individual buyer will be capped at INR 25 lakhs subject to the condition that the cost of the individual housing unit shall not exceed INR 30 lakhs.

- v. NHB is also eligible to raise ECB for financing low cost affordable housing units of individual borrowers. Further, in case, a developer of low cost affordable housing project not being able to raise ECB directly as envisaged above, National Housing Bank is permitted to avail of ECB for on-lending to such developers which satisfy the conditions prescribed to developers / builders subject to the interest rate spread set by RBI.
- vi. Interest rate spread to be charged by NHB may be decided by NHB taking into account cost and other relevant factors. NHB shall ensure that interest rate spread for HFCs for on-lending to prospective owners' of individual units under the low cost affordable housing scheme is reasonable.
- vii. Developers/ builders/ HFCs/ NHB will not be permitted to raise Foreign Currency Convertible Bonds (FCCBs) under this scheme.

ECB Facility for START – UPS :

AD Category – I banks are permitted to allow Start-Ups to raise ECB under the automatic route as per the following framework:

Eligibility :

An entity recognised as a Startup by the Central Government as on date of raising ECB will be eligible under the facility.

Maturity :

Minimum average maturity period will be 3 years.

ECB Types :

The borrowing can be in form of loans or non-convertible, optionally convertible or partially convertible preference shares.

Currency :

The borrowing should be denominated in any freely convertible currency or in Indian Rupees (INR) or a combination thereof. In case of borrowing in INR, the non – resident lender, should mobilise INR through swaps/outright sale undertaken through an AD Category – I bank in India.

Amount :

The borrowing per Start-Up will be limited to USD 3 million or equivalent per financial year either in INR or any convertible foreign currency or a combination of both.

All – in – cost :

Shall be mutually agreed between the borrower and the lender.

End uses :

For any expenditure in connection with the business of the borrower.

Issuance of Rupee Denominated Bonds Overseas (Masala Bonds) :

The framework for issuance of Rupee denominated bonds overseas enables eligible resident entities to issue only plain vanilla Rupee denominated bonds issued overseas in Financial Action Task Force (FATF) compliant financial centres. The bonds can be either placed privately or listed on exchanges as per host country regulations.

Available routes and limits of borrowing: Eligible entities can issue Rupee denominated bonds overseas both under the automatic route and the approval route.

Indian banks as eligible borrowers: Indian banks will also be eligible to issue Rupee denominated bonds overseas.

All – in – Cost :

The all – in – cost of borrowing by issuance of Rupee denominated bonds should be commensurate with prevailing market conditions.

End-use :

The proceeds of the borrowing can be used for all purposes except for the following :

- i. Real estate activities other than development of integrated township / affordable housing projects;
- ii. Investing in capital market and using the proceeds for equity investment domestically;
- iii. Activities prohibited as per the foreign direct investment guidelines;
- iv. On-lending to other entities for any of the above purposes; and
- v. Purchase of Land.

Exchange Rate for conversion :

The exchange rate for foreign currency – INR conversion shall be the market rate on the date of settlement for the purpose of transactions undertaken for issue and servicing of the bonds.

Hedging :

The overseas investors are eligible to hedge their exposure in Rupee through permitted derivative products with AD Category I banks in India. The investors can also access the domestic market through branches / subsidiaries of Indian banks abroad or branches of foreign banks with Indian presence on a back to back basis.

Trade Credit :

Trade Credits refer to the credits extended by the overseas supplier, bank and financial institution for maturity up to five years for imports into India. Depending on the source of finance, such trade credits include suppliers' credit or buyers' credit. Suppliers' credit relates to the credit for imports into India extended by the overseas supplier, while buyers' credit refers to loans for payment of imports into India arranged by the importer from overseas bank or financial institution. Imports should be as permissible under the extant Foreign Trade Policy of the Director General of Foreign Trade (DGFT).

Routes and Amount of Trade Credit: The available routes of raising Trade Credit are :**Automatic Route :**

ADs are permitted to approve trade credit for import of non-capital and capital goods up to USD 20 million or equivalent per import transaction.

Approval Route :

The proposals involving trade credit for import of non-capital and capital goods beyond USD 20 million or equivalent per import transaction are considered by the RBI.

Maturity :

Maturity prescriptions for trade credit are same under the automatic and approval routes. While for the non-capital goods, the maturity period is up to one year from the date of shipment or the operating cycle whichever is less, for capital goods, the maturity period is up to five year from the date of shipment. For trade credit up to five years, the ab-initio contract period should be 6 (six) months. No roll-over/extension will be permitted beyond the permissible period.

All – in – Cost :

The all – in – cost ceiling for raising Trade Credit is 350 basis points over 6 months LIBOR (for the respective currency of credit or applicable benchmark). The all-in- cost includes arranger fee, upfront fee, management fee, handling/ processing charges, out of pocket and legal expenses, if any.

Guarantee for Trade Credit :

AD Category I banks are permitted to issue guarantee/ Letters of Undertaking /Letters of Comfort in favour of overseas supplier, bank or financial institution up to USD 20 million per import transaction for a maximum period up to one year in case of import of non-capital goods (except gold, palladium, platinum, rhodium, silver, etc). For import of capital goods, the period of guarantee/ Letters of Credit/ Letters of Undertaking by AD can be for a maximum period up to three years. The period is reckoned from the date of shipment and the guarantee period should be co-terminus with the period of credit. Further, issuance of guarantees will be subject to prudential guidelines issued by the RBI from time to time.

Borrowing by Resident Individuals :

An individual resident in India may borrow a sum not exceeding US\$ 250,000/- or its equivalent from his close relative outside India, subject to the conditions that :

- a. the minimum maturity period of the loan is one year;
- b. the loan is free of interest; and
- c. the amount of loan is received by inward remittance in free foreign exchange through normal banking channels or by debit to the NRE/FCNR account of the non-resident lender.

9.2 WHAT IS A GLOBAL DEPOSITARY RECEIPT (GDR) :

A global depositary receipt (GDR) is a negotiable financial instrument issued by a depositary bank. It represents [shares](#) in a foreign company and trades on the local stock exchanges in investors' countries. GDRs make it possible for a company (the issuer) to access investors in capital markets beyond the borders of its own country.

GDRs are commonly used by issuers to raise capital from international investors through private placement or public stock offerings.

A global [depositary receipt](#) is very similar to an [American depositary receipt](#) (ADR) except that an ADR only lists shares of a foreign company in U.S. markets.

Understanding Global Depositary Receipts (GDRs) :

A global depositary receipt is a type of bank certificate that represents shares of stock in an international company. The shares underlying the GDR remain on deposit with a depositary bank or [custodial](#) institution.

While shares of an international company trade as domestic shares in the country where the company is located, global investors located elsewhere can invest in those shares through GDRs.

Using GDRs, companies can raise [capital](#) from investors in countries around the world. For those investors, the GDRs will be denominated in their home country currencies. Since GDRs are negotiable certificates, they trade in multiple markets and can provide arbitrage opportunities to investors.

GDRs are generally referred to as European Depositary Receipts, or EDRs, when European investors wish to trade locally the shares of companies located outside of Europe.

GDR transactions tend to have lower costs than some other mechanisms that investors use to trade in foreign securities.

Example of a GDR :

A U.S.-based company that wants its stock to be listed on the London and Hong Kong Stock Exchanges can accomplish this via a GDR. The U.S. – based company enters into a depositary receipt agreement with the respective foreign depositary banks. In turn,

these banks package and issue shares to their respective stock exchanges. These activities follow the regulatory compliance regulations for both of the countries.

GDR Characteristics :

GDRs are exchange – traded securities that are not directly backed by any underlying collateral (as shares of a company are backed by their assets). GDRs instead represent ownership of shares in a foreign company, where those actual shares are traded abroad.

Different GDRs may also have specific characteristics that differ from one to the next. These may include:

- **Conversion ratio :** The conversion ratio is the number of shares of the underlying company that are represented by each GDR. This ratio can vary from one GDR to another, and it may be adjusted over time to reflect changes in the underlying shares.
- **Denomination :** GDRs can be denominated in different currencies, such as U.S. dollars, euros, or pounds sterling. The currency used for a GDR may impact its price and the risks associated with the investment, such as currency risk, as the price of its shares overseas are priced in local currency.
- **Sponsorship :** GDRs are issued by depository banks, and the specific bank that sponsors a GDR may vary from one GDR to another. Different banks may have different reputations, financial strength, and other characteristics that could impact the risks and potential returns of a GDR.
- **Fees :** GDRs may also vary in terms of the fees that are charged for issuing, trading, or holding the GDRs. These fees can impact the overall cost and potential returns of an investment in a GDR.

Special Considerations :

A GDR distributed by a depository bank represents a particular number of underlying shares—anywhere from a fraction to multiple shares—in a specific international company. The particular share makeup for a GDR depends on how attractive an investment it will make to local investors. For instance, in the U.S., a depository bank would want to create GDRs with the number of shares, or fractions thereof, and associated U.S. dollar value that U.S. investors might be most comfortable with.

The depository bank first buys the shares of the international company (or, receives them from an investor who already owns them). It then bundles a certain number of them. This bundle is represented by a GDR. The GDR is then issued by the depository bank on a local stock exchange. The underlying shares remain on deposit with the depository bank (or custodian bank in the international country).

The trading process involving GDRs is regulated by the exchange on which they trade. For example, in the U.S., global depository receipts are quoted and trade in U.S.

dollars. They also pay dividends with U.S. dollars. They're subject to the trading and settlement process and regulations of the exchange where their transactions take place.

Typically, GDRs are offered to institutional investors via a private offer, due to the fact that they can take advantage of exemptions from registration under the Securities Act of 1933. This makes GDRs an efficient and cost-effective way to access cross-border capital. In fact, because of their flexibility and efficiencies, issuers from regions such as the Middle East and Africa, Asia Pacific, Latin America as well as Europe have increased their use of GDR programs to help them achieve the objectives they have for raising capital.

Trading GDRs :

International companies issue GDRs to attract capital from foreign investors. GDRs trade on the investors' local exchanges while offering exposure to an international marketplace. A custodian/depository bank has possession of the GDRs underlying shares while trades take place, ensuring a level of protection and facilitating participation for all involved.

Brokers who represent buyers manage the purchase and sale of GDRs. Generally, the brokers are from the home country and operate within the foreign market. The actual purchase of the [assets](#) is multi-staged, involving a broker in the investor's country, a broker located within the market of the international company, a depository bank representing the buyer, and a custodian bank.

Brokers can also sell GDRs on an investor's behalf. An investor can sell them as-is on the proper [exchanges](#), or the investor can convert them into regular stock for the company. Additionally, they can be canceled and returned to the issuing company.

Traders dealing in GDRs often compare the, for example, U.S. dollar price of the GDR with the U.S. dollar equivalent price of the shares trading on the international company's domestic exchange. They'll typically buy the less expensive security and sell the other. Eventually, this arbitrage trading activity causes the underlying shares and the GDRs to reach [parity](#).

Due to the trading activity called [arbitrage](#), a GDR's price closely tracks that of the international company's stock on its home exchange.

Advantages and Disadvantages of GDRs :

Advantages :

- GDRs help international companies reach a broader, more diverse audience of potential investors.
- They can potentially increase share liquidity.
- Companies can conduct an efficient and cost-effective private offering.
- [Shares listed on major global exchanges](#) can increase the status or legitimacy of an otherwise unknown foreign company.

- For investors, GDRs provide the opportunity to diversify portfolios internationally.
- GDRs are more convenient and less expensive than opening foreign brokerage accounts and purchasing stocks in foreign markets.
- Investors don't have to pay cross-border custody or safekeeping charges.
- GDRs trade, clear, and settle according to the investor's domestic process and procedures.
- U.S. holders of GDRs realize any dividends and capital gains in U.S. dollars.²

Disadvantages :

- GDRs may have significant administrative fees.
- Dividend payments are net of currency conversion expenses and foreign taxes.
- The depositary bank automatically withholds the amount necessary to cover expenses and foreign taxes.
- U.S. investors may need to seek a credit from the [Internal Revenue Service](#) (IRS) or a refund from the foreign government's taxing authority to avoid double taxation on capital gains realized.
- GDRs have the potential to have low [liquidity](#), making them difficult to sell.
- In addition to liquidity risk, they can have currency risk and political risk.
- This means that the value of GDR could fluctuate according to actual events in the foreign country, such as recession, financial collapse, or political upheaval.

Pros :

- Easy to track and trade
- Denominated in local currency
- Regulated by local exchanges
- Offers international portfolio diversification

Cons :

- More complex taxation
- Limited selection of companies offering GDRs
- Investors exposed indirectly to currency and geopolitical risk
- Potential lack of liquidity

GDRs vs. ADRs :**Global Depositary Receipts :**

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.

American Depositary Receipts :

On the other hand, an American depositary receipt, which also represents shares of an international company, lists only on U.S. stock exchanges. To offer ADRs, a U.S. bank will purchase shares on a foreign exchange. The depositary bank will hold the underlying shares and issue an ADR for domestic trading.

Sponsored ADRs :

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 pays the costs of issuing an ADR and retains control over it, while the bank handles the transactions with investors.

Sponsored ADRs are categorized by the degree the foreign company complies with SEC regulations and American accounting procedures.

Unsponsored ADRs :

A bank may also issue an [unsponsored](#) ADR.³ This certificate represents no direct involvement, participation, or even permission from the foreign company.

Theoretically, there could be several unsponsored ADRs for the same foreign company, issued by different U.S. banks. These different ADRs could also offer varying dividends. With sponsored programs, there is only one ADR, issued by the depositary bank working with the foreign company.

9.3 SUMMARY :

In this lesson, we will explore external commercial borrowings. ECBs are commercial loans raised by eligible resident entities from recognised non – resident entities and should conform to parameters such as minimum maturity, permitted and non-permitted end-uses, maximum all – in – cost ceiling, etc.

A global depositary receipt (GDR) is a negotiable financial instrument issued by a depositary bank. It represents shares in a foreign company and trades on the local stock exchanges in investors' countries. GDRs make it possible for a company (the issuer) to access investors in capital markets beyond the borders of its own country. GDRs are commonly used by issuers to raise capital from international investors through private placement or public stock offerings. A global depositary receipt is very similar to an American depositary receipt (ADR) except that an ADR only lists shares of a foreign company in U.S. markets.

9.4 KEY WORDS :

Exchange Contracts :

Documents issued by foreign exchange dealers, by banks dealing in foreign exchange,

and by foreign exchange brokers confirming foreign exchange transactions.

Exchange Control or Restrictions :

Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

Exchange Control Risk :

The possibility of defaults on obligations by the imposition of exchange control or restrictions.

Exchange Rates :

The price of a currency in terms of another.

Exchange Reserves :

The total amount of foreign assets (generally currencies) held by a country's central bank.

Exchange Risk :

The risk of market fluctuation of an asset or liability denominated in a foreign currency, such as the ownership of a currency (spot or forward) or trade accounts payable in foreign currency.

Export Credit Insurance :

A system to insure the collection of credits extended by exporters against various contingencies. In some countries, only non-commercial risks can be insured.

9.5 SELF ASSESSMENT QUESTIONS :

1. External Commercial Borrowings.
2. Available routes for raising ECB.
3. Global Depositary Receipt (GDR).

9.6 SUGGESTED READINGS :

1. IMF (International Monetary Fund) 2001, Balance of Payments Statistics Yearbook, Washington DC.
2. IMF (International Monetary Fund) 2001, International Finance Statistics Yearbook, Washington, DC.
3. Lipsey, Robert E. (2001) "Foreign Direct Investment and the operations of multinational firms: concepts, history, and data", Working paper 8665, National Bureau of Economic Research, Cambridge (USA).

LESSON – 10

OFF–SHORE BORROWINGS & DOCUMENTARY LETTER OF CREDIT

Objectives :

After studying this lesson, the student be able to :

- Off – shore Borrowings
- Off – shoring and Tax Avoidance
- Documentary Letter Of Credit (DLC)

Structure of the Lesson :

- 10.1 Off – shore
 - 10.1.1 Off – shoring and Tax Avoidance
 - 10.1.2 Advantages and Disadvantages of Off – shore Investing
- 10.2 Documentary Letter of Credit (DLC)
 - 10.2.1 The Purpose of a DLC
 - 10.2.2 Process of Obtaining a DLC
 - 10.2.3 Advantages of Using a DLC
 - 10.2.4 Parties involved in Documentary Credit Transaction
- 10.3 Summary
- 10.4 Key words
- 10.5 Self Assessment Questions
- 10.6 Suggested Books

10.1 WHAT IS OFF – SHORE :

The term Off – shore refers to a location outside of one's home country. The term is commonly used in the banking and financial sectors to describe areas where regulations are different from the home country.

Off – shore locations are generally island nations, where entities set up corporations, investments, and deposits. Companies and individuals (typically those with a high net worth) may move Off – shore for more favorable conditions, including tax avoidance, relaxed regulations, or asset protection. Although Off – shore institutions can also be used for illicit purposes, they aren't considered illegal.

Understanding Off – shore :

Off – shore can refer to a variety of foreign – based entities, accounts, or other financial services. In order to qualify as Off – shore , the activity taking place must be based in a country other than the company or investor’s home nation. As such, while the home base for a person or company may be in one country, the business activity takes place in another. Put simply, going Off – shore provides services to non-residents.

In the simplest sense, Off – shore can mean any location abroad; any country, territory, or jurisdiction; however, the term has become widely synonymous with specific locations that have become popular for Off – shore business activity, notably island nations like the Cayman Islands, Bermuda, the Channel Islands, and the Bahamas. Other centers in landlocked countries, including Switzerland, Ireland, and Belize, also qualify as popular Off – shore financial centers (OFCs).

The level of regulatory standards and transparency differs widely among OFCs. But they generally offer:

- Favorable tax laws, which is why they're commonly referred to as tax havens
- Reduced risk and greater growth potential
- Significant cost savings for businesses
- Protection of assets, especially during times of instability
- Loose regulations
- Confidentiality

Going Off–shore is common for companies and high – net – worth individuals (HNWIs) for the reasons mentioned above. They may also choose to bank and hold investments in a specific country Off – shore if they travel there frequently. Supporters of OFCs argue that they improve the flow of capital and facilitate international business transactions.

