FOREIGN EXCHANGE MANAGEMENT

BBA
Semester-V

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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' grade from the NAAC in the year 2016, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 443 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the door step of all the sectors of the society. 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 to housewives desirous of pursuing higher studies. Acharya Nagarjuna University has started offering B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004 onwards.

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 involved respectively. Such ideas will be incorporated for the greater efficacy ofthis 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 my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities andin turn be part of 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, Academic Coordinators, Editors and Lesson- writers of the Centre who have helped in these endeavors.

Prof. Raja Sekhar Patteti
Vice-Chancellor
Acharya Nagarjuna University

B.B.A -Semester – V

Foreign Exchange Management - 505BBE21

Unit-I:

Nature and Scope of Forex management: Objectives, significance, relationship between Forex management and financial management, Forex management and global environment.

Unit-II: I

international financial markets and instruments: An overview of international capital and money markets, arbitrage opportunities, integration of markets, international capital and money market instruments – GDRs, DRs, Euro Bonds, Dual currency bonds, euro equity, euro deposits

Unit-III:

Foreign Exchange Market: Functions, characteristics, organization, and participants, arbitrage in foreign exchange market, mechanics of making foreign payments, cost associated with international payments.

Unit-IV:

Foreign exchange rates and its determination: Exchange rate, Spot, Forward and Cross exchange rates, Forex trading and financing of international trade.

Unit-V:

Foreign Exchange Risk Hedging techniques: Swaps, Options, offshore banking, payment terms, i.e., Commercial Invoice, Letter of credit, bill of exchange, documents and financing techniques.

References:

1) Jeevanandan, C, Foreign Exchange and Risk Management, Sultan Chand and sons, New Delhi

2) Chatterjee, Principles of Foreign Exchange, Himalaya, Bombay.

3) Ian Giddy, Global Financial Markets, AIYBS, New Delhi.

4) Sailaja, G., International Finance, Universities Press.

5) Jeff Madura. International Financial Management, Cengage, New Delhi.

6) Shapiro, Alan., Multinational Financial Management, Prentice Hall of India, New Delhi.

7) ThummuluriSiddaiah, International Financial Management, Pearson, New Delhi.

8) VyuptakeshSharan, International Financial Management, Prentice Hall of India, New Delhi.

(**505BBE21**)

MODEL QUESTION PAPER

B.B.A. DEGREE EXAMINATION,

Third Year – Fifth Semester

Part II

Paper VI – FOREIGN EXCHANGE MANAGEMENT

Time : Three hours **Max. Marks: 70**

SECTION A–(5 x 4 = 20 marks)

Answer any FIVE of the following.

Each question carries 4 marks.

1. Scope of Forex Management.

2. Objectives of Forex management.

3. Features of money market

4. Arbitrage opportunities

5. Functions of Foreign Exchange Market

6. Write a short note on Retail Brokers

7. Write about Exchange Rate

8. Risk Hedging – Meaning

SECTION B – (5 x 10 = 50 marks)

Answer ALL questions.

Each question carries 10 marks.

9. (a) Explain the relationship between Forex Management, and global management.

Or

(b) Explain the functions of Foreign Exchange Market.

10. (a) Explain the instruments of international financial markets.

Or

(b) Explain the benefits of international financial market instruments.

11. (a) Explain the challenges in making foreign payments.

Or

(b) Write about major players in the forex markets.

12. (a) Explain various factors that influence foreign Exchange Rate.

Or

(b) Write a detailed note on forward and cross exchange rates.

13. (a) "An offshore bank account can make it easier to do business in foreign currencies" Explain and comment.

Or

(b) Write about Bill of Exchange and Commercial invoice.

CONTENTS

Lessons – 1
NATURE AND SCOPE OF FOREX MANAGEMENT

Objectives

Forex management may be defined as the science of management of generation, use and storage of foreign currencies in the process of exchange of one currency into other called foreign exchange.

Knowledge of the forex management can help avoid harmful effects of international events and perhaps even profit from these events. With the advent of globalization and liberalization the scope for international trade and international financing has increased tremendously. International trade has grown more quickly than trade in general. This has necessitated the study of Forex management by the finance executives.

- Concept of Forex Management
- Scope and significance of Forex Management
- Nature of Forex Management
- Forex Manager's Skills

Structure

1.0 Meaning of Forex Markets
1.1 Meaning of Forex Management
1.2 Nature of Forex Management:
  - It is part of management science
  - It refers to generation of forex
  - It pertains to use of forex
  - It covers storage of forex

1.3 Scope of Forex Management
1.4Significance of Forex Management
  - For better Planning of Forex
  - For Creating Forex Reserve
  - For Controlling the Risk of Forex
  - For Maximizing the Consolidated Earning of International Business

1.5Forex Management Objectives
1.6 Forex Manager's Skills
1.7Summary
1.8 Review Questions
1.0 Introduction – Forex Markets

Foreign exchange management (FX) is the process of managing the exchange of foreign currencies, including the purchase and sale of foreign currency, the conversion of one currency to another, and the management of currency risk

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.

1.1 Forex Management:

Meaning: Foreign Exchange (FX or Forex) management is the process of managing the exchange of foreign currencies. This includes the conversion of one currency to another, the purchase and sale of foreign currency, and the management of currency risk. FX management is a critical part of any business that has international operations or deals in foreign currencies.

The goal of FX management is to ensure that a company's exposure to currency risk is minimized, while still allowing it to take advantage of opportunities presented by fluctuations in exchange rates. An effective FX management strategy will strike a balance between these two objectives.

FOREX, an acronym for Foreign Exchange, is the largest financial market in the world. Every firm and individualoperating in international environment is concerned with foreign exchange i.e. the exchange of foreign currencyinto domestic currency and vice-a-versa. Generally, the firm's foreign operations earn income denominated insome foreign currency; however, the shareholders expect payment in domestic currency and therefore, the firmmust convert the foreign currency into domestic currency. So, what is foreign exchange?

Exchange rate is the price of one country's money in terms of other country's money. When we say that exchangerate of Indian rupee is 52.40 per US Dollar, we mean than 52.40 Indian Rupees are required to purchase one USDollar. When this exchange rate becomes 52.90 we say that the value of Indian Rupee has depreciated againstthe US Dollar. On the other hand when the exchange rate becomes 52.10 we say that Indian Rupee hasappreciated against the US dollar. Assuming that there are no exogenous factors restricting the changes inexchange rates, their movement can be traced to pure demand and supply. When Indian rupee depreciatesagainst the US Dollar, it indicates that demand for latter is more than its supply. Similarly when the supply of USdollar is more than its demand, it declines in value against the Indian Rupee.

Currency of a country is used for transactions with foreigners. Each country in the world has its own currency.Theoretically, a country should transact with all foreign entities on a one-to-one basis, i.e. for all imports from aforeign country, a host country should pay in the currency of the former and for all exports, the host countryshould be paid in its currency. But practically this is not possible because it involves keeping record of a multitudeof exchange rates and associated payment problems. Therefore, most of the countries choose a commoncurrency for trade amongst themselves. The U.S. dollar has emerged as the strongest international currency forthe past sixty years and as such is used as the payment medium for most of the world trade. In the EuropeanUnion the Euro has established itself as the common currency of about 25 countries.

It is clear that the currency of a country is evaluated against a common currency for external transactions. Incase of countries having dominant economic power, trade would be held in their currency. Hence a country isrequired to trade in U.S. dollar or in other dominant currencies like Euro, Pound or the Japanese Yen. Accountof a country's external trade is kept in the form of a Balance of payment account which is a double book entrysystem. Receipts of foreign currencies are credited to this account while payments in foreign currency aredebited to this account. The balance in this account shows a positive or a negative figure depending uponwhether the receipts of foreign currency are more or less than the payments.

Other things being equal, the presumption is that a country having a deficit balance of payments position wouldhave a weakening national currency and vice versa. A deficit in the balance of payment account results in moredemand for foreign currencies. Hence their value vis-à-vis the domestic currency increases.

1.2 NATURE OF FOREX MANAGEMENT

Forex management may be defined as the science of management of generation, use and storage of foreigncurrencies in the process of exchange of one currency into other called foreign exchange.The above definition of forex management has the following essential elements:

(a) It is part of management science

Forex management is part of the broader management science. It is a scientific discipline requiring scientificand analytic orientation. The techniques of management are applied to the broad spectrum of foreign currencies.This broad spectrum refers to all the currencies of the world excluding the domestic currency. These techniquesinclude planning for forex, organization of forex and control of forex. We use the terms forex and foreign exchangeinterchangeably. The planning part includes budgeting for forex, organization refers to utilization of forex andcontrol part focuses on creation of forex reserves.

The tools of forex management are akin to domestic currency management but the level of analytical skillsrequired for it is slightly higher because of the existence of spot, forwards and futures markets unlike the domesticcurrency area. Operations in the forex market require quicker response time because of the greater volatility inexchange rates.

(b) It refers to generation of forex

Forex is generated from international trade transactions. When a country exports goods or services, it earnsforex. When goods or services are imported by a country, forex is consumed. If the exports of a country are morethan the imports, the forex would be accumulated in reserves of the country. If the imports are more than theexports, the result would be a forex deficit which has to be met by international borrowings. Either way, the forexneeds to be generated. Generation of forex is a more difficult proposition because of variation in internationaltrade practices and extent of competition.

(c) It pertains to use of forex

Forex management is concerned with use of forex in meeting the requirements of the user group. The tools ofcash management come handy in using forex. The process of use of forex involves identification of suppliers ofgoods and services, negotiation of terms and conditions of the transaction and culmination of transaction withthe exchange of goods and services with forex. Because of relative uncertainty about availability of forex andvolatility in its rates, advance tie-up of forex is made through forward purchase contracts. In this entire process,close track of exchange rates needs to be maintained.

(d) It covers storage of forex

Forex management involving firm level forex storage could be done through forward purchase contracts orthrough deposits in foreign currency bank accounts. At the national level, forex storage is done through forexreserves which are held in the form of Gold, Special Drawing Right (SDRs) of IMF and foreign currencies. Whilesome amount of foreign exchange reserves need to be maintained to meet unforeseen contingencies, excessiveaccretion to reserves involve a cost which is sometimes justified on other economic consideration at the firm'slevel. Forex is stored for meeting future import liabilities, whether certain or contingent. While storing forex, it isimportant to bear in mind the actual cost of storage and the opportunity cost of not using the forex elsewhere.Depending upon availability of forex, if the opportunity cost is more than the cost of storage, then it is better notto store it.

1.3 SCOPE OF FOREX MANAGEMENT

Forex management has quite a wide scope of operation. We can cover in its ambit all those transactions whichinvolve use of forex. Let us consider the following illustrations:

- A citizen of India travels abroad on a business visit and purchases foreign currency from an authorizeddealer.
- An Indian citizen goes to USA for a period of three years under an employment contract. He periodicallyremits US Dollars to his bank account in India.
- An Indian student subscribes to a British scientific magazine and pays for it through an internationalcredit card held by him.
- An Indian industrialist imports raw material from Malaysia for his plant under a Letter of Credit arrangementprovided by his bank.
- A sports goods manufacturer of India exports his consignment to Europe and gets paid for it in foreigncurrency received through banking channels.
- Indian subsidiary of a Multinational corporation imports white goods in completely knocked down (CKD) from the Chinese affiliate. After reassembling these goods, the same are exported to Europe.
- The World Bank disburses aid to an Indian State under an infrastructure development project.

The above illustrations show how individuals, companies and states transact in forex. When goods or servicesare imported into a country, these are paid for in the currency of the country exporting these goods or services.When an Indian traveler goes to a foreign country on a short visit, he needs foreign currency of that country formeeting his expenses. When he stays in that country for a longer duration for employment purpose, he earnsforeign currency of that country. When an Indian firm exports goods to Europe, it is earning foreign exchange.

Thus when goods and services are sent abroad by India, foreign currencies are earned by them.

Forex management being involved in all the trade and non-trade transactions involving forex, it is essential tohave a broad idea of international banking and trading practices. Since the transactions are taking place amongcounter parties from different countries, a standardized format of documentation is used to minimise errors.

Apart from the transaction value, forex management finds scope as a mode of investment. Because of thefrequent and often miniscule fluctuations in forex values, enough arbitrage and speculative opportunities cropup in the forex market for astute investors. There are many expert forex dealers specializing in trading of forex.

1.4 SIGNIFICANCE OF FOREX MANAGEMENT

Forex management is important because with this, we can estimate Forex rate correctly and it is also helpful to control the risk of Forex.When we buy or sell any product from foreign country, Forex rate affects it deeply. For example, if Indian importer imports from USA, if USA dollar appreciate, the cost of importer will increase. All the businessmen whether they are doing the business of Forex or no, should manage Forex for reducing the risk.

Business operations in countries across the globe have been in existence for centuries, but an unprecedentedgrowth in worldwide production and distribution of a large number of capital, intermediate and consumer goodshas been witnessed in the past fifty years. At present most of the countries are economically related to eachother through a complex network of trade, foreign investment and international loans.

The emergence of WTO and the process of global integration has reinforced the importance of Internationaltrade, cross border financial flows and consequently foreign currency transactions. Each country has its owncurrency and each currency has different value in relation to a globally accepted standard. The significance offorex management lies in the study and maintenance of the exchange levels.

Every good or service reaching us from abroad involves forex. Knowledge of the forex management can helpavoid harmful effects of international events and perhaps even profit from these events. With the advent ofglobalization and liberalization the scope for international trade and international financing has increasedtremendously. International trade has grown more quickly than trade in general. This has put up both benefitsand challenges.

The principal benefit for international trade has been in the form of the gain in standard of living it has permitted.The gain has come from exploiting relative efficiencies of production in different countries. The challenges ofinternational trade are the introduction of exchange rate risk and country risk. Various methods and marketshave evolved that allow firms to avoid or reduce these risks.

The after effect of development of international trade has been swift movement of funds from one finance centreto the other. There has been investment by multinationals in the third world countries in the form of capitaloutlays. All this has necessitated the need for a better understanding of the mechanism of forex flows.

Forex management has become a more important subject because of an increased globalization of financialmarkets. The benefits of the increased flow of capital between nations include a better international allocation ofcapital and greater opportunities to diversify risk. However, globalisation of investment has meant new risksfrom exchange rates, political actions and increased interdependence of financial conditions in different countries.

Following are the points which explain the significance of Forex management:

1. For better Planning of Forex

Whether you are doing the business or Forex or not, with Forex management, you can make better plan for Forex. For example, if you see that supply of goods is from a country whose exchange rate will appreciate, you can make strategy to invest your money in that currency. You can take this decision on the basis of better understanding of Forex management.

2. For Creating Forex Reserve

Forex management is significant for us because it teaches us to create Forex reserve at optimum amount instead of creating reserve in own currency. You just go to your own bank and deposit money is reserve in your own currency. But if you make FD in the foreign bank, it is your Forex reserve. As MNC, you should create multiple currency Forex reserve.

3. For Controlling the Risk of Forex

When currency rate will change in Forex market, it may bring loss for you. Forex management can help for you to reduce this loss by providing your advance tool to control the risk of Forex. These tools are :

a) Forex future: Forex future is also called currency future. It means to contract of exchange of one currency to other currency. In this contract, we fix the future date. We just pay the purchase date price and buy it in the future date. In the future date if rate will increase, we will just pay past purchase date price. So, this will be helpful to reduce the risk of Forex because with this, buyer can lock current Forex rate for future date.

b) Forex Hedging: Forex hedging means to do two opposite future contract. One contract is of buy the Forex and second contract is of selling Forex. You can read more detail of this at here.

c) Forex Swap: Forex Swap is to buy and sell same amount of one currency for any other currency. It is also called currency swap. Currency Swap is an agreement between two parties of two countries for exchanging of principle and interest of loan at its present value. This swap is very useful for controlling foreign exchange risk. Read more this swap at here.

4. For Maximizing the Consolidated Earning of International Business

There are lots of big MNCs who does the business in more than 100 countries. All these countries' foreign exchange rate changes day by day. So, with Forex Management, Forex manager make a solid Forex policy in which he does best for maximizing the consolidated earning of international business. For example, A company sells the goods to any country. If this currency will depreciated, company get more money from that country. But same time the salary cost will increase when it has to pay the salary to the employees who are working in that country. So, company's aim always should be to maximize the consolidated earning not earning from one country due to Forex change.

1.5 THE OBJECTIVES OF FOREX MANAGEMENT

The Primary Objectives of the Forex Management includes:

- ❖ Understanding the foreign exchange market
- ❖ Understanding currency valuation principles
- ❖ Understanding techniques to hedge foreign exchange risk
- ❖ Understanding forex management in India
- ❖ Understanding the principles and procedures relating to forex markets
- ❖ Understanding different types of currency derivatives and their operations

Other objectives of forex management include:

- ➢ Restoring the balance of payments equilibrium,

- Protecting the value of the national currency,
- Preventing capital flight,
- Protecting local industry, and
- Building foreign exchange reserves.

Some secondary objectives of foreign exchange risk management include:

- Reducing fluctuations in income statements
- Reducing uncertainty about foreign currency flow
- Reducing uncertainty about the cash balance on any date

1.6 FOREX MANAGER AND HIS SKILLS

The developments in international trade have resulted in the emergence of a new brand of manager called theforex manager. The forex manager is a category apart from the finance manager or the treasury manager. Hedeals in currency and money but not of one country. He has to transact with a number of counter parts both inthe domestic country and abroad. He is face to face with special kind of risk. Yet his vocation is full of opportunities and challenges.

For effective management of forex transactions, the forex manager is expected to have the following skills:

(a) Awareness of historical development of world trade

The forex manager must have a fair idea of as to how the world trade has reached its present status. The shiftingpower alliances, emergence and decline of economic superpowers, present political situations, trade patternsetc. should be known. This knowledge base enables the manager to view the current situation in properperspective.

(b) Ability to forecast future trends

The forex manager must be in a position to derive an accurate forecast of the future trends in international tradeflows and exchange rate patterns. This forecast helps the manager to prepare his forex budget.

(c) Comparative Analysis skills

The forex manager should be able to carry out a comparative analysis of costs of domestic and imported rawmaterials, price of local sales and export sales, shipping rates, insurance costs etc. in order to determine whetherit is expedient to produce locally or to outsource

(d) In-depth knowledge of forex market

The forex manager is expected to have in-depth knowledge of functioning of foreign exchange markets, theirrules and regulations, the size of their operation, the profile of active currencies, strength and weakness of thedomestic currency etc. in order to achieve better pricing of deals.

(e) Knowledge of interest rates

Since interest rates have a direct bearing upon exchange values, awareness about domestic and internationalinterest rates enables the forex manager to form an accurate opinion about the forward premia.

(f) Willingness to undertake risk

Armed with the knowledge and awareness about international financial and trade patterns, currency positionsand interest rates, the forex manager should have the ability to undertake reasonable level of risks with a viewto profit from forex exposures.

(g) Hedging strategies

The forex manager should be in a position to hedge his positions to the best extent possible. To achieve this, asense of timing is essential in the background of ever changing world of exchange values.

1.7 Summary

Forex management, or Foreign Exchange Management, is the process of managing the exchange of foreign currencies, including the purchase and sale of foreign currency, the conversion of one currency to another, and the management of currency risk.

Forex management courses are offered under the Finance or Economics branches and focus on international financial markets, particularly the forex market. The course equips individuals with the skills to: analyze global currency dynamics, devise strategies for managing forex risk, execute international trade finance transactions, implement currency hedging techniques, and understand international financial regulations.

The forex market is an over-the-counter (OTC) market, meaning there is no physical place where participants meet to execute their deals. Instead, it is an informal arrangement among banks and brokers operating in a financing center, connected by telecommunications like telephone, telex, and a satellite communication network, SWIFT.

The forex market is one of the most active and liquid in the world, with trillions of dollars changing hands between different currencies. However, forex trading operates with a relatively high degree of leverage, which magnifies the potential risks compared to other markets.

The Foreign Exchange Management Act (FEMA) is a set of regulations that came into force in 1999, replacing the Foreign Exchange Regulation Act (FERA). FEMA empowers the Reserve Bank of India to pass regulations and the Government of India to pass rules relating to foreign exchange

1.8 Text Questions

MCQs

1. What is the primary objective of foreign exchange management?
A) Maximizing profits from currency trading
B) Minimizing exposure to exchange rate fluctuations
C) Speculating on currency movements
D) Facilitating international trade and investment
Answer: D) Facilitating international trade and investment
2. What does the term "foreign exchange market" refer to?
A) Market for buying and selling goods and services internationally
B) Market for buying and selling currencies
C) Market for trading stocks and bonds
D) Market for commodities trading
Answer: B) Market for buying and selling currencies
3. Which of the following is NOT a participant in the foreign exchange market?
A) Commercial banks B) Central banks C) Export-import companies D) Stock exchanges
Answer: D) Stock exchanges
4. What is the purpose of a currency exchange rate?
A) To determine the value of a country's exports
B) To determine the value of a country's imports
C) To determine the value of one currency relative to another

D) To determine the inflation rate of a country

Answer: C) To determine the value of one currency relative to another

Essay Questions:

1. Write about FX Management?
2. What is the nature and scope of Foreign Exchange Management?
3. What are the objectives of FX Management? Also explain the significance of it
4. What kind of skills a forex trader requires?

1.8 Suggested Readings

1. https://corporatefinanceinstitute.com/resources/knowledge/deals/mergers- acquisitions-ma/
2. https://www.thebalance.com/corporate-banking-vs-investment-banking-5200813
3. https://tutorialslink.com/Articles/What-is-Merchant-banking-What-are-the-functions- of-merchant-banks/2466
4. https://cleartax.in/g/terms/merchant-banking
5. https://www.investopedia.com/articles/general/071213/retail-banking-vs-commercial-banking.asp#:~:text=Retail%20banking%20refers%20to%20the,abundance%20in%20most%20major%20cities

Dr. Nagaraju Battu

LESSON – 2
FOREX MANAGEMENT AND FINANCIAL MANAGEMENT

Learning Objectives

International financial management, as the name suggests, deals with all the financialdecisions taken in the area of international business. Expansion in world trade has led tothe growth of multinational companies, in the developed countries as well as in developingnations. Their operations have led to a significant increase in the cross-country flow offunds. This two-way flow of funds requires efficient management. The global financial environment is highly volatile in nature, given the widely diversenature of the economies of the world. This lesson looks at various aspects ofmanaging finances in the international markets and foreign exchange transactions.