However, critics suggest that offshoring helps hide tax liabilities or ill-gotten gains from authorities, even though most countries require that foreign holdings be reported. Going Off – shore has also become a way for more illicit activities, including fraud, money laundering, and tax evasion. As such, there are increasing calls for OFCs to become more transparent with global tax authorities.

10.1.1 Off – shoring and Tax Avoidance :

Off – shoring is perfectly legal because it provides entities with a great deal of privacy and confidentiality; however, authorities are concerned that OFCs are being used to avoid paying taxes. As such, there is increased pressure on these countries to report foreign holdings to global tax authorities.

For instance, the Swiss are known for their strict privacy laws. At one point, Swiss banks didn’t even have names attached to bank accounts; however, Switzerland agreed to turn over information to foreign governments on their account holders, effectively ending tax evasion.

According to the Organisation for Economic Co-operation and Development (OECD), 100 countries automatically shared information about Off – shore accounts with tax authorities in 2019. This entailed the disclosure of 84 million accounts worth more than €10 trillion.¹

Types of Off – shoring :

There are several types of offshoring: business, investing, and banking.

Off – shoring Business :

Off – shoring is often referred to as out sourcing when it comes to business activity. This is the act of establishing certain business functions, such as manufacturing or call centers, in a nation other than where the company is headquartered.

This is often done to take advantage of more favorable conditions in a foreign country, such as lower wage requirements or looser regulations, and can result in significant cost savings for the business. Companies with significant sales overseas, such as Apple and Microsoft, may take the opportunity to keep related profits in Off – shore accounts in countries with lower tax burdens.

Off – shore Investing :

Off – shore investing can involve any situation in which the Off – shore investors reside outside the nation in which they invest. This practice is mostly used by high-net-worth investors, as operating Off – shore accounts can be particularly high. It often requires opening accounts in the nation in which the investor wishes to invest. Some of the advantages of holding Off – shore accounts include tax benefits, asset protection, and privacy.

Off – shore investment accounts are generally opened in the name of a corporation, such as a holding company or a limited liability company (LLC) rather than an individual. This opens up investments to more favorable tax treatment.

The primary downsides to Off – shore investing are the high costs and the increased regulatory scrutiny worldwide that Off – shore jurisdictions and accounts face. This makes Off – shore investing beyond the means of most investors. Off – shore investors may also be scrutinized by regulators and tax authorities to make sure taxes are paid.

Off – shore Banking :

Off – shore banking involves securing assets in financial institutions in foreign countries, which may be limited by the laws of the customer's home nation—much like Off – shore investing. Think of the famed Swiss bank account—that James Bond-like account that puts rich people's money out of reach of their own country's government.

People and companies can use Off – shore accounts to avoid the unfavorable circumstances associated with keeping money in a bank in their home nation. Most entities do this to avoid tax obligations. Holding Off – shore bank accounts also makes it more difficult for them to be seized by authorities.

For those who work internationally, the ability to save and use funds in a foreign currency for international dealings can be a benefit. This often provides a simpler way to access funds in the needed currency without the need to account for rapidly changing exchange rates.

10.1.2 Advantages and Disadvantages of Off – shore Investing :

Advantages :

Taking your investments abroad to an OFC may also help you diversify your portfolio. By going international and investing in different asset classes and currencies, you can help cut down the risk to your overall investments.

You're very apt to get favorable tax treatment on your investments, depending on where you hold your assets. For instance, the Cayman Islands doesn't impose taxes on income, dividends, or capital gains, which means you get to keep more of the money you earn.²

Your assets get a certain level of protection because many Off – shore centers are located in places with sound economic and political systems. And because they're in foreign lands, it's harder for creditors to seize your assets.

Disadvantages :

Holding accounts Off – shore subjects you to more scrutiny. That's because it's often seen as a way for people to avoid paying taxes. If you don't report your holdings to your tax authority, such as the Internal Revenue Service (IRS), you could be in serious trouble.

As mentioned above, even though some jurisdictions provide complete confidentiality to account holders, an increasing number of countries are becoming more transparent with tax authorities. This means you could be on the hook if you don't report your holdings.

You should do your due diligence if you're going to invest abroad—the same way you would if you're doing business with someone at home. Make sure you choose a reputable broker or investment professional to ensure that your money is handled properly. Failure to do so could put your investments at risk.

Pros :

- Portfolio diversification
- Favorable tax treatment
- Asset protection

Cons :

- More scrutiny
- Increased transparency from Off – shore jurisdictions
- Risk of working with the wrong professional.

10.2 WHAT IS A DOCUMENTARY LETTER OF CREDIT (DLC) :

A Documentary Letter of Credit (DLC) is an essential financial instrument in international trade that provides a guarantee of payment between buyers and sellers. This article will explore the intricacies of a DLC, its various uses and benefits, and the process involved in obtaining one.

Introduction to Documentary Letters of Credit :

A Documentary Letter of Credit, also known as a Letter of Credit at Sight, is a financial instrument issued by banks or commercial financial institutions through a SWIFT MT700 message. It ensures that sellers receive payment from buyers once the terms specified in the DLC are met. Importers and exporters often require an intermediary, such as a bank or financial institution, to guarantee payment and delivery of goods in international business transactions.

10.2.1 The Purpose of a DLC :

The primary purpose of a DLC is to provide financial security to both parties involved in a transaction, particularly when they have not yet established a close business relationship or are located in different countries. By utilizing a DLC, sellers can mitigate risks associated with international legal systems and lack of trust with buyers.

Parties Involved :

The parties involved in issuing a Documentary Letter of Credit are :

1. Seller/Exporter (Beneficiary)
2. Issuing Bank or Financial Institution
3. Buyer/Importer (Applicant), who is also a customer of the bank or financial institution
4. Advising Bank, of which the seller/exporter (beneficiary) is a client

10.2.2 Process of Obtaining a DLC :

Step 1 – Application :

To obtain a DLC, the applicant must complete a DLC application and submit it alongside their proposal documents, such as a proforma invoice, Sales and Purchase Agreement (SPA), or contract.

Step 2 – Draft :

A bank or financial institution then prepares a free draft SWIFT MT700 documentary credit for the applicant and their seller/exporter to review and confirm.

Step 3 – Draft Review and Opening Payment :

After reviewing and making any necessary changes to the draft, the applicant and seller/exporter must remit the opening fee to the bank or financial institution as per the proforma invoice. Once the remittance is received, the completed Documentary Letter of

Credit will be sent to the issuing bank or financial institution for the issuance of the SWIFT MT700.

Step 4 – Issuance :

In most cases, the bank will issue the DLC within 48 hours of approval. The bank will then email a copy of the letter of credit sent to the beneficiary via MT700 SWIFT, including the reference number of the letter of credit. The supplier/exporter can confirm receipt of the DLC shortly thereafter.

Step 5 – Submission of Documents :

After preparing and loading all goods for shipment, the seller/exporter must send the required documents for the particular shipment to their advising bank. The advising bank then forwards these documents to the issuing bank, who will email copies of the submission and all submitted documents to the buyer/importer for review and approval.

Step 6 – Payment for Goods :

Before the issuing bank can release the original documents, they must receive payment for the submission. Upon receiving payment, the bank will sign the documents and deliver them to the buyer/importer's carrier or consignee of choice the following day, completing the transaction.

10.2.3 Advantages of Using a DLC :**Enhances Trust :**

A DLC enhances trust between buyers and sellers in international trade, as it provides a guarantee of payment and delivery of goods.

Reduces Risk :

By utilizing a DLC, sellers can reduce risks associated with international legal systems and lack of trust with buyers.

Facilitates Trade :

DLCs facilitate international trade by providing a secure and efficient method of payment between parties from different countries.

Disadvantages of using a DLC :

High Cost : DLCs can be costly, as banks and financial institutions charge fees for their services in issuing and processing the instrument.

Complexity : The process of obtaining and using a DLC can be complex, particularly for businesses unfamiliar with international trade regulations and practices.

10.2.4 Parties involved in Documentary Credit Transaction :

1. Importer / Buyer is called Credit Applicant before opening credit, and Opener of Credit after it is opened.

2. Exporter/Seller is called (Credit) Beneficiary.
3. Issuing Bank issues the letter of credit and undertakes to pay, accept or negotiate documents.
4. Advising Bank informs the beneficiary of the terms of credit. It can be the Issuing Bank if it informs the beneficiary directly, or Correspondent Bank if it is in the beneficiary's country
5. Draft or Document Buyer/Negotiating Bank can be the issuing bank (or another) that receives documents and pays their values.
6. Paying Bank pays the credit amount, and is often the issuing bank, or Confirming Bank; and the issuing bank's correspondent makes the advice and confirmation.

Normally, the provisions and rules of Uniform Customs and Practice for Documentary Credits (UCPDC) issued by the International Chamber of Commerce apply to all the parties involved in the documentary credit.

Documentary (Letters Of) Credit Classification :

There are several types of letters of credit that can be classified technically, fiduciarily and administratively.

Technical Documentary Credits :

1. **Revocable Documentary Credit :** It is a documentary credit the bank can cancel or amend at the request of the credit applicant, at any time, and without prior notice to the beneficiary. However, once the documents are submitted to the advising bank and the beneficiary receives their value, the credit becomes irrevocable or unmodifiable unless all concerned parties without exception agree otherwise. Therefore, we see some banks do not consider this type a documentary credit but a revocable notice. This type of credits is definitely in the interest of the importer because it gives them maximum flexibility, and on the other hand, involves maximum risk to the exporter.
2. **Irrevocable Documentary Credit :** It is a documentary credit whereby the credit applicant and issuing bank commit to pay the credit amount against the required documents submitted by the beneficiary, ostensibly proving their fulfillment of the credit conditions within the validity period. The credit applicant and/or issuing bank may not retract from their commitment to payment under the credit conditions by cancelling or modifying it. If the credit should be modified for any reason, the consent of all parties concerned without exception should be obtained. The irrevocable documentary credit is the commonest and most used. The issuing bank should explicitly state in the letter of credit it is irrevocable. Yet, in the absence of such a provision, the credit will be regarded as under the UCPDC.
3. **Irrevocable and Confirmed Documentary Credit :** As this type of credits is

irrevocable, the issuing bank asks the advising bank to add its confirmation when it advises the beneficiary. Generally, banks apologize for not confirming irrevocable credits because they can be cancelled without notifying any of the concerned parties. Consequently, when the bank adds its confirmation, it becomes obliged to pay the credit charge when the beneficiary submits the documents that meet their terms, regardless of the financial situation of the credit applicant and issuing bank. Accordingly, banks charge a special commission for granting them credit confirmation facilities. This is the best type of credits where the exporter can get guarantees for paying the value of the exported goods, but in turn it is an additional burden on the importer, as they should pay the additional confirmation expenses that increase the cost.

4. **Revolving Letter of Credit** : It is a revocable or irrevocable credit whose conditions allow to renew or roll over its value without the need to amend the rest its conditions. The value can be renewed in time or in value. If the credit is replenished over a period, its value is automatically renewed at the beginning of the period, regardless of its balance at the end of the previous period. The credit may stipulate the value renewal cumulatively, that is adding the unused value of the previous period to the credit amount after renewal. If the credit is renewed in value, it will be replenished once its whole value or part of it is used. The irrevocable credit, which requires shipping the goods and thus paying over specific periods within its validity duration, is not a revolving credit, but an irrevocable letter of credit that allows partial shipments.
5. **Advance Payment (Red Clause) Credit** : It is an irrevocable letter of credit that includes a provision that authorizes the issuing bank, advising bank, or confirming bank (if confirmation is added) to give advances to the beneficiary prior to submission of the documents, per clear and accurately detailed instructions. The issuing bank demands the red clause credit details from the applicant to save them any liability for translation or interpretation of its instructions related about that provision. It was named Red Clause because banks traditionally have put it in the letter of credit in red ink to draw the issuing bank's attention to the special nature of the credit. These facilities may be directly from the client's (credit applicant's) account, or authorized by the advising bank or confirming bank by granting the beneficiary a loan worth the credit amount or part of it granted on standby credit, which is repaid from the credit amount allocated by the advising bank for the beneficiary after submitting the documents. Often the lending conditions are attached to bank guarantees offered by the credit beneficiary who pays them in the event of failure to ship the merchandise before the credit expiry.
6. **Transferable Credit** : It is an irrevocable letter of credit whose (first) beneficiary can transfer once to one beneficiary or more (second beneficiary). This type of credits is used when the (first) beneficiary is a mediator that agrees with the importer to provide them with goods they buy from one or more sources. This

credit allows the first beneficiary to transfer their rights and obligations or part of them to the real exporters without having to open a letter of credit or more in favor of the exporters. The credit transfer expenses, though, are defrayed fully by the beneficiary unless otherwise provided for in the credit. The credit is transferred under the same basic conditions, but the first beneficiary that transfers the credit is entitled to amend it as follows :

- The first beneficiary may replace the credit applicant's name with their name to ensure that the original applicant will not know the actual exporters.
 - The credit value may be reduced, allowing the first beneficiary to realize a profit, which is the difference between the original credit amount and the transferred credit.
 - The credit term can be shortened so that the first beneficiary can present the documents received by the bank for its benefit from the second beneficiary within the original credit term.
7. Back-to-Back Credit / Counter Credit : The importer may refuse to open a transferable letter of credit, or the second beneficiary may attach conditions that are not in the transferable letter of credit. If the first beneficiary is able to supply the goods, they should open a credit in favor of another exporter that is capable of exporting the required goods. This involves two types of collateral credits:
- A. Back – to – Back Credit : whereby the beneficiary requests from the advising bank to open a back-to-back credit with security of an advised credit. In general, banks are reluctant to open credits of this kind if the beneficiary is not one of their clients with specific facility limits.
 - B. Counter Credit : whereby the beneficiary requests from the advising bank or any bank to open a credit counter to the import credit without considering the latter a guarantee for the credit to be opened by the bank within the facility limits offered to it.
8. Standby Letter of Credit : Under this type of credits, the issuing/advising bank undertakes to compensate the beneficiary financially for the withdrawals not in excess of a certain amount, within a specified period, against the beneficiary's delivery of prescribed documents. The required documents, based on the guarantee, usually include Beneficiary Certificate that evidences the credit opener's (applicant's) failure to fulfil their obligations. This kind of credits is bound by the UCPDC that oblige the issuing bank to pay upon receipt of documents meeting the credit conditions. It is noted here that the undertaker cannot amend or cancel the credit without the consent of the beneficiary, and they are not entitled to object or stop the payment under the credit.
9. Deferred Payment Letter of Credit: Under this type of credits, the exporter (beneficiary) grants payment facilities to the importer by opening a deferred

payment letter of credit (DPLC). DPLC is an irrevocable credit whereby payment is made after the date of withdrawal or documents presentation. The issuing bank takes the risks of its credit applicant client throughout the duration of the facilities. The advising bank advises the credit conditions to its issuing client without any fiduciary responsibility.

Conclusion :

A Documentary Letter of Credit is a vital financial instrument in international business transactions, providing a guarantee of payment and delivery of goods between buyers and sellers. By understanding the intricacies of a DLC and following the proper procedures, businesses can effectively mitigate risks and enhance trust in their international trade endeavors.

10.3 SUMMARY :

Off-shore can refer to a variety of foreign-based entities, accounts, or other financial services. In order to qualify as offshore, the activity taking place must be based in a country other than the company or investor's home nation. As such, while the home base for a person or company may be in one country, the business activity takes place in another. Put simply, going offshore provides services to non – residents. There are several types of off-shoring : business, investing, and banking.

A Documentary Letter of Credit (DLC) is an essential financial instrument in international trade that provides a guarantee of payment between buyers and sellers. This article will explore the intricacies of a DLC, its various uses and benefits, and the process involved in obtaining one. A Documentary Letter of Credit, also known as a Letter of Credit at Sight, is a financial instrument issued by banks or commercial financial institutions through a SWIFT MT700 message. It ensures that sellers receive payment from buyers once the terms specified in the DLC are met. Importers and exporters often require an intermediary, such as a bank or financial institution, to guarantee payment and delivery of goods in international business transactions. A Documentary Letter of Credit is a vital financial instrument in international business transactions, providing a guarantee of payment and delivery of goods between buyers and sellers. By understanding the intricacies of a DLC and following the proper procedures, businesses can effectively mitigate risks and enhance trust in their international trade endeavours.

10.4 KEY WORDS :**External Debt :**

Total debt owed to creditors outside the country, including both private and public sector debt. In some emerging market countries, this debt may be issued under foreign law (American or English) and payable in foreign currencies.

Financial Stability Board :

Established by the G-20 countries to coordinate the development of financial regulatory policies between international standard setters, multilateral organizations,

and members' national authorities for financial regulation.

Fixed Exchange Rate System :

A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

Fixed Rate of Exchange :

A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps special drawing rights. It remains in effect as long as that government is willing and/or able to buy or sell exchange at the set rates.

Flexible Rate of Exchange :

A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, special drawing rights, or another currency when the rate fluctuates beyond certain parameters.

Floating Exchange Rate System :

A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

10.5 SELF ASSESSMENT QUESTIONS :

1. Off – shoring and Tax Avoidance.
2. Advantages and Disadvantages of Off – shore Investing.
3. Documentary Letter of Credit (DLC).
4. The Purpose of a DLC.
5. Process of Obtaining a DLC.
6. Advantages of Using a DLC.

10.6 SUGGESTED BOOKS :

1. The Law & Practice Of Off – shore Banking & Finance.
2. Fundamentals Of Off – shore Banking.
3. Documentary letter of credit; in practice by PAVEL ANDRLE.

A.S.Kalyani

LESSON – 11
**THE FOREIGN EXCHANGE
MANAGEMENT ACT, 1999**

Objectives :

After studying this lesson, the student be able to :

- To understand the basic concept of foreign exchange management.
- To provide necessary knowledge of foreign exchange management.
- To understand the different types of foreign Exchange management.

Structure of the Lesson :

- 11.1 Introduction
- 11.2 Regulation and Management of Foreign Exchange
- 11.3 Authorised Person
- 11.4 Contravention and Penalties
- 11.5 Adjudication and Appeal
- 11.6 Directorate of Enforcement
- 11.7 Miscellaneous
- 11.8 Summary
- 11.9 Key words
- 11.10 Self Assessment Questions
- 11.11 Suggested Readings

11.1 INTRODUCTION :

An Act to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India.