After going through this unit, you will be able to:

- Describe the significance of international trade
- Evaluate the finance functions in multinational companies
- Discuss trend in international trade and currency flows
- Explain the foreign exchange management

Lesson Structure

2.0 Introduction – Meaning & Definition of International Financial Management
2.1 Importance Of International Finance
2.2 Multinational Companies (MNCs) as a Factor
2.3 Finance Function in MultinationalFirms
   2.3.1Financing decision
   2.3.2Investment decision
   2.3.3 Dividend decisions
2.4 International Financial Management & Forex Management
   2.4.1 Cross-border Financial Flows
   2.4.2 Capital flows: Trends and composition
   2.4.3 Balance Of Payments
2.5 Summary
2.6 Key Terms
2.7 Review Questions

2.0 Introduction – Meaning & Definition of International Financial Management

International finance is an important factor in the decision-making process of companies.Every aspect of economic activity is affected by it; be it in the form of individuals takinga decision on asset selection, firms taking financial management decisions, fund's managersdeciding on markets to deploy funds or when to exit, government deciding to raise funds,central banks dealing with a declining foreign exchange reserve, a financial crisis, asurplus of foreign exchange reserves or commercial banks making asset-liability decision.

International finance can be defined in simple terms as the business taking placebetween two or more than two countries. The concept has gained significance followingthe opening up of economies the world over. There has been a consistent increase ininternational trade over the years due to increase in population and the ever-extendingand diverse needs of people. The concept of globalization assumes significance in thisregard. This unit will discuss the meaning and importance of international finance andthe nature of finance functions in multinational companies. It will also look at the trendsin international trade and cross-border financial flows, and other factors, such as, balanceof payment, currency convertibility and capital account convertibility.

2.1 Importance Of International Finance

The international financial environment is based on the international business phenomenonwhich takes place between two or more than two countries. International businessactivities include both trading of goods and services as well as the international productionof goods and services.

International business may be conducted in the form of international trade;contractual mode like franchising, licensing, management contracts and turnkey projects;and also foreign investment like foreign direct investment (FDI) and foreign institutionalinvestor (FII). In each of these modes, the significance of international financialmanagement is very high. This is because any transaction of goods and services involvesa simultaneous transaction of money, which is in foreign currency, either in the form ofpayment or receipt. Most of the companies today are also going in for mergers andacquisitions, which involve a lot of international financial management and a host ofinternational financial activities. Examples include Tata–Corus, Mittal–Arcelor, JetAirways–Sahara, and many more.

International finance relates to the transaction of different types of currencieswhich takes place between different countries as a part of the overall businesstransactions. These currencies may belong to different countries, and their values ofexchange may vary from country-to-country and place-to-place. In many instances, thevalue or exchange rate may vary between two different banks in the same place.

There are several reasons that lead to fluctuations in the exchange rates betweentwo points of time and between two different places. The reason for fluctuations inexchange rates are the same reasons which are given for differences in the prices of aproduct at two different places. But the approach is slightly different. A product in themarket commands some price. The currency also commands a price in different marketswhich is known as the exchange rate. But, the exchange rate fluctuates on a day-to-daybasis while prices in the commodity market do not vary so frequently.

International finance incorporates all those activities which takes place due tointernational transactions. These transactions will include financial transactions betweengovernments of two different countries, and foreign exchange transactions betweentwo individuals—both within the country and outside the country. It also includestransactions between two different banks within the country and between two differentcountries.

Thus, international finance is a compendious expression that takes within its sweepboth international trade and international investments. It affects as much the developingnations as it does the developed ones. The absence of a common currency is often anirritant because exchange rate differential often influence and distort international trade.The exporting nations have an upper hand in that, they can choose the currency in whichthey want to export, and the importing nation has no choice but to find that currency topay for its imports.

2.2 Multinational Companies (MNCs) as a Factor

The growth of MNCs has also led to an increase in the scope of international finance. Amultinational corporation is one that has offices or plants or operations located mostlyoutside its home country, and the majority of its revenue is generated from firms otherthan the ones in its country, i.e., from around the globe. An MNC is an enterprise thatowns and controls production or service facilities outside the country in which it is based(United Nations, 1973). For qualifying as an MNC, the number of countries where thefirm operates must be, at least, six (Vernon, 1971; United Nations, 1978). At the sametime, the firm must generate a sizable proportion of its revenue from its foreign operations,although no exact percentage has been specified or agreed upon. It is quite obvious thatthe growth of MNCs has led to the increase in the scope of international financetransactions.

Different multinational companies across the globe form a major part or subset ofthe international financial environment, when they operate in international financialoperations and try to gain advantage from the local or the customized environmentalconditions of that market. But the global multinational financial environment also consistsof very small, medium and large enterprises or companies which provide support to theoverall environment, directly and indirectly.

2.3 Finance Function in MultinationalFirms

. When theimport and export of goods and services takes place, then the question of payment andreceipt arises. Now, there has to be a common currency through which payments orreceipts can be made. Therefore, in any international financial transaction one has tofirst determine the foreign exchange rate. That is the rate at which one unit of domesticcurrency can be exchanged for another foreign currency. There are several ways inwhich exchange rate determination can take place. Different ways are adopted bydifferent countries depending upon their economic, monetary and fiscal conditions. Inmany cases, the exchange rate is determined by the free forces of demand and supplyof the currencies in question.

There are some institutions which directly or indirectly control the exchange rateregime. One of these institutions is the International Monetary Fund, which controls andfixes the norms and procedure for the different types of exchange rate regimes. All themember countries of IMF follow these norms and procedures.

International financial institutions like the World Bank, IMF, the Asian DevelopmentBank and others form a significant portion of the study of the multinational financialenvironment along with the different domestic and international banks, the authorizeddealers (ADs) who deal in foreign exchange, and also the agents who form a part of theinternational foreign exchange or financial environment. There is a lot of scope forspeculators and people dealing in foreign currency to gain or make profits out of foreignexchange fluctuations which make the environment more interesting and challenging.

Financing function for an MNC is also a challenge. Due to several of sources offunds and avenues of investment available to a financial manager throughout the world,the manager has to worry about the foreign exchange, political risks in positioning fundsand in mobilizing cash resources. This diversity of financial sources enables the MNC toreduce its cost of capital but at the same time, maximizes the return on its excess cashresources by investing funds in capital markets. In an organization, finance function canbe classified into:

2.3.1Financing decision: These decisions are concerned with creating funds frominternal sources or from external sources that are less expensive.

Investment decisions: A firm’s investment decisions involve capital expenditures.

They are, therefore, referred as capital budgeting decisions. A capital budgeting decisioninvolves the decision of allocation of capital or commitment of funds to long-term assetsthat would yield benefits (cash flows) in the future. Two important aspects of investmentdecisions are (a) the evaluation of the prospective profitability of new investments, and(b) the measurement of a cut-off rate against which the prospective return of newinvestments could be compared. Future benefits of investments are difficult to measureand cannot be predicted with certainty. Risk in investment arises because of the uncertainreturns. Investment proposals should, therefore, be evaluated in terms of both expectedreturn and risk. Besides the decision to commit funds in new investment proposals,capital budgeting also involves replacement decisions, that is, decision of recommittingfunds when an asset becomes less productive or non-profitable

2.3.2Investment decision: These are determine the distribution of funds over timein such a way that the use all of the shareholders a certain period is maximized.

A financing decision is the second important function to beperformed by the financial manager. Broadly, he or she must decide when, where fromand how to acquire funds to meet the firm's investment needs. The central issue beforehim or her is to determine the appropriate proportion of equity and debt. The mix of debtand equity is known as the firm's capital structure. The financial manager must strive toobtain the best financing mix or the optimum capital structure for his or her firm. Thefirm's capital structure is considered optimum when the market value of shares ismaximized.

Once the financial manager is able to determinethe best combination of debt and equity, he or she must raise the appropriate amountthrough the best available sources. In practice, a firm considers many other factors suchas control, flexibility, loan covenants, legal aspects etc. in deciding its capital structure.

2.3.3 Dividend decisions: They are concerned with distribution of profit amongshareholders or retaining it as a source of finance.

A dividend decision is the third major financial decision. Thefinancial manager must decide whether the firm should distribute all profits, or retainthem, or distribute a portion and retain the balance. The proportion of profits distributedas dividends is called the dividend-payout ratio and the retained portion of profits isknown as the retention ratio. Like the debt policy, the dividend policy should be determinedin terms of its impact on the shareholders' value. The optimum dividend policy is one thatmaximizes the market value of the firm's shares. Thus, if shareholders are not indifferentto the firm's dividend policy, the financial manager must determine the optimum dividendpayout ratio. Dividends are generally paid in cash. But a firm may issue bonus shares.Bonus shares are shares issued to the existing shareholders without any charge. Thefinancial manager should consider the questions of dividend stability, bonus shares andcash dividends in practice

The reasons for an organization to become a multinational is they want to boosttheir sales, procure resources at a lower cost and want to diversify to prevent abruptchanges in their sales and profits. It may be difficult to separate the finance functionsfrom production, marketing and other functions, but the functions themselves can bereadily identified. A firm attempts to balance cash inflows and outflows while performingthese functions. This is called liquidity decision, and we may add it to the list of importantfinance decisions or functions. Thus finance functions or decisions are divided into long-term and short-term decisions and include:

Long-term financial decisions:
• Long-term asset-mix or investment decision
• Capital-mix or financing decision
• Profit allocation or dividend decision

Short-term financial decisions: Short-term finance functions or decisions involve a period of less than one year. Thesedecisions are needed for managing the firm's day-to-day fund requirements. Generally,they relate to the management of current assets and current liabilities, short-termborrowings and investment of surplus cash for short periods.

• Short-term asset-mix or liquidity decision: Investment in current assets affects the firm's profitability andliquidity. Management of current assets that affects a firm's liquidity is yet anotherimportant finance function. Current assets should be managed efficiently for safeguardingthe firm against the risk of illiquidity. Lack of liquidity (or illiquidity) in extreme situationscan lead to the firm's insolvency. A conflict exists between profitability and liquiditywhile managing current assets. If the firm does not invest sufficient funds in currentassets, it may become illiquid and therefore, risky. It would lose profitability, as idlecurrent assets would not earn anything. Thus, a proper trade-off must be achievedbetween profitability and liquidity. The profitability-liquidity trade-off requires that thefinancial manager should develop sound techniques of managing current assets. He or she should estimate the firm's needs for current assets and make sure that funds wouldbe made available when needed.

In sum, financial decisions directly concern the firm's decision to acquire or disposeoff assets and require commitment or recommitment of funds on a continuous basis. It isin this context that finance functions are said to influence production, marketing andother functions of the firm. Hence finance functions may affect the size, growth,profitability and risk of the firm, and ultimately, the value of the firm.

A firm performs finance functions simultaneously and continuously in the normalcourse of the business. They do not necessarily occur in a sequence. Finance functionscall for skilful planning, control and execution of a firm's activities.

2.4 International Financial Management & Forex Management

Global capital flows have multiplied many times over in recent years, mainly betweenadvanced economies but increasingly also to emerging markets, reflecting the generalreduction in regulatory and informational barriers.

2.4.1 Cross-border Financial Flows: Capital flow liberalization has been part of the development strategy in severalcountries, in recognition of the benefits that such flows can bring. At the same time,capital flows carry risks, as they can be volatile and their size can be large relative todomestic markets. Because capital flows have a bearing on economic and financialstability in both individual economies and globally, an important challenge for policymakersis to develop a coherent approach to capital flows and the policies that affect them.

Policies including macroeconomic and structural policies, supervisory and regulatoryframeworks, and measures are specifically designed to limit capital flows. The lattermeasures are referred to as capital flow management measures (CFMs). The assessmentof whether a measure is designed to limit capital flows would need to take into accountcountry—specific circumstances, including the overall context in which the measurewas introduced.

2.4.2 Capital flows: Trends and composition: Capital flows have grown significantly over the last two decades in both size and volatility.Gross capital flows have occurred predominantly among AEs, although net capital flowshave been significant among both advanced and emerging economies.

In particular, net flows to emerging economies are larger as a proportion of eacheconomy's GDP than those to AEs. Global gross flows have increased dramatically,from an average of less than 5 per cent of global GDP during 1980—99 to a peak ofabout 20 per cent by 2007. Volatility has also grown, as flows dropped sharply in theaftermath of the global crisis, followed by a moderate recovery.

Capital flows to emerging economies have historically mainly comprised foreigndirect investment (FDI), although portfolio and 'other investment' (mainly bank-related)have increased substantially since 2003.

Indeed, the bulk of the increase in global capital flows during 2003-2007 comprisedshort-term inflows, including both portfolio and other investment. Debt flows havehistorically proven more volatile and risky for the financial system than have FDI andportfolio equity flows.

The process of global financial integration manifests itself in steadily rising cross-border financial flows and the accumulation of large and rising foreign assets and liabilities.These can take the form of, for instance, portfolio investment in bonds or equities, foreigndirect investment in enterprises, or loans between residents of different countries

2.4.3 Balance Of Payments: It is important to understand the concept of balance of payment (BOP) as foreignexchange market and exchange rates are connected with the position and rends ofBOP of a country. BOP evolves due to the trading between the inhabitants of onecountry with the rest of the world. BOP records international trade and capital flows, butit does not explain the reasons for the flow.

BOP is an accounting system that measures all economic transactions betweenresidents (including government) of one country and residents of all other countries.Economic transactions include exports and imports of goods and services, capital inflowsand outflows, gifts and other transfer payments and changes in a country's internationalreserves. It has been well defined by Kindleberger as 'a systematic record of all economictransactions between the residents of the reporting country and residents of foreigncountries during a given period of time'. Normally the period is one year. These transactionsare between residents of one country with those of other country.

We need to understand the difference between an economic transaction and acommercial transaction. An economic transaction is an exchange of value or transfer ofa title to a good or an asset; whereas, a commercial transaction is an exchange of goodor service for money that will result in payment in currency leading to financial flows.For example, when we buy a share or property, it is transferred to our name but whenwe buy clothes or food items, we only pay money but there is no transfer of title.BOP has the following **characteristics**:

- Is the systematic record of all economic transactions with the rest of theworld
- Is related to period of time
- Includes the Balance of Trade (BOT) in it
- Includes all transactions current as well as capital
- Includes the receipts and payments of the country
- Is just like a balance sheet
- Is based on double entry book keeping system

• Is not balanced generally it contains some induced transactions for make itbalanced and these transactions done deliberately

BOP is important for business because a foreign company will be influenced byit. As it will have the impact on GNP, employment, inflation, exchange rates, interestrates and many other macroeconomic variables. The major reasons for the interest ofthe MNCs can be because of the following **reasons**:

The BOP helps to forecast a country's market potential. If there is surplus ofBOP, the country will be able to import goods and services, giving brightprospects for MNCs. If there is a deficit BOP, it will present a gloomy picturefor the exporters who were interested in that country.

• BOP is an important indicator of pressure on a country's foreign exchangerate.

• Deficits in the country's BOP indicate future controls on outgoing capitalmovements such as payment of dividends, fees and interest to foreign firmsand investors. MNC will avoid such a country.

The other term that is used with BOP is Balance of Trade (BOT). It refers to thedifference in value of imports and exports of commodities only.

• If imports and exports are exactly equal we have balanced trade.

• If value of exports exceeds value of imports we have favourable balance oftrade.

• If value of imports exceeds value of exports, the country is said to have deficitor adverse balance of trade.

Components of BOP

Three types of international transactions are recorded in the BOP, they are as follows:

• Exports or imports of goods or services in the current account

• Purchases or sales of financial assets in the financial account

• Transfer of wealth between countries in the capital account

1. Current account: The current account records trade in goods and services, as well as transfer payments.It is divided into merchandise trade balance, the service balance and the balance onunilateral transfers. All the entries that are made in these accounts are of current valueand they do not give rise to any future claim. A surplus in the current account representsan inflow of funds while a deficit represents an outflow of funds. The detail of thesethree sub-categories is presented as follows:

• Merchandise trade: It includes the balance between exports or imports of goodssuch as machinery, electronic goods, cars, etc. A surplus balance of merchandisetrade happens when exports are greater in value than imports. A deficit in balanceof merchandise occurs when imports exceed exports.

• Invisibles: These include Services like Payments for legal assistance, tourists'expenditures, and shipping fees, royalty payments and interest payments.International interest and dividend payments and the earnings of domesticallyowned firms operating abroad

• Unilateral Transfers: These include remittances, gifts and grants by bothgovernment and private sector. Government transfers include money, goods andservices sent as an aid to other countries in the hour of need. Private gifts andgrants include personal gifts of all kinds

2. Capital account: It is an accounting measure of the total domestic currency value of financial transactionsbetween domestic residents and the rest of the world over a period of time. This accountconsists of loans, investments and other transfers of financial assets and the creation ofliabilities. It includes financial transactions associated with international trade as well asflows associated with portfolio shifts involving the purchase of foreign stocks, bonds andbank deposits. It includes three categories: direct investment, Portfolio investment andother capital flow. The detail of these three sub-categories is presented as follows:

Direct investment: It occurs when the investor acquires equity such as purchaseof stocks, acquisition of entire firms or the establishment of new subsidies. FDI takesplace when the firms tend to take advantage of various market imperfections. Firmsalso undertake FDI when the expected returns from foreign investment exceed the costof capital, allowing for foreign exchange and political risks. The expected returns fromthe foreign profits can be higher than those from domestic projects due to lower materialand labour costs, subsidized financing, investment tax allowances, exclusive access tolocal markets etc.

Portfolio investment: This represents the sales and purchases of foreign financialassets such as stocks and bonds that do not involve a transfer of management control. Adesire for return, safety and liquidity in investments is the same for international anddomestic portfolio investors. International portfolio investments have seen a boom in therecent years as the investors have become aware about the risk diversification that canbe reduced if they invest in various financial assets globally. The increased returns fromthe foreign markets have also given a boost to such category of investors.

Capital flows: It represents the claim with a maturity of less than one year. Such claimsinclude bank deposits, short-term loans, short-term securities, money market investment,etc. These investments are sensitive to both changes in relative interest rates betweencountries and the anticipated change in the exchange rate. Let us understand with thehelp of an example. If the interest rate increases in India then it will experience a capitalinflow as investors would like to take advantage of the situation.

3. Official reserve account: Official reserves are government owned assets. This account represents only purchasesand sales by the RBI. The changes in official reserves are necessary to account for thedeficit or surplus in the BOPs.

BOP is kept on a double entry book-keeping system with credits and debits ofequal size. For every transaction, there is a corresponding entry on both credit and debitsides. BOP is neither an income statement nor a balance sheet. It is a statement ofsources and uses of funds that reflects changes in assets, liabilities and net worth duringa specified period of time. Decreases in assets and increases in liabilities or net worthrepresent credits or sources of funds. Increases in assets and decreases in liabilities ornet worth represent debits or uses of funds. Sources of funds include exports of goodsand services, investment and interest earnings, unilateral transfers received from abroadand loans from foreigners. Uses of funds include imports of goods and services, dividendspaid to foreign investors, transfer payments abroad, loans to foreigners and increase inreserve assets.

A. Current Account

- (1) Merchandise
  - (a) Exports (on f.o.b basis)
  - (b) Imports (on c.i.f basis)
- (2) Invisibles (a+b+c)
  - (a) Services
    - (i) Travel
    - (ii) Transportation

(iii) Insurance
(iv) Government not included elsewhere
(v) Miscellaneous
(b) Transfers
(i) Official
(ii) Private
(c) Investment income
Total Current account (1+2)
B. Capital account
(1) Foreign investment (a+b)
(a) In India
(i) Direct
(ii) Portfolio
(b) Abroad
(2) Loans (a+b+c)
(a) External Assistance
(i) By India
(ii) To India
(b) Commercial Borrowings (MT and LT)
(i) By India
(ii) To India
(c) Short-term To India
(3) Banking capital (a+b)
(a) Commercial Banks
(i) Assets
(ii) Liabilities
(iii) Non-resident Deposits
(b) Others
(4) Rupee Debt service
(5) Other capital
Total Capital Account (1+2+3+4+5)
C. Errors and Omissions
D. Overall balance (A+B+C)
E. Monetary Movements (i + ii)

2.5 Summary

• International finance can be defined in simple terms as the business taking placebetween two or more than two countries.
• International business may be conducted in the form of international trade;contractual mode like franchising, licensing, management contracts and turnkeyprojects; and also foreign investment like foreign direct investment (FDI) andforeign institutional investor (FII).
• The growth of MNCs has also led to an increase in the scope of internationalfinance.
• Different multinational companies across the globe form a major part or subset ofthe international financial environment, when they operate in international financialoperations and try to gain advantage from the local or the customized environmentalconditions of that market.

• The product life cycle theory states that any new product, which is first introducedin a new country (probably a developed nation), is gradually exported to other lessdeveloped countries as competition in the current market intensifies.
• The long-term finance functions or decisions have a longer time horizon, generallygreater than a year.
• A firm's investment decisions involve capital expenditures. They are, therefore,referred as capital budgeting decisions.
• A financing decision is the second important function to be performed by thefinancial manager. Broadly, he or she must decide when, where from and how toacquire funds to meet the firm's investment needs.
• A dividend decision is the third major financial decision. The financial managermust decide whether the firm should distribute all profits, or retain them, or distributea portion and retain the balance.

2.6 Key Terms

• Financing decision: The decisions are concerned with creating funds from internalsources or from external sources that are less expensive.
• International trade: It refers to trade, the export and import of goods and services,between residents of any two nations.
• Current account: The current account records trade in goods and services, aswell as transfer payments.
• Capital account: It is an accounting measure of the total domestic currencyvalue of financial transactions between domestic residents and the rest of theworld over a period of time

2.7 Review Questions

Short-Answer Questions

1. What do you understand by international finance?
2. What are the finance functions of MNCs?
3. Why do countries indulge in international trade?
4. Write a note on India's foreign trade trend.
5. What do you understand by cross-border financial flow?
6. What is the significance of balance of payment to a country?
7. Briefly state the nature of financing decisions.
8. What kinds of financial procedures and systems are used by a firm?