BE it enacted by Parliament in the Fiftieth Year of the Republic of India as follows :

1. Short title, extent, application and commencement.—

- (1) This Act may be called the Foreign Exchange Management Act, 1999.
- (2) It extends to the whole of India.
- (3) It shall also apply to all branches, offices and agencies outside India owned or controlled by a person resident in India and also to any contravention

thereunder committed outside India by any person to whom this Act applies.

- (4) It shall come into force on such date¹ as the Central Government may, by notification in the Official Gazette, appoint :

Provided that different dates may be appointed for different provisions of this Act and any reference in any such provision to the commencement of this Act shall be construed as a reference to the coming into force of that provision.

2. Definitions.—

In this Act, unless the context otherwise requires,—

- (a) “Adjudicating Authority” means an officer authorised under sub-section (1) of section 16;
- (b) “Appellate Tribunal” means the Appellate Tribunal referred to in section 18;]
- (c) “authorised person” means an authorised dealer, money changer, off-shore banking unit or any other person for the time being authorised under sub-section (1) of section 10 to deal in foreign exchange or foreign securities;
- ³[(cc) “Authorised Officer” means an officer of the Directorate of Enforcement authorised by the Central Government under section 37A;]
- (d) “Bench” means a Bench of the Appellate Tribunal;
- (e) “capital account transaction” means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in sub-section (3) of section 6;
- (f) “Chairperson” means the Chairperson of the Appellate Tribunal;
- (g) “chartered accountant” shall have the meaning assigned to it in clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 (38 of 1949);
- ³[(gg) “Competent Authority” means the Authority appointed by the Central Government under sub-section (2) of section 37A;]
- (h) “currency” includes all currency notes, postal notes, postal orders, money orders, cheques, drafts, travellers cheques, letters of credit, bills of exchange and promissory notes, credit cards or such other similar instruments, as may be notified by the Reserve Bank;
- “currency notes” means and includes cash in the form of coins and bank notes;
- (j) “current account transaction” means a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction includes,—
- (i) payments due in connection with foreign trade, other current

- business, services, and short-term banking and credit facilities in the ordinary course of business,
- (ii) payments due as interest on loans and as net income from investments,
 - (iii) remittances for living expenses of parents, spouse and children residing abroad, and
 - (iv) expenses in connection with foreign travel, education and medical care of parents, spouse and children;
- (k) “Director of Enforcement” means the Director of Enforcement appointed under sub-section (1) of section 36;
- (l) “export”, with its grammatical variations and cognate expressions, means—
- (i) the taking out of India to a place outside India any goods,
 - (ii) provision of services from India to any person outside India;
- (m) “foreign currency” means any currency other than Indian currency;
- (n) “foreign exchange” means foreign currency and includes,—
- (i) deposits, credits and balances payable in any foreign currency,
 - (ii) drafts, travellers cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency,
 - (iii) drafts, travellers cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency;
- (o) “foreign security” means any security, in the form of shares, stocks, bonds, debentures or any other instrument denominated or expressed in foreign currency and includes securities expressed in foreign currency, but where redemption or any form of return such as interest or dividends is payable in Indian currency;
- (p) “import”, with its grammatical variations and cognate expressions, means bringing into India any goods or services;
- (q) “Indian currency” means currency which is expressed or drawn in Indian rupees but does not include special bank notes and special one rupee notes issued under section 28A of the Reserve Bank of India Act, 1934 (2 of 1934);
- (r) “legal practitioner” shall have the meaning assigned to it in clause (i) of sub-section (1) of section 2 of the Advocates Act, 1961 (25 of 1961);
- (s) “Member” means a Member of the Appellate Tribunal and includes the Chairperson thereof;
- (t) “notify” means to notify in the Official Gazette and the expression

“notification” shall be construed accordingly;

- (u) “person” includes—
- (i) an individual,
 - (ii) a Hindu undivided family,
 - (iii) a company,
 - (iv) a firm,
 - (v) an association of persons or a body of individuals, whether incorporated or not,
 - (vi) every artificial juridical person, not falling within any of the preceding sub-clauses, and
 - (vii) any agency, office or branch owned or controlled by such person;

“person resident in India” means

- (i) a person residing in India for more than one hundred and eighty-two days during the course of the preceding financial year but does not include—
 - (A) a person who has gone out of India or who stays outside India, in either case—
 - (a) for or on taking up employment outside India, or
 - (b) for carrying on outside India a business or vocation outside India, or
 - (c) for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period;
 - (B) a person who has come to or stays in India, in either case, otherwise than—
 - (a) for or on taking up employment in India, or
 - (b) for carrying on in India a business or vocation in India, or
 - (c) for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period;
 - (ii) any person or body corporate registered or incorporated in India,
 - (iii) an office, branch or agency in India owned or controlled by a person resident outside India,
 - (iv) an office, branch or agency outside India owned or controlled by a person resident in India;
- (w) “person resident outside India” means a person who is not resident in India;

- (x) “prescribed” means prescribed by rules made under this Act;
- (y) “repatriate to India” means bringing into India the realised foreign exchange and—
 - (i) the selling of such foreign exchange to an authorised person in India in exchange for rupees, or
 - (ii) the holding of realised amount in an account with an authorised person in India to the extent notified by the Reserve Bank,

and includes use of the realised amount for discharge of a debt or liability denominated in foreign exchange and the expression “repatriation” shall be construed accordingly;

- (z) “Reserve Bank” means the Reserve Bank of India constituted under sub-section (1) of section 3 of the Reserve Bank of India Act, 1934 (2 of 1934);

(za) “security” means shares, stocks, bonds and debentures, Government securities as defined in the Public Debt Act, 1944 (18 of 1944), savings certificates to which the Government Savings Certificates Act, 1959 (46 of 1959) applies, deposit receipts in respect of deposits of securities and units of the Unit Trust of India established under sub-section (1) of section 3 of the Unit Trust of India Act, 1963 (52 of 1963)* or of any mutual fund and includes certificates of title to securities, but does not include bills of exchange or promissory notes other than Government promissory notes or any other instruments which may be notified by the Reserve Bank as security for the purposes of this Act;

(zb) “service” means service of any description which is made available to potential users and includes the provision of facilities in connection with banking, financing, insurance, medical assistance, legal assistance, chit fund, real estate, transport, processing, supply of electrical or other energy, boarding or lodging or both, entertainment, amusement or the purveying of news or other information, but does not include the rendering of any service free of charge or under a contract of personal service ;

(zc) “Special Director (Appeals)” means an officer appointed under ¹[section 17];

(zd) “specify” means to specify by regulations made under this Act and the expression “specified” shall be construed accordingly;

(ze) “transfer” includes sale, purchase, exchange, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien.

11.2 REGULATION AND MANAGEMENT OF FOREIGN EXCHANGE :

1. **Dealing in foreign exchange, etc.**—Save as otherwise provided in this Act, rules or regulations made thereunder, or with the general or special permission

of the Reserve Bank, no person shall—

- a. deal in or transfer any foreign exchange or foreign security to any person not being an authorised person;
- b. make any payment to or for the credit of any person resident outside India in any manner;
- c. receive otherwise through an authorised person, any payment by order or on behalf of any person resident outside India in any manner.

Explanation.—For the purpose of this clause, where any person in, or resident in, India receives any payment by order or on behalf of any person resident outside India through any other person (including an authorised person) without a corresponding inward remittance from any place outside India, then, such person shall be deemed to have received such payment otherwise than through an authorised person;

- d. enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person.

Explanation.—For the purpose of this clause, “financial transaction” means making any payment to, or for the credit of any person, or receiving any payment for, by order or on behalf of any person, or drawing, issuing or negotiating any bill of exchange or promissory note, or transferring any security or acknowledging any debt.

- 2. Holding of foreign exchange, etc.**—Save as otherwise provided in this Act, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.
- 3. Current account transactions.**—Any person may sell or draw foreign exchange to or from an authorised person if such sale or drawal is a current account transaction:

Provided that the Central Government may, in public interest and in consultation with the Reserve Bank, impose such reasonable restrictions for current account transactions as may be prescribed.

- 4. Capital account transactions.**—

- (1) Subject to the provisions of sub-section (2), any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction.
- (2) The Reserve Bank may, in consultation with the Central Government, specify—

¹[(a) any class or classes of capital account transactions, involving debt instruments, which are permissible;]

(b) the limit up to which foreign exchange shall be admissible for such transactions :

²[(c) any conditions which may be placed on such transactions;]

(3) [Provided that the Reserve Bank or the Central Government shall not impose any restrictions on the drawal of foreign exchange for payment due on account of amortisation of loans or for depreciation of direct investments in the ordinary course of business.]

[(2A) The Central Government may, in consultation with the Reserve Bank, prescribe—

(a) any class or classes of capital account transactions, not involving debt instruments, which are permissible;

(b) the limit up to which foreign exchange shall be admissible for such transactions; and

(c) any conditions which may be placed on such transactions.]

(4) A person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India.

(5) A person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.

(6) Without prejudice to the provisions of this section, the Reserve Bank may, by regulation, prohibit, restrict, or regulate establishment in India of a branch, office or other place of business by a person resident outside India, for carrying on any activity relating to such branch, office or other place of business.

³[(7) For the purposes of this section, the term “debt instruments” shall mean, such instruments as may be determined by the Central Government in consultation with the Reserve Bank.]

5. Export of goods and services.—

(1) Every exporter of goods shall—

a. furnish to the Reserve Bank or to such other authority a declaration in such form and in such manner as may be specified, containing true and correct material particulars, including the amount representing the full export value 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 the goods in a market outside India;

b. furnish to the Reserve Bank such other information as may be required by the Reserve Bank for the purpose of ensuring the realisation of the export proceeds by such exporter.

(2) The Reserve Bank may, for the purpose of ensuring that the full export value of the goods or such reduced value of the goods as the Reserve Bank determines, having regard to the prevailing market conditions, is received without any delay, direct any exporter to comply with such requirements as it deems fit.

(3) Every exporter of services shall furnish to the Reserve Bank or to such other authorities a declaration in such form and in such manner as may be specified, containing the true and correct material particulars in relation to payment for such services.

6. Realisation and repatriation of foreign exchange.—Save as otherwise provided in this Act, where any amount of foreign exchange is due or has accrued to any person resident in India, such person shall take all reasonable steps to realise and repatriate to India such foreign exchange within such period and in such manner as may be specified by the Reserve Bank.

7. Exemption from realisation and repatriation in certain cases.—The provisions of sections 4 and 8 shall not apply to the following, namely:—

a. possession of foreign currency or foreign coins by any person up to such limit as the Reserve Bank may specify; foreign currency account held or operated by such person or class of persons and the limit up to which the Reserve Bank may specify;

b. foreign exchange acquired or received before the 8th day of July, 1947 or any income arising or accruing thereon which is held outside India by any person in pursuance of a general or special permission granted by the Reserve Bank;

c. foreign exchange held by a person resident in India up to such limit as the Reserve Bank may specify, if such foreign exchange was acquired by way of gift or inheritance from a person referred to in clause (c), including any income arising therefrom;

d. foreign exchange acquired from employment, business, trade, vocation, services, honorarium, gifts, inheritance or any other legitimate means up to such limit as the Reserve Bank may specify; and such other receipts in foreign exchange as the Reserve Bank may specify.

11.3 AUTHORISED PERSON :

1. Authorised person.—

- (1) The Reserve Bank may, on an application made to it in this behalf, authorise any person to be known as authorised person to deal in foreign exchange or in foreign securities, as an authorised dealer, money changer or off-shore banking unit or in any other manner as it deems fit.
- (2) An authorisation under this section shall be in writing and shall be subject to the conditions laid down therein.
- (3) An authorisation granted under sub-section (1) may be revoked by the Reserve Bank at any time if the Reserve Bank is satisfied that—
 - (a) it is in public interest so to do; or
 - (b) the authorised person has failed to comply with the condition subject to which the authorisation was granted or has contravened any of the provisions of the Act or any rule, regulation, notification, direction or order made thereunder:

Provided that no such authorisation shall be revoked on any ground referred to in clause.

- (c) unless the authorised person has been given a reasonable opportunity of making a representation in the matter.
- (4) An authorised person shall, in all his dealings in foreign exchange or foreign security, comply with such general or special directions or orders as the Reserve Bank may, from time to time, think fit to give, and, except with the previous permission of the Reserve Bank, an authorised person shall not engage in any transaction involving any foreign exchange or foreign security which is not in conformity with the terms of his authorisation under this section.
- (5) An authorised person shall, before undertaking any transaction in foreign exchange on behalf of any person, require that person to make such declaration and to give such information as will reasonably satisfy him that the transaction will not involve, and is not designed for the purpose of any contravention or evasion of the provisions of this Act or of any rule, regulation, notification, direction or order made thereunder, and where the said person refuses to comply with any such requirement or makes only unsatisfactory compliance therewith, the authorised person shall refuse in writing to undertake the transaction and shall, if he has reason to believe that any such contravention or evasion as aforesaid is contemplated by the person, report the matter to the Reserve Bank.
- (6) Any person, other than an authorised person, who has acquired or purchased foreign exchange for any purpose mentioned in the declaration made by him to authorised person under sub-section (5) does not use it for such purpose or does not surrender it to authorised person within the specified period or uses the

foreign exchange so acquired or purchased for any other purpose for which purchase or acquisition of foreign exchange is not permissible under the provisions of the Act or the rules or regulations or direction or order made thereunder shall be deemed to have committed contravention of the provisions of the Act for the purpose of this section.

2. Reserve Bank's powers to issue directions to authorised person.—

- (1) The Reserve Bank may, for the purpose of securing compliance with the provisions of this Act and of any rules, regulations, notifications or directions made thereunder, give to the authorised persons any direction in regard to making of payment or the doing or desist from doing any act relating to foreign exchange or foreign security.
- (2) The Reserve Bank may, for the purpose of ensuring the compliance with the provisions of this Act or of any rule, regulation, notification, direction or order made thereunder, direct any authorised person to furnish such information, in such manner, as it deems fit.
- (3) Where any authorised person contravenes any direction given by the Reserve Bank under this Act or fails to file any return as directed by the Reserve Bank, the Reserve Bank may, after giving reasonable opportunity of being heard, impose on the authorised person a penalty which may extend to ten thousand rupees and in the case of continuing contravention with an additional penalty which may extend to two thousand rupees for every day during which such contravention continues.

3. Power of Reserve Bank to inspect authorised person.—

- (1) The Reserve Bank may, at any time, cause an inspection to be made, by any officer of the Reserve Bank specially authorised in writing by the Reserve Bank in this behalf, of the business of any authorised person as may appear to it to be necessary or expedient for the purpose of—
 - a. verifying the correctness of any statement, information or particulars furnished to the Reserve Bank;
 - b. obtaining any information or particulars which such authorised person has failed to furnish on being called upon to do so;
 - c. securing compliance with the provisions of this Act or of any rules, regulations, directions or orders made thereunder.
- (2) It shall be the duty of every authorised person, and where such person is a company or a firm, every director, partner or other officer of such company or firm, as the case may be, to produce to any officer making an inspection under sub-section (1), such books, accounts and other documents in his custody or power and to furnish any statement or information relating to the affairs of such person, company or firm as the said officer may require within such time and in

such manner as the said officer may direct.

11.4 CONTRAVENTION AND PENALTIES :

1. Penalties.—

- (1) If any person contravenes any provision of this Act, or contravenes any rule, regulation, notification, direction or order issued in exercise of the powers under this Act, or contravenes any condition subject to which an authorisation is issued by the Reserve Bank, he shall, upon adjudication, be liable to a penalty up to thrice the sum involved in such contravention where such amount is quantifiable, or up to two lakh rupees where the amount is not quantifiable, and where such contravention is a continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues.

¹[(1A) If any person is found to have acquired any foreign exchange, foreign security or immovable property, situated outside India, of the aggregate value exceeding the threshold prescribed under the proviso to sub-section (1) of section 37A, he shall be liable to a penalty up to three times the sum involved in such contravention and confiscation of the value equivalent, situated in India, the Foreign exchange, foreign security or immovable property.

(1B) If the Adjudicating Authority, in a proceeding under sub-section (1A) deems fits, he may, after recording the reasons in writing, recommend for the initiation of prosecution and if the Director of Enforcement is satisfied, he may, after recording the reasons in writing, may direct prosecution by filing a Criminal Complaint against the guilty person by an officer not below the rank of Assistant Director.

(1C) If any person is found to have acquired any foreign exchange, foreign security or immovable property, situated outside India, of the aggregate value exceeding the threshold prescribed under the proviso to sub-section (1) of section 37A, he shall be, in addition to the penalty imposed under sub-section (1A), punishable with imprisonment for a term which may extend to five years and with fine.

(1D) No court shall take cognizance of an offence under sub-section (1C) of section 13 except as on complaint in writing by an officer not below the rank of Assistant Director referred to in sub-section (1B).]

- (2) Any Adjudicating Authority adjudging any contravention under sub-section (1), may, if he thinks fit in addition to any penalty which he may impose for such contravention direct that any currency, security or any other money or property in respect of which the contravention has taken place shall be confiscated to the Central Government and further direct that the foreign exchange holdings, if any, of the persons committing the contraventions or any part thereof, shall be brought back into India or shall be retained outside India in accordance with the

directions made in this behalf.

Explanation.—

For the purposes of this sub-section, “property” in respect of which contravention has taken place, shall include—

- (a) deposits in a bank, where the said property is converted into such deposits;
- (b) Indian currency, where the said property is converted into that currency; and
- (c) any other property which has resulted out of the conversion of that property.