Long-Answer Questions

1. Discuss the significance of international finance.
2. How do companies draw up their finance plans?
3. What has been the trend of global trade in the past five years? Discuss.
4. Discuss the composition and trend of capital flow
5. What is international finance?
6. What are the factors that have led to the growth of multinational financial environment?
7. What is the difference between long-term and shortterm finance functions or decisions?
8. What are the various finance functions?
9. What is the difference between domestic interregional trade and inter-regional foreign trade?
10. Name the constituents of global trade.
11. What is balance of payment?

12. How is BOP classified?

2.8 Suggested Readings

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LESSON-3
FOREX MANAGEMENT AND GLOBAL ENVIRONMENT

OBJECTIVES:

- To know the Forex management Concept.
- To identify various capabilities of Forex Manager
- To understand the global environment

STRUCTURE:

3.1 Concept of Forex Management
3.2 Importance of Forex Management
3.3 Scope of Forex Management
3.4 Elements of Forex Management
3.5 Capability of Forex Manager
3.6 Global Environment
3.7 Summary
3.8 Key words
3.9 Self-Assessment Questions
3.10 Further Readings

3.1 CONCEPT OF FOREX MANAGEMENT

Foreign exchange (Forex or FX) is the conversion of one currency into another at a specific rate known as the foreign exchange rate. The conversion rates for almost all currencies are constantly floating as they are driven by the market forces of supply and demand. Forex management may be defined as the science of management of generation, use and storage of foreign currencies in the process of exchange of one currency into other called foreign exchange.

Whereas there are thousands of securities on the stock market, on the FOREX market most trading takes place in only a few currencies; the U.S. (Dollar) ($), European Currency Unit (Euro) (€), Japanese (Yen) (¥), British (Pound Sterling) (£), Swiss (Franc) (Sf), Canadian (Dollar) (Can$), and to a lesser extent, the Australian and New Zealand (Dollars). These major currencies are most often traded because they represent the countries having similar internationally recognized trading practices and these currencies are backed by their respective Central Banks. The tools of forex management are akin to domestic currency management but the level of analytical skills required for it is slightly higher because of the existence of spot, forwards and futures markets unlike the domestic currency area. Operations in the forex market require quicker response time because of the greater volatility in exchange rates.

FOREX, an acronym for Foreign Exchange, is the largest financial market in the world. Forex provides income to millions of traders and large banks worldwide. Forex, unlike other financial markets, is not tied to an actual stock exchange. Currencies are traded directly through networks of banks and brokers via an electronic network or the telephone. The Foreign Exchange Market is, therefore, also referred to as an "Interbank" or "Over the Counter (OTC)" market. When goods or services are imported into a country, these are paid for in the currency of the country exporting these goods or services. When an Indian traveler goes to a foreign country on a short visit, he needs foreign currency of that country for meeting his expenses. When he stays in that country for a longer duration for employment purpose, he earns foreign currency of that country. When an Indian firm exports goods to Europe, it is earning foreign exchange. Thus when goods and services are sent abroad by India, foreign currencies are earned by them.

Historically, Forex have been dominated by inter-world investment and commercial banks, money portfolio managers, money brokers, large corporations, and very few private traders. Lately this trend has changed. With the advances in internet technology, plus the industry's unique leveraging options, more and more individual traders are getting involved in the market for the purposes of speculation. While other reasons for participating in the market include facilitating commercial transactions (whether it is an international corporation converting its profits, or hedging against future price drops), speculation for profit has become the most popular motive for Forex trading for both big and small participants. Apart from the transaction value, forex management finds scope as a mode of investment. Because of the frequent and often miniscule fluctuations in forex values, enough arbitrage and speculative opportunities crop up in the forex market for astute investors. There are many expert forex dealers specializing in trading of forex.

FEMA stands for “Foreign Exchange Management Act.” It is a legislation enacted in India in the year 1999 to replace the earlier Foreign Exchange Regulation Act (FERA) of 1973. FEMA is a comprehensive legal framework that regulates foreign exchange transactions, cross-border trade, payments, foreign investments, and various other matters related to foreign exchange management. Foreign Exchange Management Act, 1999 (FEMA) came into force by an act of Parliament. It was enacted on 29 December 1999. This new Act is in consonance with the frameworks of the World Trade Organisation (WTO). It also paved the way for the Prevention of Money Laundering Act, 2002 which came into effect from July 1, 2005.

The primary goal of the Foreign Exchange Management Act (FEMA) 1999 in India is to regulate foreign exchange transactions in a manner that fosters economic growth, stability, and development while ensuring adherence to regulatory guidelines. The primary objective of FEMA is to facilitate external trade and payments, promote the orderly development and functioning of the foreign exchange market, and ensure the proper utilization of foreign exchange resources in the country. It provides a legal framework for dealing with foreign exchange transactions, foreign investments, and other financial activities involving non-residents. Features of Foreign Exchange Management Act, 1999 (FEMA Act)

- ❖ As per this act, Indians residing in India, have the permission to conduct a foreign exchange, foreign security transactions or the right to hold or own immovable property in a foreign country in case security, property, or currency was acquired, or owned when the individual was based outside of the country, or when they inherit the property from individual staying outside the country.
- ❖ In the general interest of the public, the Government of India can restrict an authorized individual from carrying out foreign exchange deals within the current account.
- ❖ FEMA Act 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. All transactions must be carried out through “Authorised Persons.”

- ❖ Empowers RBI to place restrictions on transactions from capital Account even if it is carried out via an authorized individual.
- ❖ There are 5 zonal offices in Delhi, Mumbai, Kolkata, Chennai, and Jalandhar, each office is headed by a Deputy Director.
- ❖ Every 5 zones are further divided into 7 sub-zonal offices headed by Assistant Directors and 5 field units headed by Chief Enforcement Officers.
- ❖ The Head Office of FEMA, also known as the Enforcement Directorate, headed by the Director is located in New Delhi.

3.2 IMPORTANCE OF FOREX MANAGEMENT

- Trade operations in countries across the globe have been in existence for centuries, but an unprecedented growth in worldwide production and distribution of a large number of capital, intermediate and consumer goods has been witnessed in the past fifty years.
- At present most of the countries are economically related to each other through a complex network of trade, foreign investment and international loans. The emergence of WTO and the process of global integration has reinforced the importance of International trade, cross border financial flows and consequently foreign currency transactions.
- Each country has its own currency and each currency has different value in relation to a globally accepted standard. The significance of forex management lies in the study and maintenance of the exchange levels.
- Every good or service reaching us from abroad involves forex. Knowledge of the forex management can help avoid harmful effects of international events and perhaps even profit from these events. With the advent of globalization and liberalization the scope for international trade and international financing has increased tremendously. International trade has grown more quickly than trade in general.
- This has put up both benefits and challenges. The principal benefit for international trade has been in the form of the gain in standard of living it has permitted. The gain has come from exploiting relative efficiencies of production in different countries.
- The challenges of international trade are the introduction of exchange rate risk and country risk. Various methods and markets have evolved that allow firms to avoid or reduce these risks.
- The after effect of development of international trade has been swift movement of funds from one finance centre to the other. There has been investment by multinationals in the third world countries in the form of capital outlays.
- All this has necessitated the need for a better understanding of the mechanism of forex flows. Forex management has become a more important subject because of an increased globalization of financial markets.
- The benefits of the increased flow of capital between nations include a better international allocation of capital and greater opportunities to diversify risk.
- However, globalisation of investment has meant new risks from exchange rates, political actions and increased interdependence of financial conditions in different countries.

3.3 SCOPE OF FOREX MANAGEMENT

Forex management has quite a wide scope of operation. It can cover in its ambit all those transactions which involve use of forex.

The following are the scope for Fore Management:

- A citizen of India travels abroad on a business visit and purchases foreign currency from an authorized dealer.
- An Indian citizen goes to USA for a period of three years under an employment contract. He periodically remits US Dollars to his bank account in India.
- An Indian student subscribes to a British scientific magazine and pays for it through an international credit card held by him.
- An Indian industrialist imports raw material from Malaysia for his plant under a Letter of Credit arrangement provided by his bank.
- A sports goods manufacturer of India exports his consignment to Europe and gets paid for it in foreign currency received through banking channels.
- Indian subsidiary of a Multinational corporation imports white goods in completely knocked down (CKD) from the Chinese affiliate. After reassembling these goods, the same are exported to Europe.
- The World Bank disburses aid to an Indian State under an infrastructure development project.

3.4 ELEMENTS OF FOREX MANAGEMENT

Forex management has the following essential elements:

- It is part of management science: Forex management is part of the broader management science. It is a scientific discipline requiring scientific and analytic orientation. The techniques of management are applied to the broad spectrum of foreign currencies. This broad spectrum refers to all the currencies of the world excluding the domestic currency. These techniques include planning for forex, organization of forex and control of forex. Use the terms forex and foreign exchange interchangeably. The planning part includes budgeting for forex, organization refers to utilization of forex and control part focuses on creation of forex reserves.
- It refers to generation of forex: Forex is generated from international trade transactions. When a country exports goods or services, it earns forex. When goods or services are imported by a country, forex is consumed. If the exports of a country are more than the imports, the forex would be accumulated in reserves of the country. If the imports are more than the exports, the result would be a forex deficit which has to be met by international borrowings. Either way, the forex needs to be generated. Generation of forex is a more difficult proposition because of variation in international trade practices and extent of competition.
- It pertains to use of forex: Forex management is concerned with use of forex in meeting the requirements of the user group. The tools of cash management come handy in using forex. The process of use of forex involves identification of suppliers of goods and services, negotiation of terms and conditions of the transaction and culmination of transaction with the exchange of goods and services with forex. Because of relative uncertainty about availability of forex and volatility in its rates, advance tie-up of forex is made through forward purchase contracts. In this entire process, close track of exchange rates needs to be maintained.
- It covers storage of forex : Forex management involving firm level forex storage could be done through forward purchase contracts or through deposits in foreign currency bank accounts. At the national level, forex storage is done through forex reserves which are held in the form of Gold, Special Drawing Right (SDRs) of IMF and foreign currencies. While some

amount of foreign exchange reserves need to be maintained to meet unforeseen contingencies, excessive accretion to reserves involve a cost which is sometimes justified on other economic consideration at the firm‘s level. Forex is stored for meeting future import liabilities, whether certain or contingent. While storing forex, it is important to bear in mind the actual cost of storage and the opportunity cost of not using the forex elsewhere. Depending upon availability of forex, if the opportunity cost is more than the cost of storage, then it is better not to store it.