2. Enforcement of the orders of Adjudicating Authority.—

- (1) Subject to the provisions of sub-section (2) of section 19, if any person fails to make full payment of the penalty imposed on him under section 13 within a period of ninety days from the date on which the notice for payment of such penalty is served on him, he shall be liable to civil imprisonment under this section.
- (2) No order for the arrest and detention in civil prison of a defaulter shall be made unless the Adjudicating Authority has issued and served a notice upon the defaulter calling upon him to appear before him on the date specified in the notice and to show cause why he should not be committed to the civil prison, and unless the Adjudicating Authority, for reasons in writing, is satisfied—
 - (a) that the defaulter, with the object or effect of obstructing the recovery of penalty, has after the issue of notice by the Adjudicating Authority, dishonestly transferred, concealed, or removed any part of his property, or
 - (b) that the defaulter has, or has had since the issuing of notice by the Adjudicating Authority, the means to pay the arrears or some substantial part thereof and refuses or neglects or has refused or neglected to pay the same.
- (3) Notwithstanding anything contained in sub-section (1), a warrant for the arrest of the defaulter may be issued by the Adjudicating Authority if the Adjudicating Authority is satisfied, by affidavit or otherwise, that with the object or effect of delaying the execution of the certificate the defaulter is likely to abscond or leave the local limits of the jurisdiction of the Adjudicating Authority.
- (4) Where appearance is not made pursuant to a notice issued and served under sub-section (1), the Adjudicating Authority may issue a warrant for the arrest of the defaulter.
- (5) A warrant of arrest issued by the Adjudicating Authority under sub-section (3) or sub-section (4) may also be executed by any other Adjudicating Authority within whose jurisdiction the defaulter may for the time being be found.

- (6) Every person arrested in pursuance of a warrant of arrest under this section shall be brought before the Adjudicating Authority issuing the warrant as soon as practicable and in any event within twenty-four hours of his arrest (exclusive of the time required for the journey):

Provided that, if the defaulter pays the amount entered in the warrant of arrest as due and the costs of the arrest to the officer arresting him, such officer shall at once release him.

Explanation.—

For the purposes of this sub-section, where the defaulter is a Hindu undivided family, the *karta* thereof shall be deemed to be the defaulter.

- (7) When a defaulter appears before the Adjudicating Authority pursuant to a notice to show cause or is brought before the Adjudicating Authority under this section, the Adjudicating Authority shall give the defaulter an opportunity showing cause why he should not be committed to the civil prison.
- (8) Pending the conclusion of the inquiry, the Adjudicating Authority may, in his discretion, order the defaulter to be detained in the custody of such officer as the Adjudicating Authority may think fit or release him on his furnishing the security to the satisfaction of the Adjudicating Authority for his appearance as and when required.
- (9) Upon the conclusion of the inquiry, the Adjudicating Authority may make an order for the detention of the defaulter in the civil prison and shall in that event cause him to be arrested if he is not already under arrest:

Provided that in order to give a defaulter an opportunity of satisfying the arrears, the Adjudicating Authority may, before making the order of detention, leave the defaulter in the custody of the officer arresting him or of any other officer for a specified period not exceeding fifteen days, or release him on his furnishing security to the satisfaction of the Adjudicating Authority for his appearance at the expiration of the specified period if the arrears are not satisfied...

- (10) When the Adjudicating Authority does not make an order of detention under sub-section (9), he shall, if the defaulter is under arrest, direct his release.
- (11) Every person detained in the civil prison in execution of the certificate may be so detained,—
- (a) where the certificate is for a demand of an amount exceeding rupees one crore, up to three years, and
- (b) in any other case, up to six months:

Provided that he shall be released from such detention on the amount mentioned in the warrant for his detention being paid to the officer-in-

charge of the civil prison.

- (12) A defaulter released from detention under this section shall not, merely by reason of his release, be discharged from his liability for the arrears, but he shall not be liable to be arrested under the certificate in execution of which he was detained in the civil prison.
- (13) A detention order may be executed at any place in India in the manner provided for the execution of warrant of arrest under the Code of Criminal Procedure, 1973 (2 of 1974).
- (14) Power of recover arrears of penalty .
- (1) Save as otherwise provided in this Act, the Adjudicating Authority may, by order in writing, authorise an officer of Enforcement not below the rank of Assistant Director to recover any arrears of penalty from any person who fails to make full payment of penalty imposed on him under section 13 within the period of ninety days from the date on which the notice for payment of such penalty is served on him.
- (2) The officer referred to in sub-section (1) shall exercise all the like powers which are conferred on the income-tax authority in relation to recovery of tax under the Income-tax Act, 1961 (43 of 1961) and the procedure laid down under the Second Schedule to the said Act shall *mutatis mutandis* apply in relation to recovery of arrears of penalty under this Act.]

3. Power to compound contravention :

- (1) Any contravention under section 13 may, on an application made by the person committing such contravention, be compounded within one hundred and eighty days from the date of receipt of application by the Director of Enforcement or such other officers of the Directorate of Enforcement and officers of the Reserve Bank as may be authorised in this behalf by the Central Government in such manner as may be prescribed.
- (2) Where a contravention has been compounded under sub-section (1), no proceeding or further proceeding, as the case may be, shall be initiated or continued, as the case may be, against the person committing such contravention under that section, in respect of the contravention so compounded.

11.5 ADJUDICATION AND APPEAL :

1. Appointment of Adjudicating Authority.—

- (1) For the purpose of adjudication under section 13, the Central Government may, by an order published in the Official Gazette, appoint as many officers of the Central Government as it may think fit, as the Adjudicating Authorities for holding an inquiry in the manner prescribed after giving the person alleged to have committed contravention under section 13, against whom a complaint has

been made under sub-section (3) (hereinafter in this section referred to as the said person) a reasonable opportunity of being heard for the purpose of imposing any penalty :

Provided that where the Adjudicating Authority is of opinion that the said person is likely to abscond or is likely to evade in any manner, the payment of penalty, if levied, it may direct the said person to furnish a bond or guarantee for such amount and subject to such conditions as it may deem fit.

- (2) The Central Government shall, while appointing the Adjudicating Authorities undersub-section (1), also specify in the order published in the Official Gazette, their respective jurisdictions.
- (3) No Adjudicating Authority shall hold an enquiry under sub-section (1) except upon a complaint in writing made by any officer authorised by a general or special order by the Central Government.
- (4) The said person may appear either in person or take the assistance of a legal practitioner or a chartered accountant of his choice for presenting his case before the Adjudicating Authority.
- (5) Every Adjudicating Authority shall have the same powers of a civil court which are conferred on the Appellate Tribunal under sub-section (2) of section 28 and—
 - (a) all proceedings before it shall be deemed to be judicial proceedings within the meaning of sections 193 and 228 of the Indian Penal Code (45 of 1860);
 - (b) shall be deemed to be a civil court for the purposes of sections 345 and 346 of the Code of Criminal Procedure, 1973 (2 of 1974).
- (6) Every Adjudicating Authority shall deal with the complaint under sub-section (2) as expeditiously as possible and endeavour shall be made to dispose of the complaint finally within one year from the date of receipt of the complaint:

Provided that where the complaint cannot be disposed of within the said period, the Adjudicating Authority shall record periodically the reasons in writing for not disposing of the complaint within the said period.

2. Appeal to Special Director (Appeals).—

- (1) The Central Government shall, by notification, appoint one or more Special Directors (Appeals) to hear appeals against the orders of the Adjudicating Authorities under this section and shall also specify in the said notification the matter and places in relation to which the Special Director (Appeals) may exercise jurisdiction.
- (2) Any person aggrieved by an order made by the Adjudicating Authority, being an Assistant Director of Enforcement or a Deputy Director of Enforcement, may prefer an appeal to the Special Director (Appeals).

- (3) Every appeal under sub-section (1) shall be filed within forty-five days from the date on which the copy of the order made by the Adjudicating Authority is received by the aggrieved person and it shall be in such form, verified in such manner and be accompanied by such fee as may be prescribed:

Provided that the Special Director (Appeals) may entertain an appeal after the expiry of the said period of forty-five days, if he is satisfied that there was sufficient cause for not filing it within that period.

- (4) On receipt of an appeal under sub-section (1), the Special Director (Appeals) may after giving the parties to the appeal an opportunity of being heard, pass such order thereon as he thinks fit, confirming, modifying or setting aside the order appealed against.
- (5) The Special Director (Appeals) shall send a copy of every order made by him to the parties to appeal and to the concerned Adjudicating Authority.
- (6) The Special Director (Appeals) shall have the same powers of a civil court which are conferred on the Appellate Tribunal under sub-section (2) of section 28 and—
- (a) all proceedings before him shall be deemed to be judicial proceedings within the meaning of sections 193 and 228 of the Indian Penal Code (45 of 1860);
 - (b) shall be deemed to be a civil court for the purposes of sections 345 and 346 of the Code of Criminal Procedure, 1973 (2 of 1974).

3. Appellate Tribunal.—

The Appellate Tribunal constituted under sub-section (1) of section 12 of the Smugglers and Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976 (13 of 1976), shall, on and from the commencement of Part XIV of Chapter VI of the Finance Act, 2017 (7 of 2017), be the Appellate Tribunal for the purposes of this Act and the said Appellate Tribunal shall exercise the jurisdiction, powers and authority conferred on it by or under this Act.]

4. Appeal to Appellate Tribunal—

- (1) Save as provided in sub-section (2), the Central Government or any person aggrieved by an order made by an Adjudicating Authority, other than those referred to in sub-section (1) of section 17, or the Special Director (Appeals), may prefer an appeal to the Appellate Tribunal :

Provided that any person appealing against the order of the Adjudicating Authority or the Special Director (Appeals) levying any penalty, shall while filing the appeal, deposit the amount of such penalty with such authority as may be notified by the Central Government:

Provided further that where in any particular case, the Appellate Tribunal is of the opinion that the deposit of such penalty would cause undue hardship to such person, the Appellate Tribunal may dispense with such deposit subject to such

conditions as it may deem fit to impose so as to safeguard the realisation of penalty.

- (2) Every appeal under sub-section (1) shall be filed within a period of forty-five days from the date on which a copy of the order made by the Adjudicating Authority or the Special Director (Appeals) is received by the aggrieved person or by the Central Government and it shall be in such form, verified in such manner and be accompanied by such fee as may be prescribed:

Provided that the Appellate Tribunal may entertain an appeal after the expiry of the said period of forty-five days if it is satisfied that there was sufficient cause for not filing it within that period.

- (3) On receipt of an appeal under sub-section (1), the Appellate Tribunal may, after giving the parties to the appeal an opportunity of being heard, pass such orders thereon as it thinks fit, confirming, modifying or setting aside the order appealed against.
- (4) The Appellate Tribunal shall send a copy of every order made by it to the parties to the appeal and to the concerned Adjudicating Authority or the Special Director (Appeals), as the case may be.
- (5) The appeal filed before the Appellate Tribunal under sub-section (1) shall be dealt with by it as expeditiously as possible and endeavour shall be made by it to dispose of the appeal finally within one hundred and eighty days from the date of receipt of the appeal:

Provided that where any appeal could not be disposed of within the said period of one hundred and eighty days, the Appellate Tribunal shall record its reasons in writing for not disposing off the appeal within the said period.

- (6) The Appellate Tribunal may, for the purpose of examining the legality, propriety or correctness of any order made by the Adjudicating Authority under section 16 in relation to any proceeding, on its own motion or otherwise, call for the records of such proceedings and make such order in the case as it thinks fit.

5. **[Composition of Appellate Tribunal.]** *Omitted by the finance Act, 2017 (7 of 2017), s. 165(w.e.f. 26-5-2017).*

6. **Qualifications, for appointment of Special Director (Appeals).**

—A person shall not be qualified for appointment as a Special Director (Appeals) unless he—

- a. has been a member of the Indian Legal Service and has held a post in Grade I of that Service; or
- b. has been a member of the Indian Revenue Service and has held a post equivalent to a Joint Secretary to the Government of India.]

7. **[Term of office.]** *Omitted by the Finance Act, 2017 (7 of 2017), s. 165 (w.e.f. 26-5-*

2017).

8. Terms and Condition of service of Special Director of (Appeals).—

The salary and allowances payable to and the other terms and conditions of service of the Special Director (Appeals) shall be such as may be prescribed.]

[Vacancies.] *Omitted by the Finance Act, 2017 (7 of 2017), s. 165 (w.e.f. 26-5-2017).*

[Resignation and removal.] *Omitted by s. 165, ibid. (w.e.f. 26-5-2017).*

[Member to act as Chairperson in certain circumstances.] *Omitted by s. 165, ibid. (w.e.f. 26-5-2017).*

9. Staff of Special Director (Appeal).—

- (1) The Central Government shall provide the office of the Special Director (Appeals) with such officers and employees as it may deem fit.
- (2) The officers and employees of the office of the Special Director (Appeals) shall discharge their functions under the general superintendence of the Special Director (Appeals).
- (3) The salaries and allowances and other terms and conditions of service of the officers and employees of the office of the Special Director (Appeals) shall be such as may be prescribed.]

10. Procedure and powers of Appellate Tribunal and Special Director (Appeals).—

- (1) The Appellate Tribunal and the Special Director (Appeals) shall not be bound by the procedure laid down by the Code of Civil Procedure, 1908 (5 of 1908), but shall be guided by the principles of natural justice and, subject to the other provisions of this Act, the Appellate Tribunal and the Special Director (Appeals) shall have powers to regulate its own procedure.
- (2) The Appellate Tribunal and the Special Director (Appeals) shall have, for the purposes of discharging its functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), while trying a suit, in respect of the following matters, namely:—
 - (a) summoning and enforcing the attendance of any person and examining him on oath;
 - (b) requiring the discovery and production of documents;
 - (c) receiving evidence on affidavits;
 - (d) subject to the provisions of sections 123 and 124 of the Indian Evidence Act, 1872 (1 of 1872), requisitioning any public record or document or copy of such record or document from any office;
 - (e) issuing commissions for the examination of witnesses or documents;

- (f) reviewing its decisions;
 - (g) dismissing a representation of default or deciding it *ex parte*;
 - (h) setting aside any order of dismissal of any representation for default or any order passed by it *ex parte*; and
 - (i) any other matter which may be prescribed by the Central Government.
- (3) An order made by the Appellate Tribunal or the Special Director (Appeals) under this Act shall be executable by the Appellate Tribunal or the Special Director (Appeals) as a decree of civil court and, for this purpose, the Appellate Tribunal and the Special Director (Appeals) shall have all the powers of a civil court.
- (4) Notwithstanding anything contained in sub-section (3), the Appellate Tribunal or the Special Director (Appeals) may transmit any order made by it to a civil court having local jurisdiction and such civil court shall execute the order as if it were a decree made by that court.
- (5) All proceedings before the Appellate Tribunal and the Special Director (Appeals) shall be deemed to be judicial proceedings within the meaning of sections 193 and 228 of the Indian Penal Code (45 of 1860) and the Appellate Tribunal shall be deemed to be a civil court for the purposes of sections 345 and 346 of the Code of Criminal Procedure, 1973 (2 of 1974).

11. [Distribution of business amongst Benches.]

Omitted by the Finance Act, 2017 (7 of 2017), s. 165 (w.e.f. 26-5-2017).

12. [Power of Chairperson to transfer cases.]

Omitted by s. 165, ibid. (w.e.f. 26-5-2017).

13. [Decision to be by majority.]

Omitted by s. 165, ibid. (w.e.f. 26-5-2017).

14. Right of appellant to take assistance of legal practitioner or chartered accountant and of Government, to appoint presenting officers.—

- (1) A person preferring an appeal to the ¹[Special Director (Appeals)] under this Act may either appear in person or take the assistance of a legal practitioner or a chartered accountant of his choice to present his case before the ²[Special Director (Appeals)].
- (2) The Central Government may authorise one or more legal practitioners or chartered accountants or any of its officers to act as presenting officers and every person so authorised may present the case with respect to any appeal before the ²[Special Director (Appeals)]. ³[33. Officers and employees etc., to be public servant. — The Adjudicating Authority, Competent Authority and the Special Director (Appeals) and other officers and employees of the Special

Director (Appeals) shall be deemed to be public servants within the meaning of section 21 of the Indian Penal Code, 1860 (45 of 1860).]

15. Civil court not to have jurisdiction.—

No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which an Adjudicating Authority or the Appellate Tribunal or the Special Director (Appeals) is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act.

16. Appeal to High Court.—

Any person aggrieved by any decision or order of the Appellate Tribunal may file an appeal to the High Court within sixty days from the date of communication of the decision or order of the Appellate Tribunal to him on any question of law arising out of such order:

Provided that the High Court may, if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days.

Explanation.—

In this section “High Court” means—

- (a) the High Court within the jurisdiction of which the aggrieved party ordinarily resides or carries on business or personally works for gain; and
- (b) where the Central Government is the aggrieved party, the High Court within the jurisdiction of which the respondent, or in a case where there are more than one respondent, any of the respondents, ordinarily resides or carries on business or personally works for gain.

11.6 DIRECTORATE OF ENFORCEMENT :

1. Directorate of Enforcement.—

- (1) The Central Government shall establish a Directorate of Enforcement with a Director and such other officers or class of officers as it thinks fit, who shall be called officers of Enforcement, for the purposes of this Act.
- (2) Without prejudice to the provisions of sub-section (1), the Central Government may authorise the Director of Enforcement or an Additional Director of Enforcement or a Special Director of Enforcement or a Deputy Director of Enforcement to appoint officers of Enforcement below the rank of an Assistant Director of Enforcement.
- (3) Subject to such conditions and limitations as the Central Government may impose, an officer of Enforcement may exercise the powers and discharge the duties conferred or imposed on him under this Act.

2. Power of search, seizure, etc.—

- (1) The Director of Enforcement and other officers of Enforcement, not below the rank of an Assistant Director, shall take up for investigation the contravention referred to in section 13.
- (2) Without prejudice to the provisions of sub-section (1), the Central Government may also, by notification, authorise any officer or class of officers in the Central Government, State Government or the Reserve Bank, not below the rank of an Under Secretary to the Government of India to investigate any contravention referred to in section 13.
- (3) The officers referred to in sub-section (1) shall exercise the like powers which are conferred on income-tax authorities under the Income-tax Act, 1961 (43 of 1961) and shall exercise such powers, subject to such limitations laid down under that Act.

¹[37A. Special provisions relating to assets held outside India in contravention of section 4.—

- (1) Upon receipt of any information or otherwise, if the Authorised Officer prescribed by the Central Government has reason to believe that any foreign exchange, foreign security, or any immovable property, situated outside India, is suspected to have been held in contravention of section 4, he may after recording the reasons in writing, by an order, seize value equivalent, situated within India, of such foreign exchange, foreign security or immovable property:

Provided that no such seizure shall be made in case where the aggregate value of such foreign exchange, foreign security or any immovable property, situated outside India, is less than the value as may be prescribed.

- (2) The order of seizure along with relevant material shall be placed before the Competent Authority, appointed by the Central Government, who shall be an officer not below the rank of Joint Secretary to the Government of India by the Authorised Officer within a period of thirty days from the date of such seizure.
- (3) The Competent Authority shall dispose of the petition within a period of one hundred eighty days from the date of seizure by either confirming or by setting aside such order, after giving an opportunity of being heard to the representatives of the Directorate of Enforcement and the aggrieved person.

Explanation.—

While computing the period of one hundred eighty days, the period of stay granted by court shall be excluded and a further period of at least thirty days shall be granted from the date of communication of vacation of such stay

order.

- (4) The order of the Competent Authority confirming seizure of equivalent asset shall continue till the disposal of adjudication proceedings and thereafter, the Adjudicating Authority shall pass appropriate directions in the adjudication order with regard to further action as regards the seizure made under sub-section (1) :

Provided that if, at any stage of the proceedings under this Act, the aggrieved person discloses the fact of such foreign exchange, foreign security or immovable property and brings back the same into India, then the Competent Authority or the Adjudicating Authority, as the case may be, on receipt of an application in this regard from the aggrieved person, and after affording an opportunity of being heard to the aggrieved person and representatives of the Directorate of Enforcement, shall pass an appropriate order as it deems fit, including setting aside of the seizure made under sub-section (1).

- (5) Any person aggrieved by any order passed by the Competent Authority may prefer an appeal to the Appellate Tribunal.
- (6) Nothing contained in section 15 shall apply to this section.]

3. Empowering other officers.—

- (1) The Central Government may, by order and subject to such conditions and limitations as it thinks fit to impose, authorise any officer of customs or any central excise officer or any police officer or any other officer of the Central Government or a State Government to exercise such of the powers and discharge such of the duties of the Director of Enforcement or any other officer of Enforcement under this Act as may be stated in the order.
- (2) The officers referred to in sub-section (1) shall exercise the like powers which are conferred on the income-tax authorities under the Income-tax Act, 1961 (43 of 1961), subject to such conditions and limitations as the Central Government may impose.

11.7 MISCELLANEOUS :

1. Presumption as to documents in certain cases.—Where any document—

- (1) is produced or furnished by any person or has been seized from the custody or control of any person, in either case, under this Act or under any other law; or
- (2) has been received from any place outside India (duly authenticated by such authority or person and in such manner as may be prescribed) in the course of investigation of any contravention under this Act alleged to have been committed by any person, and such document is tendered in any proceeding under this Act in evidence against him, or against him and any other person who is proceeded against jointly with him, the court or the Adjudicating Authority,

as the case may be, shall—

- (a) presume, unless the contrary is proved, that the signature and every other part of such document which purports to be in the handwriting of any particular person or which the court may reasonably assume to have been signed by, or to be in the handwriting of, any particular person, is in that person's handwriting, and in the case of a document executed or attested, that it was executed or attested by the person by whom it purports to have been so executed or attested;
- (b) admit the document in evidence notwithstanding that it is not duly stamped, if such document is otherwise admissible in evidence;
- (c) in a case falling under clause (i), also presume, unless the contrary is proved, the truth of the contents of such document.

(2) Suspension of operation of this Act.—

- (1) If the Central Government is satisfied that circumstances have arisen rendering it necessary that any permission granted or restriction imposed by this Act should cease to be granted or imposed, or if it considers necessary or expedient so to do in public interest, the Central Government may, by notification, suspend or relax to such extent either indefinitely or for such period as may be notified, the operation of all or any of the provisions of this Act.
- (2) Where the operation of any provision of this Act has under sub-section (1) been suspended or relaxed indefinitely, such suspension or relaxation may, at any time while this Act remains in force, be removed by the Central Government by notification.
- (3) Every notification issued under this section shall be laid, as soon as may be after it is issued, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the notification or both Houses agree that the notification should not be issued, the notification shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that notification.

(3) Power of Central Government to give directions.—

For the purposes of this Act, the Central Government may, from time to time, give to the Reserve Bank such general or special directions as it thinks fit, and the Reserve Bank shall, in the discharge of its functions under this Act, comply with any such directions.

(4) Contravention by companies.—

- (1) Where a person committing a contravention of any of the provisions of this Act or of any rule, direction or order made thereunder is a company, every person who, at the time the contravention was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company as well as the company, shall be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly:

Provided that nothing contained in this sub-section shall render any such person liable to punishment if he proves that the contravention took place without his knowledge or that he exercised due diligence to prevent such contravention.

- (2) Notwithstanding anything contained in sub-section (1), where a contravention of any of the provisions of this Act or of any rule, direction or order made thereunder has been committed by a company and it is proved that the contravention has taken place with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly.

Explanation.—

For the purposes of this section—

- (i) “company” means any body corporate and includes a firm or other association of individuals; and
- (ii) “director”, in relation to a firm, means a partner in the firm.

(5) Death or insolvency in certain cases.—

Any right, obligation, liability, proceeding or appeal arising in relation to the provisions of section 13 shall not abate by reason of death or insolvency of the person liable under that section and upon such death or insolvency such rights and obligations shall devolve on the legal representative of such person or the official receiver or the official assignee, as the case may be:

Provided that a legal representative of the deceased shall be liable only to the extent of the inheritance or estate of the deceased.

(6) Bar of legal proceedings.—

No suit, prosecution or other legal proceeding shall lie against the Central Government or the Reserve Bank or any officer of that Government or of the Reserve Bank or any other person exercising any power or discharging any functions or performing any duties under this Act, for anything in good faith done or intended to be done under this Act or any rule, regulation, notification, direction or order made thereunder.

¹[44A. Powers of Reserve Bank not to apply to International Financial Services Centre.— Notwithstanding anything contained in any other law for the time being in force, the powers exercisable by the Reserve Bank under this Act,—

- (a) shall not extend to an International Financial Services Centre set up under sub-section (1) of section 18 of the Special Economic Zones Act, 2005 (28 of 2005);
- (b) shall be exercisable by the International Financial Services Centres Authority established under sub-section (1) of section 4 of the International Financial Services Centres Authority Act, 2019, in so far as regulation of financial products, financial services and financial institutions that are permitted in the International Financial Services Centres are concerned.]

(7) Removal of difficulties.—

- (1) If any difficulty arises in giving effect to the provisions of this Act, the Central Government may, by order, do anything not inconsistent with the provisions of this Act for the purpose of removing the difficulty:

Provided that no such order shall be made under this section after the expiry of two years from the commencement of this Act.

- (2) Every order made under this section shall be laid, as soon as may be after it is made, before each House of Parliament.

(8) Power to make rules.—

- (1) The Central Government may, by notification, make rules to carry out the provisions of this Act.
- (2) Without prejudice to the generality of the foregoing power, such rules may provide for,—
 - (a) the imposition of reasonable restrictions on current account transactions under section 5;
 - ¹[(aa) the instruments which are determined to be debt instruments under sub-section (7) of section 6;
 - (ab) the permissible classes of capital account transactions in accordance with sub-section (2A) of section 6, the limits of admissibility of foreign exchange, and the prohibition, restriction or regulation of such transactions;]
 - (b) the manner in which the contravention may be compounded under sub-section (1) of section 15;
 - (c) the manner of holding an inquiry by the Adjudicating Authority under sub-section (1) of section 16;
 - (d) the form of appeal and fee for filing such appeal under sections 17 and 19;
 - (e) the salary and allowances payable to and the other terms and

conditions of service of the ²[Special Director (Appeals)] under section 23;

- (f) the salaries and allowances and other conditions of service of the officers and employees of the

³[office of the Special Director (Appeals)] under sub-section (3) of section 27;

- (g) the additional matters in respect of which the Appellate Tribunal and the Special Director (Appeals) may exercise the powers of a civil court under clause (i) of sub-section (2) of section 28;

⁴[(gg) the aggregate value of foreign exchange referred to in sub-section (1) of section 37A;]

- (h) the authority or person and the manner in which any document may be authenticated under clause (ii) of section 39; and

- (i) any other matter which is required to be, or may be, prescribed.

(9) Power to make regulations.—

- (1) The Reserve Bank may, by notification, make regulations to carry out the provisions of this Act and the rules made thereunder.

- (2) Without prejudice to the generality of the foregoing power, such regulations may provide for,—

⁵[(a) the permissible classes of capital account transactions involving debt instruments determined under sub-section (7) of section 6, the limits of admissibility of foreign exchange for such transactions, and the prohibition, restriction or regulation of such capital account transactions under section 6;]

- (b) the manner and the form in which the declaration is to be furnished under clause (a) of sub-section (1) of section 7; the period within which and the manner of repatriation of foreign exchange under section 8;

- (c) the limit up to which any person may possess foreign currency or foreign coins under clause (a) of section 9;

- (d) the class of persons and the limit up to which foreign currency account may be held or operated under clause (b) of section 9;

- (e) the limit up to which foreign exchange acquired may be exempted under clause (d) of section 9;

- (f) the limit up to which foreign exchange acquired may be retained under clause (e) of section 9;

¹[(ga) export, import or holding of currency or currency notes;]

- (g) any other matter which is required to be, or may be, specified.

²[(3) All regulations made by the Reserve Bank before the date on which

the provisions of this section are notified under section 6 and section 47 of this Act on capital account transactions, the regulation making power in respect of which now vests with the Central Government, shall continue to be valid, until amended or rescinded by the Central Government.]

(10) Rules and regulations to be laid before Parliament.—

Every rule and regulation made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or regulation, or both Houses agree that the rule or regulation should not be made, the rule or regulation shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule or regulation.

(11) Repeal and saving.—

- (1) The Foreign Exchange Regulation Act, 1973 (46 of 1973) is hereby repealed and the Appellate Board constituted under sub-section (1) of section 52 of the said Act (hereinafter referred to as the repealed Act) shall stand dissolved.
- (2) On the dissolution of the said Appellate Board, the person appointed as Chairman of the Appellate Board and every other person appointed as Member and holding office as such immediately before such date shall vacate their respective offices and no such Chairman or other person shall be entitled to claim any compensation for the premature termination of the term of his office or of any contract of service.
- (3) Notwithstanding anything contained in any other law for the time being in force, no court shall take cognizance of an offence under the repealed Act and no adjudicating officer shall take notice of any contravention under section 51 of the repealed Act after the expiry of a period of two years from the date of the commencement of this Act.
- (4) Subject to the provisions of sub-section (3) all offences committed under the repealed Act shall continue to be governed by the provisions of the repealed Act as if that Act had not been repealed.
- (5) Notwithstanding such repeal,—
 - (a) anything done or any action taken or purported to have been done or taken including any rule, notification, inspection, order or notice made or issued or any appointment, confirmation or declaration made or any license, permission, authorization or exemption granted or any document or instrument executed or any direction given under the Act hereby repealed shall, in so far as it is not inconsistent with the provisions of this Act,

be deemed to have been done or taken under the corresponding provisions of this Act;

- (b) any appeal preferred to the Appellate Board under sub-section (2) of section 52 of the repealed Act but not disposed of before the commencement of this Act shall stand transferred to and shall be disposed of by the Appellate Tribunal constituted under this Act;
- (c) every appeal from any decision or order of the Appellate Board under sub-section (3) or sub-section (4) of section 52 of the repealed Act shall, if not filed before the commencement of this Act, be filed before the High Court within a period of sixty days of such commencement:

Provided that the High Court may entertain such appeal after the expiry of the said period of sixty days if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period.

- (6) Save as otherwise provided in sub-section (3), the mention of particular matters in sub-sections (2), (4) and (5) shall not be held to prejudice or affect the general application of section 6 of the General Clauses Act, 1897 (10 of 1897) with regard to the effect of repeal.

11.8 SUMMARY :

Main Features of Foreign Exchange Management Act, 1999 (FEMA Act) It gives powers to the Central Government to regulate the flow of payments to and from a person situated outside the country. All financial transactions concerning foreign securities or exchange cannot be carried out without the approval of FEMA. Foreign exchange risk management is crucial for several reasons. Firstly, it helps businesses and individuals mitigate potential financial losses caused by unfavourable currency movements. Secondly, effective risk management enhances cash flow predictability and facilitates better budgeting and financial planning.

It is a set of regulations that empowers the Reserve Bank of India to pass regulations and enables the Government of India to pass rules relating to foreign exchange in tune with the foreign trade policy of India.

11.9 KEY WORDS :

Foreign Bonds :

Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

Foreign Deposits :

Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also Nostro Account.

Foreign Draft :

An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

G-7 (Group of Seven) :

A group of industrialized countries comprising Canada, France, Germany, Great Britain, Italy, Japan, and the U.S.

G-10 Countries :

The informal term for the Group of ten countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the U.S. Switzerland joined in 1984, but the name remains as is. Luxembourg is an associate member.

Global Bond :

A temporary debt certificate issued by a Eurobond borrower, representing the borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

Global Line :

A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis.

11.10 SELF ASSESSMENT QUESTIONS :

1. Write about foreign exchange management
2. Define authorized person
3. What are penalties

11.11 SUGGESTED READINGS :

1. The Foreign exchange management Act; S K SARVARIA APOORV SARVARIA
2. Foreign exchange management Dr. Manisha Paliwal
3. The Foreign exchange management act,1999 ; by PROFESSIONALBOOK PUBLISHERS.

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LESSON – 12

FOREIGN EXCHANGE RESERVES

Objectives :

After studying this lesson, the student be able to :

- understand the basic concept of foreign exchange reserves;
- provide necessary knowledge of foreign exchange theories;
- understand the Gold, SDRs and other matters.

Structure of the Lesson :

- 12.1 Introduction
- 12.2 Reserve Accumulation
- 12.3 Theories
- 12.4 History
- 12.5 Gold, SDRs and other matters
- 12.6 Summary
- 12.7 Key Words
- 12.8 Self Assessment Questions
- 12.9 Suggested Readings

12.1 INTRODUCTION :

Foreign exchange reserves (also called forex reserves or FX reserves) are cash and other reserve assets such as gold and silver held by a central bank or other monetary authority that are primarily available to balance payments of the country, influence the foreign exchange rate of its currency, and to maintain confidence in financial markets. Reserves are held in one or more reserve currencies, nowadays mostly the United States dollar and to a lesser extent the euro.[1]

Foreign exchange reserves assets can comprise banknotes, bank deposits, and government securities of the reserve currency, such as bonds and treasury bills.[2] Some countries hold a part of their reserves in gold, and special drawing rights are also considered reserve assets. Often, for convenience, the cash or securities are retained by the central bank of the reserve or other currency and the "holdings" of the foreign country are tagged or otherwise identified as belonging to the other country without them actually leaving the vault of that central bank. From time to time they may be physically moved to the home or another country.

Normally, interest is not paid on foreign cash reserves, nor on gold holdings, but the

central bank usually earns interest on government securities. The central bank may, however, profit from a depreciation of the foreign currency or incur a loss on its appreciation. The central bank also incurs opportunity costs from holding the reserve assets (especially cash holdings) and from their storage, security costs, etc.

Definition :

Foreign exchange reserves are also known as reserve assets and include foreign banknotes, foreign bank deposits, foreign treasury bills, and short and long-term foreign government securities, as well as gold reserves, special drawing rights (SDRs), and International Monetary Fund (IMF) reserve positions.

In a central bank's accounts, foreign exchange reserves are called reserve assets in the capital account of the balance of payments, and may be labeled as reserve assets under assets by functional category. In terms of financial assets classifications, reserve assets can be classified as gold bullion, unallocated gold accounts, special drawing rights, currency, reserve position in the IMF, interbank position, other transferable deposits, other deposits, debt securities, loans, stocks (listed and unlisted), investment fund shares and financial derivatives, such as forward contracts and options. There is no counterpart for reserve assets in liabilities of the International Investment Position. Usually, when the monetary authority of a country has some kind of liability, this will be included in other categories, such as Other Investments.[3] On a central bank's Balance sheet, foreign exchange reserves are assets, along with domestic credit.

Purpose :

Typically, one of the critical functions of a country's central bank is reserve management, to ensure that the central bank has control over adequate foreign assets to meet national objectives.

These objectives may include :

- Supporting and maintaining confidence in the national monetary and exchange rate management policies,
- Limiting external vulnerability to shocks during times of crisis or when access to borrowing is curtailed, and in doing so -
- Providing a level of confidence to markets,
- Demonstrating backing for the domestic currency,
- Assisting the government to meet its foreign exchange needs and external debt obligations, and
- Maintaining a reserve for potential national disasters or emergencies.
- Reserves assets allow a central bank to purchase the domestic currency, which is considered a liability for the central bank (since it prints the money or fiat currency as IOUs). Thus, the quantity of foreign exchange reserves can change as a central bank implements monetary policy, but this dynamic should be

analyzed generally in the context of the level of capital mobility, the exchange rate regime and other factors. This is known as trilemma or impossible trinity. Hence, in a world of perfect capital mobility, a country with fixed exchange rate would not be able to execute an independent monetary policy.

A central bank which chooses to implement a fixed exchange rate policy may face a situation where supply and demand would tend to push the value of the currency lower or higher (an increase in demand for the currency would tend to push its value higher, and a decrease lower) and thus the central bank would have to use reserves to maintain its fixed exchange rate. Under perfect capital mobility, the change in reserves is a temporary measure, since the fixed exchange rate attaches the domestic monetary policy to that of the country of the base currency. Hence, in the long term, the monetary policy has to be adjusted in order to be compatible with that of the country of the base currency. Without that, the country will experience outflows or inflows of capital. Fixed pegs were usually used as a form of monetary policy, since attaching the domestic currency to a currency of a country with lower levels of inflation should usually assure convergence of prices.

In a pure flexible exchange rate regime or floating exchange rate regime, the central bank does not intervene in the exchange rate dynamics; hence the exchange rate is determined by the market. Theoretically, in this case reserves are not necessary. Other instruments of monetary policy are generally used, such as interest rates in the context of an inflation targeting regime. Milton Friedman was a strong advocate of flexible exchange rates, since he considered that independent monetary (and in some cases fiscal) policy and openness of the capital account are more valuable than a fixed exchange rate. Also, he valued the role of exchange rate as a price. As a matter of fact, he believed that sometimes it could be less painful and thus desirable to adjust only one price (the exchange rate) than the whole set of prices of goods and wages of the economy, that are less flexible.