3.5 CAPABILITY OF FOREX MANAGER

The developments in international trade have resulted in the emergence of a new brand of manager called the forex manager. The forex manager is a category apart from the finance manager or the treasury manager. Forex manager deals in currency and money but not of one country. Forex manager has to transact with a number of counter parts both in the domestic country and abroad. Forex manager is face to face with special kind of risk. Yet Forex manager vocation is full of opportunities and challenges. For effective management of forex transactions, the forex manager is expected to have the following capability:

- Awareness of historical development of world trade :

  The forex manager must have a fair idea of as to how the world trade has reached its present status. The shifting power alliances, emergence and decline of economic superpowers, present political situations, trade patterns etc. should be known. This knowledge base enables the manager to view the current situation in proper perspective.
- Ability to forecast future trends

  The forex manager must be in a position to derive an accurate forecast of the future trends in international trade flows and exchange rate patterns. This forecast helps the manager to prepare his forex budget.
- Comparative Analysis skills

  The forex manager should be able to carry out a comparative analysis of costs of domestic and imported raw materials, price of local sales and export sales, shipping rates, insurance costs etc. in order to determine whether it is expedient to produce locally or to outsource
- In-depth knowledge of forex market

  The forex manager is expected to have in-depth knowledge of functioning of foreign exchange markets, their rules and regulations, the size of their operation, the profile of active currencies, strength and weakness of the domestic currency etc. in order to achieve better pricing of deals.
- Knowledge of interest rates

  Since interest rates have a direct bearing upon exchange values, awareness about domestic and international interest rates enables the forex manager to form an accurate opinion about the forward premia.
- Willingness to undertake risk

  Armed with the knowledge and awareness about international financial and trade patterns, currency positions and interest rates, the forex manager should have the ability to undertake reasonable level of risks with a view to profit from forex exposures.
- Hedging strategies

The forex manager should be in a position to hedge his positions to the best extent possible. To achieve this, a sense of timing is essential in the background of ever changing world of exchange values.

3.6 GLOBAL ENVIRONMENT

The global business environment is a term used to describe the challenges and opportunities that businesses face when operating in a global marketplace. It reflects the interconnectedness of all parts of the world, which means that what happens in one country or region has an impact on other regions or countries. The global environment is at the core of the operations of business organizations.

The factors of the global environment affect businesses in their daily transactions, but they are generally beyond the control of management, plus they constantly change. Businesses that align with global environment factors' requirements achieve increased performance, elevated morale to their employees, and ultimately a higher profit margin for individuals and their businesses. Success in international business means understanding a wide range of cultural, economic, legal, and political differences between countries.

The global business environment is a complex one. When businesses operate across national borders to buy, sell, produce or manufacture goods and services in different countries, they are obligated to consider a number of important variables.The following are some of the importance of the global business environment to businesses.A concise argument of the multiple factors comprising the global environment of the company is includes different:

- Legal Environment

  Legal Environment includes various laws passed by the government, administrative orders issued by government authorities, court judgments as well as decisions rendered by the central, state or local governments. Understanding of legal knowledge is a pre-requisite for the smooth functioning of business and industry. And the legal environment by business houses helps them not to fall in a legal tangle.These factors involve changes in government laws and regulations.

  An understanding of these legal regulations is utmost essential owing to increasing trade as well as financial linkages among the international economies. Laws and concerning rules and regulations are changing over a period of time. To quote, laws relating to consumer health and consumerism are particularly different across nations. So, for successful functioning of business houses, international trade laws and regulations play a pivotal role.

- Political Environment

  Political Environment means that the actions were taken by the government, which potentially affects the routine activities of any business or company on a domestic or at the global level. The success of business and industry depends upon the government’s attitude towards the business and industry, Stability of Government, Peace in the country.This refers to political ideologies comprising changes in government policies. These factors have an impact on overall operations of the business.

  For example, rules relating to foreign direct investments (FDI) and foreign financial flows are changing over the years. These changing patterns are particularly relevant for the emerging markets, like India. On a similar note, fiscal policy initiatives undertaken in the emerging economies are particularly increasing competing elements among the said markets. The international business houses are required to comprehend these political ideologies time and again.

- Economic Environment

  The economic environment consists of an economic system, economic policies and economic conditions prevailing in a country. Interest Rates, Taxes, Inflation, Stock Market Indices, Value of Rupee, Personal Disposable Income, Unemployment rate etc. are the factors which affect the economic environment. These factors involve changes in overall economic structures. Inflationary pressures are the core economic factors driving international business strategies. Increasing living standards imply increasing inflationary pressures due to increase in demand for products. Consequently, increase in demand for the products causes business houses to witness profits.

  So, an understanding of overall economic conditions is essential for successful operations of business. Other economic factors that affect business include changes in real interest rate, wage rates, unemployment levels, consumer confidence levels, production levels, etc. Increasing consumer confidences also channelize business strategies across the nations.

- Social Environment

  Social Environment consists of social forces like traditions, values, social trends, level of education, the standard of living etc. These factors include behavior, tastes, socio-cultural and lifestyles patterns of a population. Demographics play an important role in determining buying patterns of population. Age, gender, profession, composition, etc, have an impact on overall buying behavior of population and understanding of such changes is critical for developing corporate strategies. In a globalized environment, the social factors vary from one country to another.

  For instance, global chain of Quick Service Restaurants (QSR) McDonalds introduces products considering not only the taste and preferences of its domestic consumers, but religion sentiments are also considered at the time of designing menu strategies. All these forces have a vast impact on business. Like tradition, values, and social trends etc.

- Technological Environment

  It consists of scientific improvements and innovations which provide new ways of producing goods, rendering services, new methods and techniques to operate a business. It is very important for a firm to understand the level of scientific achievements of a particular economy before introducing its products.Technological compatibility of products also drives the demand for manufactured products by a company.New innovations and inventions always have an impact on overall business operations because the said factors reduce costs and develop new products. With the advent of modern information and communication technologies, relevant information can be transferred from one country to another in just few micro seconds.

  This further helps in gaining competitive advantage. For instance, international brokerage houses are heavily reliant on modern technologies, whereby buy and sell related strategies are provided with respect to worldwide markets across different nations.

In addition to these considerations, global business management requires organisations to have a solid understanding of the current conversations, trends, issues and challenges that can impact businesses operating in the global market.

- Tax systems and tariffs
- Regulatory and compliance frameworks
- Economic and market factors
- Shipping and transport processes

3.7 SUMMARY

Foreign Exchange (FX or Forex) management is the process of managing the exchange of foreign currencies. This includes the conversion of one currency to another, the purchase and sale of foreign currency, and the management of currency risk. Foreign exchange management differs from foreign exchange risk management in as much it is the management of the exposures created and the actual management of the various currencies purchased or received and the relevant payments. The tools of forex management are akin to domestic currency management but the level of analytical skills required for it is slightly higher because of the existence of spot, forwards and futures markets unlike the domestic currency area. Operations in the forex market require quicker response time because of the greater volatility in exchange rates. Management is part of the broader management science. It is a scientific discipline requiring scientific and analytic orientation.

Forex management is concerned with use of forex in meeting the requirements of the user group. The tools of cash management come handy in using forex. The process of use of forex involves identification of suppliers of goods and services, negotiation of terms and conditions of the transaction and culmination of transaction with the exchange of goods and services with forex. Forex manager deals in currency and money but not of one country. Forex manager has to transact with a number of counter parts both in the domestic country and abroad. Forex manager is face to face with special kind of risk. The factors of the global environment affect businesses in their daily transactions, but they are generally beyond the control of management, plus they constantly change. Businesses that align with global environment factors' requirements achieve increased performance, elevated morale to their employees, and ultimately a higher profit margin for individuals and their businesses.

Every good or service reaching us from abroad involves forex. Knowledge of the forex management can help avoid harmful effects of international events and perhaps even profit from these events. With the advent of globalization and liberalization the scope for international trade and international financing has increased tremendously. International trade has grown more quickly than trade in general.

3.8 KEY WORDS

- **Foreign Exchange Management Act (FEMA):** FEMA stands for “Foreign Exchange Management Act.” It is a legislation enacted in India in the year 1999 to replace the earlier Foreign Exchange Regulation Act (FERA) of 1973. FEMA is a comprehensive legal framework that regulates foreign exchange transactions, cross-border trade, payments, foreign investments, and various other matters related to foreign exchange management. Foreign Exchange Management Act, 1999 (FEMA) came into force by an act of Parliament. It was enacted on 29 December 1999.
- **Significant of FEMA:** Foreign Exchange Management Act holds significant importance in India’s economic landscape due to its role in regulating foreign exchange transactions, facilitating international trade and investment, maintaining currency stability, and preventing illegal activities.

- **FOREX:** An acronym for Foreign Exchange is the largest financial market in the world. Forex provides income to millions of traders and large banks worldwide. Forex, unlike other financial markets, is not tied to an actual stock exchange.
- **Forex Manager:** The developments in international trade have resulted in the emergence of a new brand of manager called the forex manager. The forex manager is a category apart from the finance manager or the treasury manager. Forex manager deals in currency and money but not of one country. Forex manager has to transact with a number of counter parts both in the domestic country and abroad. Forex manager is face to face with special kind of risk.
- **Global environment:** Global environment refers to the interrelationships and transactions among cultures, people, and organisations worldwide. As a result of international business and other global trends, today's global environment has become a complex set of interdependent networks. The global environment can be understood as the environment within which international business operates and is characterized by influential factors beyond administrative control .The local environment are those factors affecting a business within its country or region of operation.
- **Legal Environment:** It includes various laws passed by the government, administrative orders issued by government authorities, court judgments as well as decisions rendered by the central, state or local governments.
- **Social Environment:** It consists of social forces like traditions, values, social trends, level of education, the standard of living etc. These factors include behavior, tastes, socio-cultural and lifestyles patterns of a population. Demographics play an important role in determining buying patterns of population. Age, gender, profession, composition, etc, have an impact on overall buying behavior of population and understanding of such changes is critical for developing corporate strategies.

3.9 SELF-ASSESSMENT QUESTIONS

1. What is Forex Management? Explain its importance in present business?
2. Discuss the scope of Forex Management?
3. Give brief about FEMA Act?
4. Who is Forex Manager? What are its capabilities to do effective Forex Management?
5. Define global environment? Explain the different factors of the global environment affect businesses in their daily transactions.

3.10 FURTHER READINGS

- Foreign Exchange Management and International Finance by VivekViswan V. & M.M. Sulphey, Viva Books, 2016.
- Foreign Exchange Management Act, 1999 Bare Actby EBC , Eastern Book Company, 2022
- Foreign Exchange & Risk Management by C Jeevanandam Sultan Chand and Sons, 2016

Dr.SADHIK SAYYED

LESSON – 4
INTERNATIONAL FINANCIAL MARKETS AND INSTRUMENTS

Learning Objectives:

- Understand the purpose of capital markets, domestic and international.
- Explore the major components of the international capital markets.
- Understand the role of international banks, investment banks, securities firms, and financial institutions.

Lesson Structure

4.0 Introduction of International Financial Markets

Finance is the lifeblood of every organisation. But this is available in limited quantity. hence, there comes a need for organisations to explore different contemporary sources from where these funds can be arranged including domestic and international platforms. in this article, we will discuss in detail the meaning of international financial markets, their relevance and the different instruments available.

Globalization of trade implies 'universalisation of the process of trade'. In 1990,increased openness to international trade, under such headings as, "outward orientation"or "trade liberalization" has been advocated as an engine of economic growth and a roadto development. The marginalization of Indian economy together with many other factorsresulted in a severe balance of payment crisis. The foreign exchange reserves fell rapidly toless than three weeks of our imports needs. In order to overcome this situation, and boostup exports, the Government initiated steps for the dismantling of restrictive policy instruments through reforms m trade, tariff, and exchange rate policies.