Mixed exchange rate regimes ('dirty floats', target bands or similar variations) may require the use of foreign exchange operations to maintain the targeted exchange rate within the prescribed limits, such as fixed exchange rate regimes. As seen above, there is an intimate relation between exchange rate policy (and hence reserves accumulation) and monetary policy. Foreign exchange operations can be sterilized (have their effect on the money supply negated via other financial transactions) or unsterilized.

Non-sterilization will cause an expansion or contraction in the amount of domestic currency in circulation, and hence directly affect inflation and monetary policy. For example, to maintain the same exchange rate if there is increased demand, the central bank can issue more of the domestic currency and purchase foreign currency, which will increase the sum of foreign reserves. Since (if there is no sterilization) the domestic money supply is increasing (money is being 'printed'), this may provoke domestic inflation. Also, some central banks may let the exchange rate appreciate to control inflation, usually by the channel of cheapening tradable goods.

Since the amount of foreign reserves available to defend a weak currency (a currency in low demand) is limited, a currency crisis or devaluation could be the result. For a currency

in very high and rising demand, foreign exchange reserves can theoretically be continuously accumulated, if the intervention is sterilized through open market operations to prevent inflation from rising. On the other hand, this is costly, since the sterilization is usually done by public debt instruments (in some countries Central Banks are not allowed to emit debt by themselves). In practice, few central banks or currency regimes operate on such a simplistic level, and numerous other factors (domestic demand, production and productivity, imports and exports, relative prices of goods and services, etc.) will affect the eventual outcome. Besides that, the hypothesis that the world economy operates under perfect capital mobility is clearly flawed.

As a consequence, even those central banks that strictly limit foreign exchange interventions often recognize that currency markets can be volatile and may intervene to counter disruptive short-term movements (that may include speculative attacks). Thus, intervention does not mean that they are defending a specific exchange rate level. Hence, the higher the reserves, the higher is the capacity of the central bank to smooth the volatility of the Balance of Payments and assure consumption smoothing in the long term.

12.2 RESERVE ACCUMULATION :

After the end of the Bretton Woods system in the early 1970s, many countries adopted flexible exchange rates. In theory reserves are not needed under this type of exchange rate arrangement; thus the expected trend should be a decline in foreign exchange reserves. However, the opposite happened and foreign reserves present a strong upward trend. Reserves grew more than gross domestic product (GDP) and imports in many countries. The only ratio that is relatively stable is foreign reserves over M2.[7] Below are some theories that can explain this trend.

12.3 THEORIES :

- **Signaling or vulnerability indicator :**

Credit risk agencies and international organizations use ratios of reserves to other external sector variables to assess a country's external vulnerability. For example, Article IV of 2013[8] uses total external debt to gross international reserves, gross international reserves in months of prospective goods and nonfactor services imports to broad money, broad money to short-term external debt, and short-term external debt to short-term external debt on residual maturity basis plus current account deficit. Therefore, countries with similar characteristics accumulate reserves to avoid negative assessment by the financial market, especially when compared to members of a peer group.

- **Precautionary aspect :**

Reserves are used as savings for potential times of crises, especially balance of payments crises. Original fears were related to the current account, but this gradually changed to also include financial account needs.[9] Furthermore, the creation of the IMF was viewed as a response to the need of countries to accumulate reserves. If a specific country is suffering from a balance of payments crisis, it would be able to borrow from the IMF. However, the process of obtaining resources from the Fund is not automatic, which can cause problematic

delays especially when markets are stressed. Therefore, the fund only serves as a provider of resources for longer term adjustments. Also, when the crisis is generalized, the resources of the IMF could prove insufficient. After the 2008 crisis, the members of the Fund had to approve a capital increase, since its resources were strained.[10] Moreover, after the 1997 Asian crisis, reserves in Asian countries increased because of doubt in the IMF reserves.[11] Also, during the 2008 crisis, the Federal Reserve instituted currency swap lines with several countries, alleviating liquidity pressures in dollars, thus reducing the need to use reserves.

- **External trade :**

Countries engaging in international trade, maintain reserves to ensure no interruption. A rule usually followed by central banks is to hold in reserve at least three months of imports. Also, an increase in reserves occurred when commercial openness increased (part of the process known as globalization). Reserve accumulation was faster than that which would be explained by trade, since the ratio has increased to several months of imports. Furthermore, the ratio of reserves to foreign trade is closely watched by credit risk agencies in months of imports.

- **Financial openness :**

The opening of a financial account of the balance of payments has been important during the last decade. Hence, financial flows such as direct investment and portfolio investment became more important. Usually financial flows are more volatile than enforce the necessity of higher reserves. Moreover, holding reserves, as a consequence of the increasing of financial flows, is known as Guidotti–Greenspan rule that states a country should hold liquid reserves equal to their foreign liabilities coming due within a year. For example, international wholesale financing relied more on Korean banks in the aftermath of the 2008 crisis, when the Korean Won depreciated strongly, because the Korean banks' ratio of short-term external debt to reserves was close to 100%, which exacerbated the perception of vulnerability.[12]

- **Exchange rate policy :**

Reserve accumulation can be an instrument to interfere with the exchange rate. Since the first General Agreement on Tariffs and Trade (GATT) of 1948 to the foundation of the World Trade Organization (WTO) in 1995, the regulation of trade is a major concern for most countries throughout the world. Hence, commercial distortions such as subsidies and taxes are strongly discouraged. However, there is no global framework to regulate financial flows. As an example of regional framework, members of the European Union are prohibited from introducing capital controls, except in an extraordinary situation. The dynamics of China's trade balance and reserve accumulation during the first decade of the 2000 was one of the main reasons for the interest in this topic. Some economists are trying to explain this behavior. Usually, the explanation is based on a sophisticated variation of mercantilism, such as to protect the take-off in the tradable sector of an economy, by avoiding the real exchange rate appreciation that would naturally arise from this process. One attempt[13] uses a standard model of open economy intertemporal consumption to show that it is possible to replicate a tariff on imports or a subsidy on exports by closing the capital account and

accumulating reserves. Another[14] is more related to the economic growth literature. The argument is that the tradable sector of an economy is more capital intense than the non-tradable sector. The private sector invests too little in capital, since it fails to understand the social gains of a higher capital ratio given by externalities (like improvements in human capital, higher competition, technological spillovers and increasing returns to scale). The government could improve the equilibrium by imposing subsidies and tariffs, but the hypothesis is that the government is unable to distinguish between good investment opportunities and rent-seeking schemes. Thus, reserves accumulation would correspond to a loan to foreigners to purchase a quantity of tradable goods from the economy. In this case, the real exchange rate would depreciate and the growth rate would increase. In some cases, this could improve welfare, since the higher growth rate would compensate the loss of the tradable goods that could be consumed or invested. In this context, foreigners have the role to choose only the useful tradable goods sectors.

- **Intergenerational savings :**

Reserve accumulation can be seen as a way of "forced savings". The government, by closing the financial account, would force the private sector to buy domestic debt for lack of better alternatives. With these resources, the government buys foreign assets. Thus, the government coordinates the savings accumulation in the form of reserves. Sovereign wealth funds are examples of governments that try to save the windfall of booming exports as long-term assets to be used when the source of the windfall is extinguished.

- **Costs :**

There are costs in maintaining large currency reserves. Fluctuations in exchange rates result in gains and losses in the value of reserves. In addition, the purchasing power of fiat money decreases constantly due to devaluation through inflation. Therefore, a central bank must continually increase the amount of its reserves to maintain the same power to manage exchange rates. Reserves of foreign currency may provide a small return in interest. However, this may be less than the reduction in purchasing power of that currency over the same period of time due to inflation, effectively resulting in a negative return known as the "quasi-fiscal cost". In addition, large currency reserves could have been invested in higher yielding assets.

Several calculations have been attempted to measure the cost of reserves. The traditional one is the spread between government debt and the yield on reserves. The caveat is that higher reserves can decrease the perception of risk and thus the government bond interest rate, so this measure can overstate the cost. Alternatively, another measure compares the yield in reserves with the alternative scenario of the resources being invested in capital stock to the economy, which is hard to measure. One interesting[7] measure tries to compare the spread between short term foreign borrowing of the private sector and yields on reserves, recognizing that reserves can correspond to a transfer between the private and the public sectors. By this measure, the cost can reach 1% of GDP to developing countries. While this is high, it should be viewed as an insurance against a crisis that could easily cost 10% of GDP to a country. In the context of theoretical economic models it is possible to simulate

economies with different policies (accumulate reserves or not) and directly compare the welfare in terms of consumption. Results are mixed, since they depend on specific features of the models.

A case to point out is that of the Swiss National Bank, the central bank of Switzerland. The Swiss franc is regarded as a safe haven currency, so it usually appreciates during market's stress. In the aftermath of the 2008 crisis and during the initial stages of the Eurozone crisis, the Swiss franc (CHF) appreciated sharply. The central bank resisted appreciation by buying reserves. After accumulating reserves during 15 months until June 2010, the SNB let the currency appreciate. As a result, the loss with the devaluation of reserves just in 2010 amounted to CHF 27 Billion or 5% of GDP (part of this was compensated by the profit of almost CHF6 Billion due to the surge in the price of gold).[15] In 2011, after the currency appreciated against the Euro from 1.5 to 1.1, the SNB announced a ceiling at the value of CHF 1.2. In the middle of 2012, reserves reached 71% of GDP.

12.4 HISTORY :

• **Origins and Gold Standard Era :**

The modern exchange market as tied to the prices of gold began during 1880. Of this year the countries significant by size of reserves were Austria-Hungary, Belgium, Canadian Confederation, Denmark, Grand Duchy of Finland, German Empire and Sweden-Norway.

Official international reserves, the means of official international payments, formerly consisted only of gold, and occasionally silver. But under the Bretton Woods system, the US dollar functioned as a reserve currency, so it too became part of a nation's official international reserve assets. From 1944 to 1968, the US dollar was convertible into gold through the Federal Reserve System, but after 1968 only central banks could convert dollars into gold from official gold reserves, and after 1973 no individual or institution could convert US dollars into gold from official gold reserves. Since 1973, no major currencies have been convertible into gold from official gold reserves. Individuals and institutions must now buy gold in private markets, just like other commodities. Even though US dollars and other currencies are no longer convertible into gold from official gold reserves, they still can function as official international reserves.

Central banks throughout the world have sometimes cooperated in buying and selling official international reserves to attempt to influence exchange rates and avert financial crisis. For example, in the Baring crisis (the "Panic of 1890"), the Bank of England borrowed GBP 2 million from the Bank of France.[18] The same was true for the Louvre Accord and the Plaza Accord in the post gold-standard era.

• **Post Gold Standard Era :**

Historically, especially before the 1997 Asian financial crisis, central banks had rather meager reserves (by today's standards) and were therefore subject to the whims of the market, of which there was accusations of hot money manipulation, however Japan was the exception. In the case of Japan, forex reserves began their ascent a decade earlier, shortly after the Plaza Accord in 1985, and were primarily used as a tool to weaken the surging

yen.[19] This effectively granted the United States a massive loan as they were almost exclusively invested in US Treasuries, which assisted the US to engage the Soviet Union in an arms race which ended with the latter's bankruptcy, and at the same time, turned Japan into the world's largest creditor and the US the largest debtor, as well as swelled Japan's domestic debt (Japan sold its own currency to fund the buildup of dollar based assets). By end of 1980, foreign assets of Japan were about 13% of GDP but by the end of 1989 had reached an unprecedented 62%.[19] After 1997, nations in East and Southeast Asia began their massive build-up of forex reserves, as their levels were deemed too low and susceptible to the whims of the market credit bubbles and busts. This build-up has major implications for today's developed world economy, by setting aside so much cash that was piled into US and European debt, investment had been crowded out, the developed world economy had effectively slowed to a crawl, giving birth to contemporary negative interest rates.[citation needed].

By 2007, the world had experienced yet another financial crisis, this time the US Federal Reserve organized central bank liquidity swaps with other institutions. Developed countries authorities adopted extra expansionary monetary and fiscal policies, which led to the appreciation of currencies of some emerging markets. The resistance to appreciation and the fear of lost competitiveness led to policies aiming to prevent inflows of capital and more accumulation of reserves. This pattern was called currency war by an exasperated Brazilian authority, and again in 2016 followed the commodities collapse, Mexico had warned China of triggering currency wars.

- **Adequacy and excess reserves :**

The IMF proposed a new metric to assess reserves adequacy in 2011.[21] The metric was based on the careful analysis of sources of outflow during crisis. Those liquidity needs are calculated taking in consideration the correlation between various components of the balance of payments and the probability of tail events. The higher the ratio of reserves to the developed metric, the lower is the risk of a crisis and the drop in consumption during a crisis. Besides that, the Fund does econometric analysis of several factors listed above and finds those reserves ratios are generally adequate among emerging markets.[citation needed]

Reserves that are above the adequacy ratio can be used in other government funds invested in more risky assets such as sovereign wealth funds or as insurance to time of crisis, such as stabilization funds. If those were included, Norway, Singapore and Persian Gulf States would rank higher on these lists, and United Arab Emirates' estimated \$627 billion Abu Dhabi Investment Authority would be second after China. Apart from high foreign exchange reserves, Singapore also has significant government and sovereign wealth funds including Temasek Holdings (last valued at US\$375 billion) and GIC (last valued at US\$440 billion).

ECN is a unique electronic communication network that links different participants of the Forex market: banks, centralized exchanges, other brokers and companies and private investors.

12.5 GOLD, SDRS AND OTHER MATTERS :

This is a short account of what I think we achieved at Washington DC consultation (April 2011) as well where I think we should be going. Our deliberations have been given greater urgency by what the Standard & Poor's said about the US debt and what has happened to the price of gold even in the short span of one week.

On gold we went over some familiar ground but also could see that it excites strong loyalties. There are several ideas about gold – as a monetary base on its own, as an addition to the SDRs to 'harden them, as a 'circuit breaker' which gives an early warning as to the impending dangers.

- **Gold as a monetary base :**

This is the option for those who want price stability. The appeal of gold is that it is 'no one's liability'. The tables presented at the consultation in Washington DC (April 2011) were designed to show the property of gold standard as the guarantee of price stability. Indeed, between the time Isaac Newton standardized the gold content of sterling at £3.19s.9d in 1660 (if I recall correctly) there was zero trend in the British price level till 1939. There were cycles of inflation – 1797–1815 (when the Bank of England went off gold and adopted paper currency during the French Wars), 1919–1921 (when Bank of England had again gone off the Gold Standard during the war; it did not return until 1924), with each episode followed by a sharp deflationary movement. There was also a long downward trend in prices in the second half of the 19th century, matched by an upsurge in the twenty years 1895-1914. But while the Gold Standard gives price stability, it sacrifices economic – income and employment – stability. The trade-off between price stability and income or employment stability is the Phillips Curve trade-off. Thus during the period 1861–1913, which was the original period for which A. W. Phillips fitted his famous Phillips Curve, there were six-and-a-half regular eight-year cycles of unemployment. Indeed the research in trade cycles began in the second half of the 19th century because crises and fluctuations in income/employment became quite regular. It was the Great Depression that was excessively deflationary and led to high and persistent unemployment for ten years and longer. It was then thought, by Keynes principally but by others as well, that gold as a monetary base had a deflationary bias. This idea has not gone away.

The Gold Exchange Standard was mooted by David Ricardo when the Bank of England went back on gold after 1815, but the Bank chose a full Gold Standard. Ricardo felt that the Bank could economize on gold stocks if it adopted the Gold Exchange Standard. It would make the money supply more flexible as long as some prudence was exercised when it came to assuring the convertibility of the currency. In the late 19th century Indian currency was based on this idea, which Keynes surveyed in his *Indian Currency and Finance*.¹ This was the standard adopted at Bretton Woods which then broke down in August 1971. The Gold-Dollar Exchange Standard is associated with a twenty-five year period of full employment and steady economic growth but it came to an end owing to inflationary pressures and a lack of fiscal discipline in the United States. The convertibility of the dollar

could not be guaranteed by the US. Since 1971 we have been on the dollar, a fiat currency serving *faute de mieux* as an international reserve currency. It will be impossible to revive the Gold Standard or even the Gold Exchange Standard.

- **Gold as SDR supplement :**

From what we were told about the SDRs, the idea that gold could be added to the four currencies currently comprising the SDR is legally a non-starter. Since SDRs are everyone's liability, and gold is not part of any currency's base, gold cannot be made part of SDRs as it cannot be collected when some country presents SDRs to a Central Bank.

Despite this legal barrier we must not give up exploring the case for gold at the global level. If the case makes economic sense then a legal basis can be explored. We should explore what changes would be necessary to the IMF articles if we are to 'lace' SDRs with a 'gold lining'. The purpose will be to make the SDRs a putative international currency which can be used as a means of payment and a store of value. Will this require allowing private holding of SDRs? Should we let SDRs be traded like any other currency on forex markets as they may be more stable than the component currencies? If, as per the Articles of the IMF, no country is allowed to base its currency on gold, can the IMF make SDRs its own liability and stand ready to exchange the SDRs for a combination of currencies and gold or all currencies converting gold at the prevailing market price? If so, will adding gold not help make SDRs worth holding as stores of value?

Parenthetically in the light of the Hainan Summit, should the BRICS currencies be seen as potential candidates for inclusion in the SDR in future? The 5 Rs – RMB, Rupee, Rouble, Real and Rand – are not yet ready but surely they are candidates knocking at the door. How would the SDR look if it had the five plus the old four? How do the 5 R's correlate in their movements with each other and with the SDR?

One argument about the IMF playing a bigger role in solving the problem of global imbalances is that if there were alternative sources to the dollar as places to park the surpluses in the privilege of the dollar as well as the pressure on the US to deliver stability would be that much less. One could even argue that it has been the flooding of surpluses into the T Bills which caused the conditions – cheap credit, malinvestments etc. – that led to the crisis of 2007–09.

How can this be done? Can the IMF become like a bank (not a Central Bank) and take deposits and lend them out to countries that may need them for investment? What changes would be necessary to the Articles of the IMF for this to happen?

Not all this may be legally feasible but if it makes economic sense then one can explore what needs to change to make it legally possible.

- **Gold as a circuit breaker :**

This does not require any legal move at all and is happening right now. The price of gold is a sort of bellwether as it reflects the uneasiness in the market about the fragility of currencies. The question is, can this role be given any official sanction?

12.6 SUMMARY :

Foreign exchange reserves (also called forex reserves or FX reserves) are cash and other reserve assets such as gold and silver held by a central bank or other monetary authority that are primarily available to balance payments of the country, influence the foreign exchange rate of its currency, and to maintain confidence in financial markets. Reserves are held in one or more reserve currencies, nowadays mostly the United States dollar and to a lesser extent the euro.

Foreign exchange reserves assets can comprise banknotes, bank deposits, and government securities of the reserve currency, such as bonds and treasury bills.[2] Some countries hold a part of their reserves in gold, and special drawing rights are also considered reserve assets. Often, for convenience, the cash or securities are retained by the central bank of the reserve or other currency and the "holdings" of the foreign country are tagged or otherwise identified as belonging to the other country without them actually leaving the vault of that central bank. From time to time they may be physically moved to the home or another country. Normally, interest is not paid on foreign cash reserves, nor on gold holdings, but the central bank usually earns interest on government securities. The central bank may, however, profit from a depreciation of the foreign currency or incur a loss on its appreciation. The central bank also incurs opportunity costs from holding the reserve assets (especially cash holdings) and from their storage, security costs, etc.

12.7 KEY WORDS :

International Banking Act of 1978 (IBA) :

The principal legislation pertaining to the activities of foreign banks in the U.S. It established a regulatory framework for foreign banks operating in the U.S.

International Banking Facility :

A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency or a foreign bank, or an Edge Act or agreement corporation. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. IBFs may receive certain tax advantages from individual states.

International Monetary Fund (IMF) :

A specialized agency of the United Nations. It encourages monetary cooperation, establishes international standards for a currency exchange policy, promotes stable foreign exchange rates among member nations, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. In some cases, the IMF advances money subject to conditions that must be met by the borrowing country. Its resources come mainly from subscriptions of members.

International Money Market of the Chicago Mercantile Exchange (IMM) :

The IMM is one of the world's largest markets for foreign currency and Eurodollar futures trading.

Letter of Credit (Cash) :

A letter addressed from one bank to one or more correspondent banks making available to the party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

Letter of Credit (Commercial) :

A letter of credit addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

12.8 SELF ASSESSMENT QUESTIONS :

1. Define Foreign Exchange Reserves
2. What Are The Theories Of Foreign Exchange
3. Describe The Gold, Sdrs And Other Matters

12.9 SUGGESTED READINGS :

1. Foreign exchange management Dr. Manisha Paliwal.
2. The Foreign exchange management act,1999; by PROFESSIONALBOOK PUBLISHERS.
3. OECD (Organisation for Economic Cooperation and Development) 1996, Benchmark Definition of Foreign Direct Investment, 3rd Edition, Paris.

A.S.Kalyani

LESSON – 13

Current and Capital Account Convertibility in India

Objectives :

After studying this lesson, the student be able to :

- To understand the basic concept of capital and current account convertibility
- To provide necessary knowledge of different accounts
- To understand their difference

Structure of the Lesson :

- 13.1 Introduction
- 13.2 Capital Account Convertibility
- 13.3 Current Account Convertibility
- 13.4 Difference Between Current Account And Capital Account
- 13.5 Summary
- 13.6 Key Words
- 13.7 Self Assessment Questions
- 13.8 Suggested Readings

13.1 INTRODUCTION :

Currency convertibility plays a major role in the economy of the country. Convertibility refers to the relative ease with which the currency can be converted into other assets.

Current Account Convertibility refers to the freedom to convert the currency into another currency for the purpose of international trade in goods and services (and other invisibles like transfer payments/income from investment).

Capital Account Convertibility refers to the freedom to convert the currency into another currency for the purpose of investment in assets (like financial assets).

As movement of goods/services and investments in assets hold significant importance in the functioning of the economy, currency convertibility is crucial for economic development.

● Background :

The Indian Rupee was linked to the British Pound in the pre-Independence period. After World War II was over and the Bretton Woods System was set up, the Indian Rupee was pegged to the US Dollar (and Gold under the Gold Standard). The value of the Indian

Rupee remained fairly constant till the mid-1960s. During this period, India had a high dependence on foreign economies for the supply of goods for domestic consumption. The Government also borrowed from abroad for meeting its own expenses. Two wars in the first half of the 1960s (Indo-China, 1962 and Indo-Pak, 1965 wars) coupled with drought in 1966 resulted in high inflation and price rise. Higher inflation had further deteriorated India's already negative foreign trade (higher imports and lower exports). The Government was also running a consistent fiscal deficit since the 1950s (high expenditure on Infrastructure in the Second Year Plan). The prevalence of twin deficits made it difficult for the Government to borrow from abroad because of high debt levels (due to consistent deficit).

When the foreign Governments refused to lend or provide aid to India till India reduced the domestic restrictions on the foreign trade, the Government of India was left with no other option but to devalue the Indian Rupee in 1966. The 1965 war was a major factor in devaluation as war had increased the Government's budget deficit (Defence Spending was 24% of the total expenditure in 1965–66) and the US had stopped aid in the wake of the war. In June 1966, Rupee was devalued from INR 4.76/USD to INR 7.5/USD (INR was devalued by 57.5%)

This exchange rate was maintained till 1971. After the Bretton Woods System broke down in 1971, India pegged its currency to the British Pound Sterling. In 1975, the Indian Rupee was pegged to a basket of currencies in order to ensure stability of the currency and avoid risks associated with a single currency peg. The system continued till 1991.

- **Overview :**

The Balance of Payment Crisis of 1991 again necessitated another devaluation in 1991. The Rupee was devalued in two steps; 9% on July 1, 1991 and another 11% on July 3, 1991.

In March 1992, the Liberalized Exchange Rate Management System was introduced as a step towards transition to a market determined exchange rate system. LERMS was a scheme to gradually liberalize the exchange rate markets; as a move towards immediate full convertibility could have led to instability just as India was emerging from the crisis of 1991.

Under the LERMS the Rupee was made partially convertible. LERMS introduced a dual exchange rate system. 40% of the foreign exchange earnings through exports and remittances were purchased at the official exchange rate determined by the RBI. The 40% of the purchases were to be submitted to the RBI at the official exchange rate to improve the Foreign Exchange Reserves as well as for financing imports.

The rest of the 60% of the exchange inflows were to be converted at the market determined rate. The imports of goods were also to be carried out at market determined rates except for certain special goods like petroleum, oil products, fertilizers, pharmaceuticals etc. which were to be imported at official exchange rate.

RBI could also intervene in the market if the market rate deviated a large extent from the official rate.

In March 1993, the LERMS was abolished and the dual exchange rate system was

removed. The limitation of 60:40 ratio was no longer applicable and all receipts of the foreign exchange were to be converted at the market determined rate. Thus the dual exchange rate system was replaced by a unified exchange rate system.

The Rupee was made fully convertible on the current account in August 1994. Article VIII of the Articles of Agreement of the IMF was accepted. Article VIII restricts the members of the Fund from putting any restriction on payments/transactions on current international accounts without the approval of the IMF. The country can't maintain multiple exchange rates.

Further relaxations were undertaken in foreign exchange controls in the subsequent years. In 1997, the RBI removed the ceiling on the remittance of foreign exchange for multiple purposes and authorized dealers could undertake transactions for those purposes without prior approval of the RBI.

- **Impact :**

India's Balance of Payments situation improved subsequent to liberalization of the exchange control regime.

In the few years after the crisis and the reforms, the exports improved while the imports remained constant in dollar terms leading to improvement in the Balance of Payments.

The Forex Reserves also witnessed an improving trend. The forex reserves increased from USD 5.8 billion in March 1991 to USD 25.2 billion in March 1995. The increasing trend continued in the later 1990s with the reserves touching USD 38 billion in March 2000. In September 2020, the forex reserves stood at USD 502 billion.

The remittance from Indian residents abroad also increased significantly due to removal of barriers and free conversion of the foreign currency.

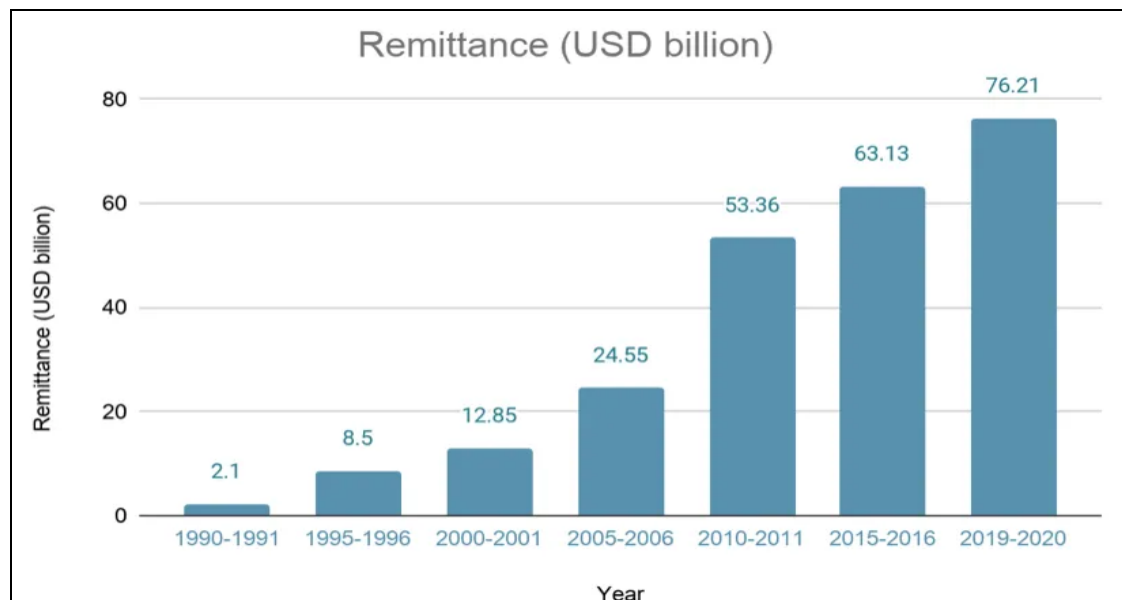


Exhibit : Trend of Remittance

Another advantage of Current Account Convertibility is that it leads to self correction in the exchange rate. If the currency depreciates too much, the exports become cheaper and the demand for domestic goods abroad increases. This increases the demand for domestic currency and thus leading to appreciation in exchange rate. If the currency appreciates too much, reverse happens (exports become expensive and demand decreases) and ultimately the exchange rate achieves an equilibrium.

India's external sector became fairly stable with the improvement in the foreign investment norms.

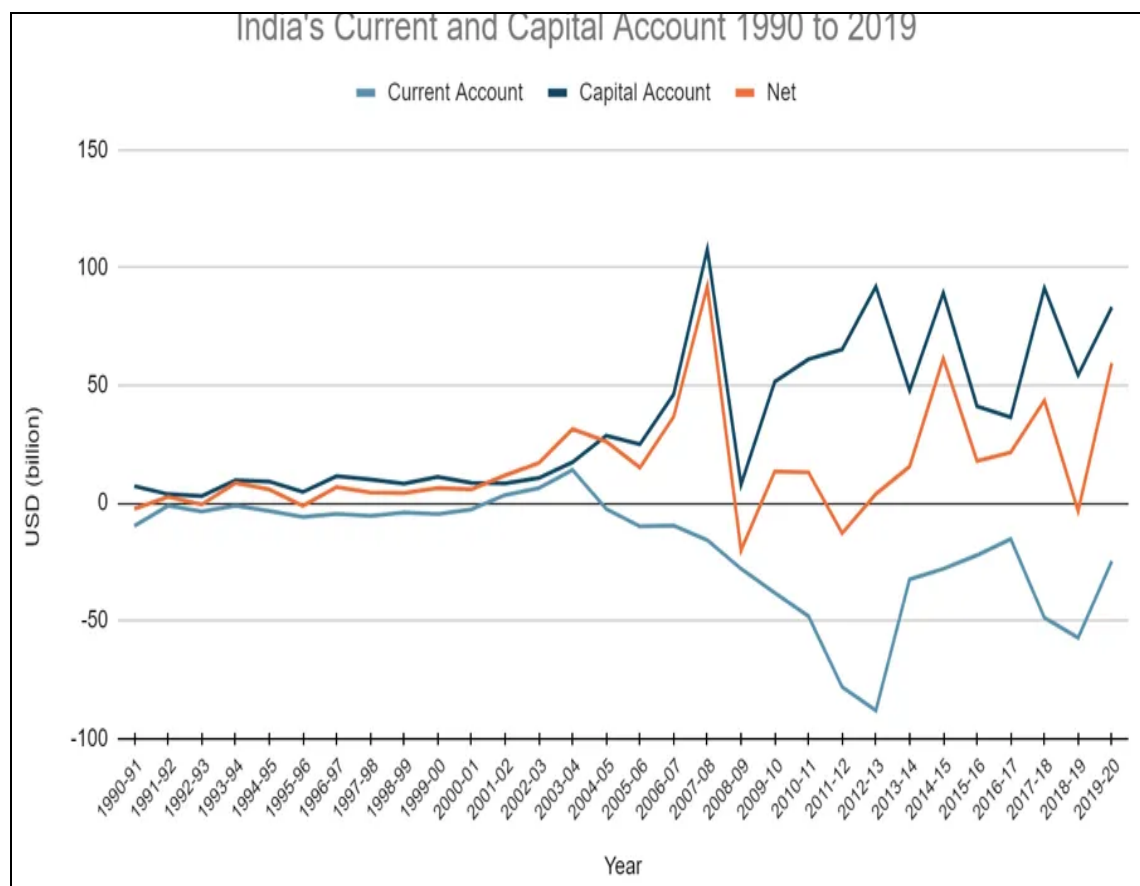


Exhibit : Current and Capital Account Trend in India (1990–2019)

13.2 CAPITAL ACCOUNT CONVERTIBILITY :

While the Indian Rupee has been made fully convertible on the Current Account, there are still considerable restrictions on the convertibility on the Capital Account.

Capital Account Convertibility is related to the flow of money into the Capital Account like investment in financial assets (Capital Markets (Portfolio Investment in equity stocks, bonds), dividend and interest incomes on financial assets, investments in infrastructure projects etc. at a market determined exchange rate.

- **Advantages of Capital Account Convertibility :**

Allowing Capital Account Convertibility has several advantages.

1. Capital Account Convertibility attracts foreign investment. As the investors are able to take out investments at a market determined rate, economies with Capital Account Convertibility are perceived as less risky. There is generally a larger inflow of foreign capital into a country with full capital convertibility and macroeconomic stability.
2. Foreign investment also helps create more business and employment opportunities.
3. Government and Private sector can also access foreign capital, reducing the cost of capital. Money can be borrowed from foreign countries at a lower rate and invested in domestic infrastructure. Domestic financial institutions (like banks) can also borrow cheaper money from abroad and improve their capital base.

- **Disadvantages of Capital Account Convertibility :**

However there are multiple disadvantages of Capital Account Convertibility.

1. Full convertibility on Capital Account makes the exchange market more volatile and consequently increases the risks. A flight of capital (large outflow of foreign investment) may result in response to adverse domestic economic shock which can cause a large depreciation of domestic currency. The exchange market may also become prone to speculators.
2. A large depreciation resulting due to flight of capital may worsen the fiscal condition of the Government if it holds large foreign debt. As the foreign loan must be paid in foreign currency, depreciation in exchange rate results in higher payment in terms of domestic currency (*e.g. For a debt of USD 1 billion borrowed at exchange rate of INR 50/USD, total repayment will be INR 50 billion. If the exchange rate depreciates to INR 60/USD, the total repayment will increase to INR 60 billion*).

- **Conditions necessary to achieve Capital Account Convertibility :**

Given the disadvantages associated with Capital Account Convertibility, it is necessary that certain conditions must be met before the introduction of full Capital Account Convertibility especially in case of developing countries :

- Most economists argue that the Capital Account Convertibility should be allowed only after allowing full current account convertibility. Reverse sequence (opening Capital Account before Current Account) may result in appreciation of exchange rate which can hamper the opening of the current account (as exports would become expensive) and an adverse impact on the trade balance.
- The Government Fiscal Deficit must be under control, so that the Government is not exposed to high foreign currency debt risk. Stable fiscal deficit also ensures a stable fiscal policy regime which also enhances general macroeconomic stability. A large fiscal deficit may cause higher interest rates (high Government

borrowing) which can attract volatile short term foreign capital. The volatile short term foreign capital may put pressure on the exchange rate (push up during inflow and pull down during outflow) impacting foreign trade as well.

- The country's domestic financial sector must be well developed. The system should be free from excessive interest rate controls or Government mandated lending to certain sectors.
- The country should have high foreign exchange reserves in order to handle any adverse economic shock which may lead to high outflows of capital (leading to depreciation pressure on exchange rate).
- The Current Account Deficit must be under control as high CAD may result in high borrowing and high debt servicing obligations which impacts fiscal deficit.
- The authorities must maintain an appropriate degree of exchange rate flexibility. The policy should not let the rate appreciate so much so as to hamper the competitiveness of the exports. Nor should the authorities spend too much forex reserve or maintain high interest rates in order to maintain a fixed exchange rate.

● Conceptual and Explanatory Notes :

Bretton Woods System :

Bretton Woods System refers to the international monetary system set up in July 1944 during the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire, US. This conference led to the creation of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) in December, 1945. The motive behind creation of these institutions was the belief of leaders in the WWII period that free international trade promoted peace and development. The idea was to create institutions to provide financial assistance to countries experiencing balance of payment or debt crisis. Such assistance would prevent them from adopting protectionist policies like during the Great Depression of 1929–30, which was a driving factor for WWII.

It also created a system of Gold Standard, in which the value of the US Dollar was linked to the Gold and other currencies were pegged to the US Dollar. The establishment of the Gold Standard stabilized the international currency market and reduced volatility. This helped the international trade. Currency stability also facilitated the international lending programme of the IMF and the WB.

The Gold standard eventually broke in 1973. But the Bretton Woods Institutions, the IMF and the World Bank have continued to play a crucial role in the World Economy.

IMF provides loans to countries struggling with balance of payment/currency or sovereign debt crisis, while the WB, provides assistance to developing countries for development projects.