Global Economic War after Global Political War

After the Second War and the IMF par value system came into existence, we becamepart of the new world system. Countries had exchange control and various sorts of traderestrictions. It was after the Seventies that gradually a scheme of flexible exchange ratescame into existence among leading developed countries. Gradually the developed countriesstarted freeing their exchange rates and also moved towards their system off free trade.

The World Trade Organization, of which we are a member, is now introducing allover the world a free trade system. After the advent of Economic Reforms from 1991-1992,we have moved over to currency, convertibility on current account. The importance ofthe World Bank as financier has diminished considerably. The world is now dependenton private capital imports. Even the role of the IMF has diminished with most countriesadopting currency convertibility. Capital flows are moving on a large scale dependent onincentives. Most countries have lifted trade barriers and reduced import duties.

The WTO is introducing system in which domestic subsidies have to be removedand uniform and low import duties have now to become the standard. There is no place fortariff barriers and non-tariff barriers are also now getting lifted. The world's industries arenow organized largely in terms of multinational corporations whose operations transcendmany countries. International demonstration effects are working powerfully in determiningthe living styles in all countries.

Indian Foreign Investment Policy

In June 1991, Indian government initiated Programme of macroeconomicstabilization and structural adjustment supported by IMF and the World Bank. As part ofthis Programme a new industrial policy was announced on July 24, 1991 in the Parliament,which has started the process of full-scale liberalization and intensified the process ofintegration of India with the global economy.

A Foreign Investment Promotion Board (FIPB), authorized to provide a singlewindow clearance as been set up. India became a signatory to the convention of MIGA forprotection of foreign investments. Companies with more than 40 per cent of foreign equityare now treated on par with fully Indian owned companies. New sectors such as mining,banking, telecommunications, high-way construction, and management have been thrownOpen to private, including foreign owned companies.

4.1 International Financial Markets and Instruments Overview

1.1.1Basic Terms - Meaning

The International Financial Market functions as a platform for the exchange of financial assets between individuals and nations. It can be perceived as a comprehensive framework comprising rules and institutions facilitating the trading of assets between surplus and deficit entities, with these institutions establishing the regulatory guidelines.

An asset is anything of durable value, that is, anything that acts as a means to storevalue over time. Real assets are assets in physical form (e.g., land, equipment, houses,etc.), including "human capital" assets embodied in people (natural abilities, learned skills,knowledge). Financial assets are claims against real assets, either directly (e.g., stock shareequity claims) or indirectly (e.g., money holdings, or claims to future income streams thatoriginate ultimately from real assets). Securities are financial assets exchanged in auctionand over-the-counter markets (see below) whose distribution is subject to legal requirementsand restrictions (e.g., information disclosure requirements).

Lenders are people who have available funds in excess of their desired expendituresthat they are attempting to loan out, and borrowers are people who have a shortage of fundsrelative to their desired expenditures who are seeking to obtain loans.

Borrowers attempt toobtain funds from lenders by selling to lenders newly issued claims against the borrowers'real assets, i.e., by selling the lenders newly issued financial assets.

A financial market is a market in which financial assets are traded. In additionto enabling exchange of previously issued financial assets, financial markets facilitateborrowing and lending, by facilitating the sale by newly issued financial assets. A financialinstitution is an institution whose primary source of profits is through financial assettransactions. Examples of such financial institutions include discount brokers, banks,insurance companies, and complex multi-function financial institutions.

4.1.2 International Financial Markets - Functions

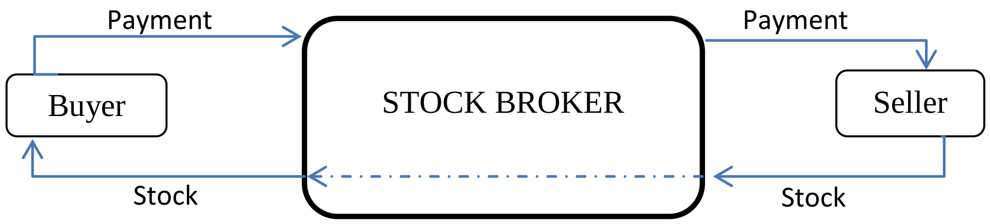
Financial markets serve six basic functions. These functions are briefly listed below:

- **Borrowing and Lending**: Financial markets permit the transfer of funds from one agent to another for either investment or consumption purposes.
- **Price Determination**: Financial markets provide vehicles by which prices are set both for newly issued financial assets and for the existing stock of financial assets.
- **Information Aggregation and Coordination**: Financial markets act as collectors and aggregators of information about financial asset values and the flow of funds from lenders to borrowers.
- **Risk Sharing**: Financial markets allow a transfer of risk from those who undertake investments to those who provide funds for those investments.
- **Liquidity**: Financial markets provide the holders of financial assets with a chance to resell or liquidate these assets.
- **Efficiency**: Financial markets reduce transaction costs and information costs.

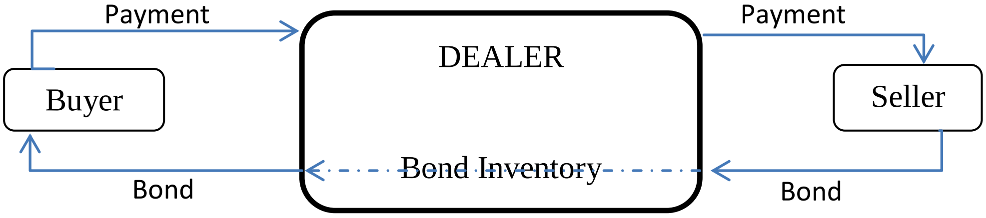
4.2.3 Major Players in Global Financial Markets

By definition, financial institutions are institutions that participate in financialmarkets, i.e., in the creation and/or exchange of financial assets. The following are the majorplayers of financial markets:

- **Brokers:** A broker is a commissioned agent of a buyer (or seller) who facilitates trade by locating a seller (or buyer) to complete the desired transaction. A broker does not take a position in the assets they trade. The profits of brokers are determined by the commissions they charge to the users of their services (the buyers, the sellers, or both).



- **Dealers:** Like brokers, dealers facilitate trade by matching buyers with sellers of assets; they do not engage in asset transformation. Unlike brokers, however, a dealer can and does "take positions" (i.e., maintain inventories) in the assets he or she trades that permit the dealer to sell out of inventory rather than always having to locate sellers to match every offer to buy. Also, unlike brokers, dealers do not receive sales commissions. Rather, dealers make profits by buying assets at relatively low prices and reselling them at relatively high prices (buy low - sell high). The price at which a dealer offers to sell an asset (the "asked price") minus the price at which a dealer offers to buy an asset (the "bid price") is called the bid-ask spread and represents the dealer's profit margin on the asset exchange.



- **Investment Banks:** An investment bank assists in the initial sale of newly issued securities (i.e., in IPOs = Initial Public Offerings) by engaging in a number of different activities:
  - ➢ Advice: Advising corporate on whether they should issue bonds or stock, and, for bond issues, on the particular types of payment schedules these securities should offer;
  - ➢ Underwriting: Guaranteeing corporate a price on the securities they offer, either individually or by having several different investment banks form a syndicate to underwrite the issue jointly;
  - ➢ Sales Assistance: Assisting in the sale of these securities to the public.
- **Financial Intermediaries:** Unlike brokers, dealers, and investment banks, financial intermediaries are financial institutions that engage in financial asset transformation. That is, financial intermediaries purchase one kind of financial asset from borrowers - generally some kind of long-term loan contract whose terms are adapted to the specific circumstances of the borrower (e.g. a mortgage) - and sell a different kind of financial asset to savers, generally some kind of relatively liquid claim against the financial intermediary (e.g. a deposit account). In addition, unlike brokers and dealers, financial intermediaries typically hold financial assets as part of an investment portfolio rather than as an inventory for resale. In addition to making profits on their investment portfolios, financial intermediaries make profits by charging relatively high interest rates to borrowers and paying relatively low interest rates to savers.

  Types of financial intermediaries include

  Depository Institutions (commercial banks, savings and loan associations, mutual savings banks, credit unions); Contractual Savings Institutions (life insurance companies,fire and casualty insurance companies, pension funds, government retirement funds); andInvestment Intermediaries (finance companies, stock and bond mutual funds, money marketmutual funds).

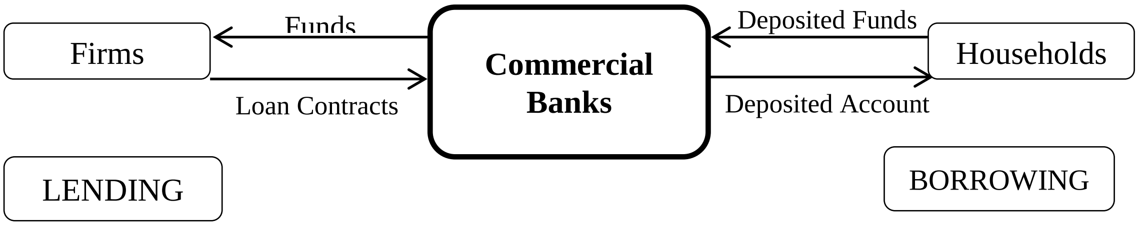


Fig: Process of Financial Intermediary

4.2 Existing Types of Financial Market Structures

The costs of collecting and aggregating information determine, to a large extent, thetypes of financial market structures that emerge. These structures take four basic forms:

- Auction markets conducted through brokers;
- Over-the-counter (OTC) markets conducted through dealers;
- Organized Exchanges, such as the New York Stock Exchange, which combine auction and OTC market features. Specifically, organized exchanges permit buyers and sellers to trade with each other in a centralized location, like an auction. However, securities are traded on the floor of the exchange with the help of specialist traders who combine broker and dealer functions.
- Intermediation financial markets conducted through financial intermediaries; Financial markets taking the first three forms are generally referred to as securities markets. Some financial markets combine features from more than one of these categories, so the categories constitute only rough guidelines.

a. **Auction Markets:** An auction market is some form of centralized facility (or clearing house) by which buyers and sellers, through their commissioned agents (brokers), execute trades in an open and competitive bidding process. The "centralized facility" is not necessarily a place where buyers and sellers physically meet. Rather, it is any institution that provides buyers and sellers with a centralized access to the bidding process.

All of the needed information about offers to buy (bid prices) and offers to sell (askedprices) is centralized in one location which is readily accessible to all would-be buyers andsellers, e.g., through a computer network. No private exchanges between individual buyersand sellers are made outside of the centralized facility.

An auction market is typically a public market in the sense that it open to all agentswho wish to participate. Auction markets can either be call markets - such as art auctions- for which bid and asked prices are all posted at one time, or continuous markets - such asstock exchanges and real estate markets.

b. **Over-the-Counter Markets:** An over-the-counter market has no centralized mechanism or facility for trading. Instead, the market is a public market consisting of a number of dealers spread across a region, a country, or indeed the world, who make the market in some type of asset. That is, the dealers themselves post bid and asked prices for this asset and then stand ready to buy or sell units of this asset with anyone who chooses to trade at these posted prices.