• **Impossible Trinity / Trilemma :**

In International Economics Impossible Trinity or Trilemma refers to the hypothesis that it is

impossible to achieve fixed exchange rate, free capital movement and independent monetary policy all together. The concept was developed by Mundell and Fleming in the early 1960s. Independent monetary policy means the Central Bank can set the domestic interest rates independently.

There is enough empirical evidence to support this hypothesis.

There are three options for the policymakers

1. Free Capital Flow and Fixed Exchange Rate: The Central Bank can't maintain an interest rate different from the interest rate prevalent in the external sector as it would lead to appreciation/depreciation of the currency.
2. Free Capital Flow and Independent Monetary Policy: The different interest rates will cause appreciation/depreciation of the currency resulting in floating exchange rate.
3. Independent Monetary Policy and Fixed Exchange Rate: Higher domestic interest rate will attract foreign capital which will lead to appreciation in exchange rate. To maintain a fixed exchange rate, the flow of capital must be restricted.

The hypothesis is based on the concept of Interest Rate Parity. Interest rate parity states that in the absence of any arbitrage, the interest rates available on deposits in banks of two countries are the same. Arbitrage is achieving profits from the condition of different prices of the same product in different markets.

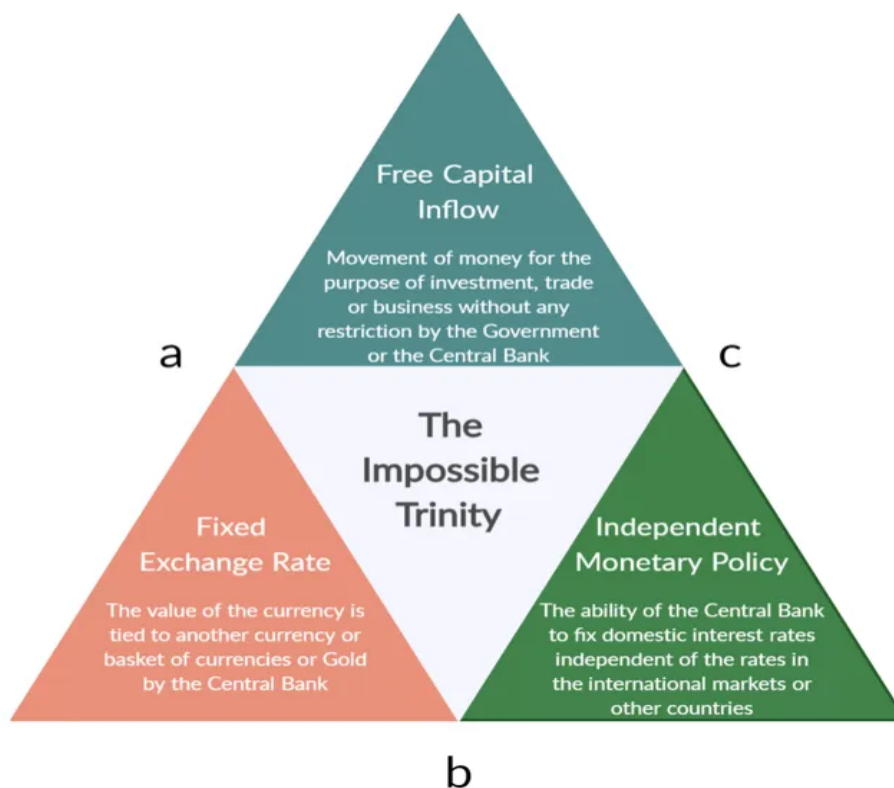


Exhibit : The Impossible Trinity (Adapted from: Oxelheim, 1990)

- **Interest Rate Parity**

Interest Rate Parity expresses the relationship between the currency exchange rate and the interest rate. It is the condition of absence of any arbitrage between the exchange rate and the interest rate.

It is based on the concept that the return due to domestic interest rate is equal to the return on foreign interest rate adjusted to the exchange rate. In the absence of the parity, an arbitrageur can earn arbitrage profits by borrowing in a country with lower interest rate, converting into foreign currency and investing in a country with higher interest rate and then converting back.

Consider the US-India combination. Assume current exchange rate is INR 60/USD. Further assume interest rates in India and the US by 5% and 3% respectively. Then according to Interest Rate Parity, the future exchange rate should be

$$60 \times (1+5\%) / (1+3\%) = \text{INR } 61.16 / \text{USD}$$

- **Derivation :**

Assume investment of USD 1000 in India.

Investment in terms of INR = $1000 \times 60 = \text{INR } 60,000$

Investment after 1 Year = $60,000 \times (1+5\%) = 63,000$

Investment after 1 Year in the US = $1000 \times (1+3\%) = \text{USD } 1030$

When there is no arbitrage

$\text{USD } 1,030 = \text{INR } 63,000$

$\text{USD } 1 = 63,000 / 1,030 = 61.165$

In the absence of parity, an arbitrage condition exists.

Assume the exchange rate is INR 60/USD. Then the amount on maturity is USD $(63,000/60) = \text{USD } 1050$. This is higher than the amount if the money were invested in the US. Thus there will be inflow of capital due to higher returns in India. This will lead to appreciation in the currency leading to convergence to the no-arbitrage value of exchange rate of INR 61.165/USD.

13.3 CURRENT ACCOUNT CONVERTIBILITY :

When you make payments, current account convertibility refers to your ability to freely change your rupees into other internationally accepted currencies and vice versa. It is the free trade in commodities to change native currency into a foreign currency and vice versa (services, transfers, or income from investment). If you want to know What Is Current Account Convertibility in details keep reading this article till the end.

Currencies can be converted to foreign exchange markets by individuals and corporations. In order to satisfy their international commitments, exporters, importers, residents, businesses, foreign investors, domestic investors abroad, etc. want to transform

their domestic money into foreign currency.

The term “current account convertibility” refers to the movement of funds into and out of an account that is not linked to any sort of capital income or expense. Transactions which are considered part of current account convertibility usually include commercial problems such as the purchase of goods or services such as the acquisition of a new kitchen appliance or the payment of the plane fare for the package of travel. This is distinct from capital account convertibility, which would entail transactions like making loan payments or utilizing cash to buy investments that are liabilities or capital assets.

Current account convertibility occurs when the transactions in question necessitate some form of currency conversion to be performed. For instance, if a customer in the United States wanted to buy a CD from a customer in the United Kingdom using cash from his or her checking account, the transaction would require currency conversion from US dollars to British pounds.

Similarly, if a client wanted to buy and import items from a foreign provider, there’s a significant probability that a currency conversion would be necessary, which would need knowing the current exchange rate and applying it to the transaction.

Whether a transaction involves current account convertibility or capital account convertibility is usually determined by the application of certain financial and trade regulations. These rules are typically set by the countries involved in the transaction. The total value of the transaction is sometimes the focus, with smaller sums being regarded as a current account transaction and amounts above a certain threshold being considered a capital account transaction. Transactions involving specialized assets such as heavy equipment are processed as capital account convertibility in some nations, regardless of the amount of money involved.

All financial exchanges between countries are made up of current account transactions (such as a country’s exports and imports of commodities and services) and capital account transactions (which represent net changes in ownership of national assets). The capital account includes all sorts of investment assets, such as debt, shares, and property, as well as corporate assets, such as commodities generated by a foreign company’s Indian subsidiary.

Current account convertibility entails loosening limits on current international transactions and allowing for payment of current transactions involving foreign exchange at market-determined prices. The rupee was made completely convertible in India for a current account for all trade transactions, remittances, and indivisibles in the mid-1990s (operationalized on August 19, 1994). To comply with Article VIII of the International Monetary Fund (IMF), which forbids any exchange limitations on current international transactions, India had to formalize current account convertibility.

- **Current account convertibility in India :**

Current account convertibility allows for the free movement of foreign currency for imports and exports, internal and external foreign currency transactions, access to foreign currency for medical and tourism purposes, travel, studying abroad, and other uses at current

market prices. However, capital account convertibility in India is still only partially convertible.

This indicates that Indians have a capacity under current account convertibility to acquire and sell goods and services, but still need regulatory approval when investing or purchasing assets outside of India for a specific limit. Additionally, in certain sectors such as insurance or retail (certain investments are limited in a particular percentage), FDI restrictions persist, and regulatory permits continue in these areas to be necessary to achieve increased investment limits.

While convertibility on the current account provides for free entry and supply to India of foreign currencies with a high level of free trade at market rates, regulators still usually need to be authorized under the liberalized payment system for higher exchange rates beyond the limit set for foreign currency acquisitions for traveling or studying outside India, medicine or tourism. Moreover, RBI is taking steps to stabilize the rupee and keep exchange rates at allowed prices when buying/selling US dollars in the event of excessive volatility in the Rupee foreign-currency market.

- **Current account convertibility in the Indian economy :**

During and after 1991 economic reforms, the Indian Government launched steps to allow for the partial convertibility of rupees into foreign currency under liberalized currency management schemes in which 60 percent of all electronic receipts could be freely transferred to rupees, with the fixed exchange rate quoted by authorized dealers, while the remaining 40 are freely Convertable to rupees. Current account transactions include all commodities and services being imported and exported.

This 40% of foreign currency was intended to meet the government's departmental needs and pay for the government's imports of critical commodities. This is why it was referred to as the Dual Currency System.

- **Advantages of Current account convertibility :**

1. *Facility to freely transmit your foreign income to India* : Current account convertibility enables you to receive and convert the income sent by your family members working abroad, without going through a complicated procedure prior.
2. *Promote international trade* : Current account convertibility facilitates the conversion of foreign currency into domestic currency and vice versa. This helps to integrate trade across countries around the world. By eliminating trade barriers, it increases international trade links among countries.
3. *Encouragement to exports* : A major advantage of current account conversion is that it promotes exports by improving profits. Export convertibility grows because the exchange rate of the market exchange is higher than the government fixed exchange rate. This means that exporters can receive more foreign exchange rupees from exporters' exports (e.g. US dollars). In particular, currency convertibility favors low-import exports.

4. *Imports and exports can be carried out at market-determined rates* : Before the free current account conversion, one must either forfeit a portion of their foreign exchange receivable to Indian rupees at the rates specified by RBI or convert it to Indian rupees. Previously, the rate decided was usually lower than the market rate. This enables you to convert your foreign currency at the market-determined rate that is fairer than pre-determined rates.
5. *Encouragement to import substitution* : Imports become more expensive following a currency's convertibility because the free or market-determined exchange rate is higher than the prior government-regulated exchange rate. This discourages imports and encourages the replacement of imports.
6. *An incentive to send remittances from abroad* : Rupee convertibility gave more incentives for Indian employees residing overseas and NRIs to send remittances of foreign exchange. It also makes illegal remittances like "hawala money" and gold smuggling less appealing.
7. *A self-balancing mechanism* : The self-balancing mechanism is another key advantage of current account convertibility. When the balance of payments is in deficit due to exchange rates being overvalued, the currency of the country is under convertibility and it degrades, boosting its exports, on the one hand, by cutting prices and discouraging imports, on the other, by increasing prices. This automatically corrects the balance of payments deficit without the Government or its Central Bank interference. Instead, the balance of payments is excess because the exchange rate is undervalued.
8. *Comparative advantage specialization* : Another advantage of currency convertibility gives a production pattern in line with its relative advantage and resources for different trading countries. When currencies are convertible, the exchange rate simply represents the purchasing power of the currencies, which is based on prices and expenses in different nations. Exports will be encouraged since prices in a competitive market reflect reduced pricing for those goods in which the country has a comparative advantage. On the other hand, in a country that has a comparative disadvantage, it will be prone to import such products into production. As a result, currency convertibility ensures specialization and international trade based on comparative advantage, which benefits all countries.
9. *Integration of the World Economy* : Lastly, currency convertibility promotes global economic integration. Currency convertibility facilitates the growth of trade and capital flows between countries by providing simple access to foreign exchange. Trade and capital *flow* between countries will expand, ensuring significant economic growth in the world's economies. Indeed, currency convertibility is regarded to be a precondition for globalization success.

● **Disadvantages of Current account convertibility :**

1. *Effects on Balance of Trade and Exports* : In overseas markets, a rising, unregulated currency makes Indian exports less competitive. Export-based

economies such as India and China prefer to keep their exchange rates down so that the low-cost benefit remains. Once the exchange-rate rules fall away, India is in danger of losing its worldwide competitiveness.

2. *Lack of basics* : In well-regulated nations with a strong infrastructure, the convertibility of full current accounts has worked successfully. India's fundamental issues — high export dependency, rising populations, corruption, socio-economic complexities, and bureaucratic challenges — may cause economic failures after full rupee convertibility.
3. *High Volatility* : High degrees of volatility, devaluation, or inflation in forex rates may occur due to a lack of appropriate regulatory control and rates subject to open markets with a large number of global market participants, posing a threat to the country's economy.
4. *The burden of Foreign Debt* : Businesses can readily take on international loans, but they run the danger of having to make large repayments if exchange values deteriorate. Consider an Indian company taking out a 4 percent U.S. dollar loan versus a 7 percent credit offered in India. However, if the US dollar is up to the Indian rupee, more rupees will be needed to receive the same amount of dollars, making the refund expensive.

13.4 DIFFERENCE BETWEEN CURRENT ACCOUNT AND CAPITAL ACCOUNT :

- **Current Account :**

The current account deals with the inflow and outflow of money within a given year for a particular country. This inflow/outflow of currency occurs due to trading activities (export and import of goods and services) and financial transfers. It is one of the two accounts that is part of the balance of payments. The transactions that are a part of the current account are referred to as the actual transactions since they make a real impact on the income, output as well as employment levels through the movement of commodities and services in the economy. The reporting of the current account is done by the Reserve Bank of India. A negative balance in the current account means that the imports are more than exports, and the overall consumption exceeds savings. While a positive balance means that the exports are greater than imports and savings are more than consumption.

The current account contains transactions that reflect the export and import of goods (visible trade) and services (invisible trade), income transfers and investment income from factors like land or foreign shares. The current account is a reflection of the actual financial status of an economy. Both the debit and credit of foreign exchange from these transactions also get recorded in the final balance for the current account. The balance of the current account is seen as the sum total of the balance of trade.

- **Capital Account**

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 mainly concerned with the transactions

which are a part of international trade. It is also a part of the balance of payments. The main components that are a part of the capital account include banking, foreign investment, loans, and other capital or monetary movements in the foreign exchange reserve. The capital account flow reflects the factors like commercial borrowings, investments, loans, banking and capital.

A surplus in capital account indicates an inflow of money into a country, while a deficit indicates capital moving out of the country. This may also point to the fact that the country is looking to increase their overall value of foreign holdings. In other words, the capital account is concerned with payments of debts and claims, regardless of the time period. The balance of the capital account also includes all items reflecting changes in stocks.

• **Difference between Current Account and Capital Account :**

Although both are a part of the balance of payments of a country, there are several areas of difference between current account and capital account, which we will discuss in the below table :

| Current Account | Capital Account |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Definition | |
| The current account mainly focuses on recording the export and import of merchandise along with any unilateral transfers that are completed within the year by a country. | The capital account mainly focuses on recording the trading of foreign assets and liabilities during a year by a country. |
| Implication | |
| The current account reflects the total net income of a country within a year. | The capital account reflects the net change in the ownership of national assets of a country within a year. |
| Transaction | |
| The current account mainly focuses on the receipts and disbursements related to the cash and non-capital items. | The capital account mainly focuses on the sources and utilisation of capital. |
| Components | |
| The main components within a current account are as follows: <ul style="list-style-type: none"> • Export and import of goods and services | The main components within a capital account are as follows: <ul style="list-style-type: none"> • Foreign direct investment • Portfolio investment |

| | |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> • Investment income and • Current transfers | <ul style="list-style-type: none"> • Loans by the government of one country to another |
| Evaluation | |
| The main purpose of a current account is that it helps the investors find out the trade deficit or trade surplus of a country. | The main purpose of a capital account is to help the investors determine the net investment position of a country. |
| Balance | |
| If the current account balance is negative, then a country is a net borrower. Similarly, if the account balance is positive, then the country is a net lender. | If there is a surplus in the capital account, it indicates an inflow of money for a country. Similarly, if there is a deficit in the capital account, it indicates an outflow of currency from the country. |
| Objective | |
| The current account is mainly concerned with the receipts and payment of cash and non-capital items. | The capital account is mainly concerned with the sources and utilisations of the capital items. |

- **Conclusion :**

It is important to understand that a firm requires both a Current Account and Capital Account to run its operations smoothly. Both of these accounts are a part of the balance of payments, and there are several points of difference between the two. But still, every country should aim to maintain a surplus balance to have a steady outlook in the long term. They have a very important role to play in the monetary and fiscal policies of a nation, and as such, governments must focus on transactions related to these accounts to have stronger growth potential.

13.5 SUMMARY :

In this lesson, we will explore Currency convertibility plays a major role in the economy of the country. Convertibility refers to the relative ease with which the currency can be converted into other assets. Current Account Convertibility refers to the freedom to convert the currency into another currency for the purpose of international trade in goods and services (and other invisibles like transfer payments/income from investment).

Capital Account Convertibility refers to the freedom to convert the currency into another currency for the purpose of investment in assets (like financial assets). As movement of goods/services and investments in assets hold significant importance in the functioning of the economy, currency convertibility is crucial for economic development.

13.6 KEY WORDS:**Nationalization :**

A process where a nation's central government assumes ownership and operation of private enterprises within its territory.

Net Exchange Position :

An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

Odd Dates :

Deals within the market are usually for spot, one month, two months, three months or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

Offer Rate :

The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

Official Rate :

The rate established by a country at which it permits conversion of its currency into that of other countries.

Offshore Branch :

Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

Offshore Dollars :

Same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the U.S., including Europe.

Open Contracts :

The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions.

Open Market Operations :

Purchases or sales of securities or other assets by a central bank on the open market.

13.7 SELF ASSESSMENT QUESTIONS :

1. Write about current account convertibility.

2. Explain capital account convertibility.
3. What are differences between capital account and current account convertibility?

13.8 SUGGESTED READINGS :

1. Capital account convertibility in india- Biswajit Chatterjee Asim K. Karmakar.
2. Capital account convertibility – An Introduction.
3. Capital account convertibility ; Monetary policy and Reforms.

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