The dealers provide customers more flexibility in trading than brokers, becausedealers can offset imbalances in the demand and supply of assets by trading out of theirown accounts.

c. **Intermediation Financial Markets:** An intermediation financial market is a financial market in which financial intermediaries help transfer funds from savers to borrowers by issuing certain types of financial assets to savers and receiving other types of financial assets from borrowers. The financial assets issued to savers are claims against the financial intermediaries, hence liabilities of the financial intermediaries, whereas the financial assets received from borrowers are claims against the borrowers, hence assets of the financial intermediaries

4.3 Types of International Financial Markets

International financial markets relate to the global marketplace where individuals and entities are involved in the trading of various financial assets, including stocks, bonds, currencies, goods, and derivations, transcending national borders.

International financial markets act as the Channel or source for the global transfer of finances, encompassing both ownership and debt finances, with varying maturity periods, similar to short-term, medium-term, and long-term.

International financial transactions involve exchange of assets between residents ofdifferent financial centres across national boundaries. International financial centres arereservoirs of savings and transfer them to their most efficient use irrespective of where thesavings are generated.

There are three important functions of financial markets. First, the interactions ofbuyers and sellers in the markets determine the prices of the assets traded which is calledthe price discovery process. Secondly, the financial markets ensure liquidity by providing amechanism for an investor to sell a financial asset. Finally, the financial markets reduce thecost of transactions and information.

International financial markets and operations comprise exchange deals i.e. buying/selling currencies; banking transactions i.e., deposit taking and lending; andcapital market operations i.e., issuance of securities. However market segmentsare classified according to the nature of financial operations:

(a) Money markets (or exchange markets): exchange or exchange related transactions
(b) Creditmarkets: deposit taking and lending,
(c) Capital markets: issuance of securitiesand
(e) Equity markets: issuance of international equities.

The International Financial Markets can be categorised into the following segments:

4.3.1 Foreign Exchange Market

a. The foreign exchange market, often referred to as the forex market, facilitates thebuying and selling of foreign currencies.
b. When engaging in international borrowing or investment, individuals and organisations rely on the foreign exchange market to convert currencies.
c. Unlike traditional physical trading floors, the forex market operates as an over-the-counter system.
d. Traders are dispersed across the offices of major commercial banks worldwide and communicate through electronic terminals, telephones, telexes, and other communication channels.

41.3.2 International Bond Market

The international bond market is the arena for the trading of international bonds. Companies seeking long-term funds in foreign currencies issue international bonds, which come in two primary forms: foreign and Euro bonds.

Bonds are the most common form of debt instrument, which is basically a loan from the holder to the issuer of the bond. The international bond market consists of all the bonds sold by an issuing company, government, or entity outside their home country. Companies that do not want to issue more equity shares and dilute the ownership interests of existing shareholders prefer using bonds or debt to raise capital (i.e., money). Companies might access the international bond markets for a variety of reasons, including funding a new production facility or expanding its operations in one or more countries. There are several types of international bonds, which are detailed in the next sections.

Foreign bonds	**Euro bonds**
Foreign bonds are underwritten in the country where they are issued, cater to the needs of investors in that specific country and are subject to the regulations of the issuing country.	Euro bonds are underwritten internationally, offered to investors in multiple countries simultaneously, issued beyond any single country’s jurisdiction, and not registered through a regulatory agency. They typically make annual coupon payments and are offered in substantial amounts for placement

	across various countries.

4.3.3 International Equity Market

a. Companies raise equity capital by issuing shares, which are also traded on the stock exchanges of their individual countries.
b. These shares are also listed on the stock exchanges of those countries.
c. This strategy may be employed to secure foreign currency funds for specific projects, enhance the company's global market presence, or when the domestic market lacks the capacity to absorb a significant stock offering.

4.3.4 International Money Market

A money market is a market for instruments and a means of lending (or investing)and borrowing funds for relatively short periods, typically regards as from one day to oneyear. Such means and instruments include short term bank loans. Treasury bills, bankcertificates of deposit, commercial paper, banker's acceptances and repurchase agreementsand other short term asset backed claims.

As a key elements of the financial system of a country, the money market playsa crucial economic role that if reconciling the cash needs of so called deficit units (suchas farmers needing to borrow in anticipation of their later harvest revenues), with theinvestment needs of surplus units (such as insurance companies wanting to invest cashproductively prior to making long term investment choices). Holding or borrowing liquidclaims is more productive than holding cash balances. A smoothly functioning moneymarket can perform these functions very efficiently if borrowing lending spreads (or bidoffers spreads for traded instruments) are small (operational efficiency), and if funds arelent to those who can make the most productive use of them (allocation efficiency). Bothborrowers and lenders prefer to meet their short term needs without bearing the liquidityrisk or interest rate risk that characterizes longer term instruments, and money marketinstruments allow this. In addition money market investors tend not to want to spend muchtime analyzing credit risk, so money market instruments are generally characterized by ahigh degree of safety of principal. Thus the money market sets a market interest rate thatbalances cash management needs, and sets different rates for different uses that balancetheir risks and potential for productive use. Unlike stock or futures markets, the moneymarkets of the major industrial countries have no central location; they operate as atelephone market that is accessible from all parts of the world.

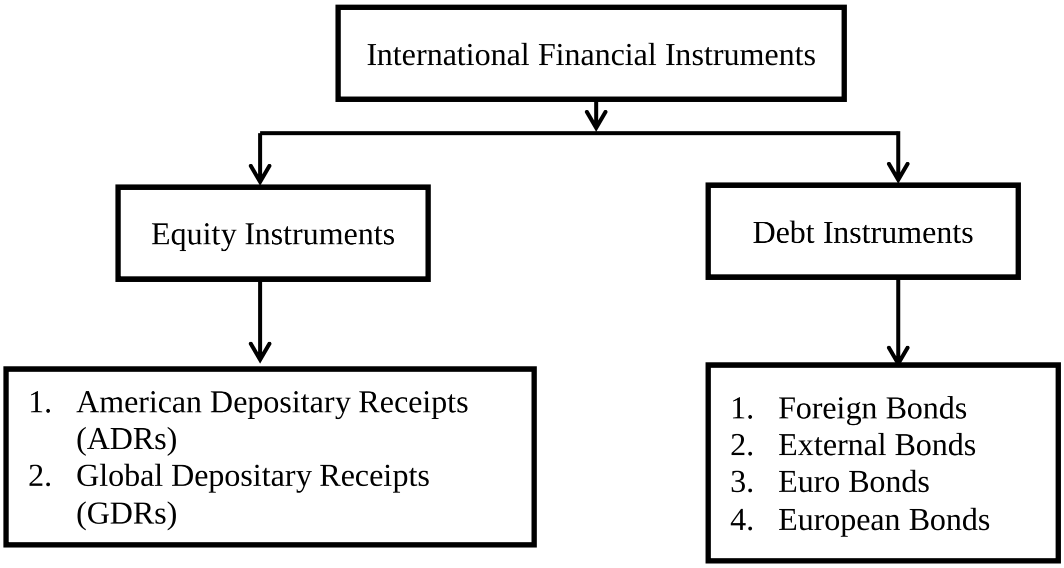
The international money market encompasses the transfer of short-term funds.

a. It involves transactions in various currencies and relies heavily on international banks and financial institutions as the primary fund suppliers.
b. Major users of these funds include multinational corporations and governments from different countries.
c. The money market, along with the bond market, is used to finance the government deficit.
d. The transmission of monetary policy (including exchange rate policy) is typically done through the money market, either through banks or through freely traded money market instruments.
e. The government uses the institutions of the money market to influence credit allocation toward favored uses in the economy.

4.3.5 International Credit Market

a. Within the international financial market, the member allocated to the exchange of medium-term finances between fund suppliers and borrowers is occasionally referred to as the international credit market.
b. International corporations can access short-term finances in foreign currencies from the international money markets and gain long-term finances in foreign currencies from the international bond markets.

1.4 Instruments of International Financial Markets



4.4.1 Equity Instruments

Until the end of 1970s, International Capital Markets focused on debt financing and theequity finances were raised by the corporate entities primarily in the domestic markets. This wasdue to restrictions on cross-border equity investments prevailing until then in many countries.

Inventors too preferred to invest in domestic equity issues due to perceived risks implied inforeign equity issue either related to foreign currency exposure or related to apprehensions ofrestrictions on such investments by the national authorities.Early ‘80s witnessed liberalization of many domestic economies and globalization of thesame. Issuers from developing countries, where issue of dollar/foreign currency denominatedequity shares are not permitted, are now able to access international equity markets through theissue of an intermediate instrument called ‘Depository Receipt’.

A Depository Receipt (DR) is a negotiable certificate issued by a depository bank whichrepresents the beneficial interest in shares issued by a company. These shares are deposited with alocal ‘custodian’ appointed by the depository, which issues receipts against the deposit of shares

According to the placements planned, DRs are referred to as (i) Global DepositoryReceipts (GDRs) (ii) American Depository Receipts (ADRs) and (iii) InternationalDepository Receipts (IDRs). Each of the Depository Receipt represents a specified numberof shares in the domestic markets. Usually, in countries with capital account convertibility,the GDRs and domestic shares are convertible (may be redeemed) mutually. This impliesthat, an equity shareholder may deposit the specified number of shares and obtain the GDRand vice versa. The holder of GDR is entitled to a dividend on the value of the underlyingshares of the GDR (issued normally in the currency of the investor country). As far asIndian companies are concerned, the dividends are announced as a percentage of the valueof GR sans premium in rupee terms converted at the prevailing exchange rate

- American Depository Receipts (ADRs)

ADRs represent a noteworthy facet of international equity instruments. These negotiable certificates, issued by American banks, hold a specific quantity of shares from foreign corporations, which are actively traded within the U.S. financial markets. By providing a convenient means for U.S. investors to participate in foreign companies, ADRs contribute significantly to the globalization of investment portfolios.

- Global Depository Receipts (GDRs)

GDRs, also recognized as International Depositary Receipts (IDRs), are versatile financial instruments issued by depositary banks. They hold the potential to represent shares from foreign corporations and bear a resemblance to ADRs. What sets GDRs apart is their global nature – they can be converted into varying numbers of shares and are denominated in freely convertible currencies. Furthermore, GDRs find listing and active trading on European stock markets, expanding the reach and accessibility of foreign investment opportunities.

4.4.2 Debt Instruments

- Foreign Bonds

Foreign bonds stand as a prominent category within international debt instruments. These bonds are issued by foreign corporations or borrowers in their domestic currency for investors within the issuing country. Foreign bonds are typically listed on the domestic stock exchanges, allowing cross-border capital flows and diversification of funding sources.

- External Bonds

External bonds represent foreign currency-denominated domestic bonds issued by domestic companies. An intriguing subtype of external bonds is the Foreign Currency Convertible Bonds (FCCBs). These bonds offer investors the option to convert them into shares, either partially or fully, at predetermined prices or ratios upon maturity. FCCBs cater to the evolving needs of international investors and companies seeking flexible financing solutions.

- Euro Bonds

Euro bonds emerged as a compelling facet of international finance, involving bonds issued by international companies or syndicates. These bonds are unique in that they are denominated in currencies other than those of the countries where they are issued. Euro bonds are categorized based on the specific currency in which they are denominated. They offer multinational entities a flexible financing avenue while contributing to the diversification of investors' portfolios.

- European Bonds

European bonds constitute an innovative solution to address debt crises and associated challenges within the Eurozone. These bonds are collectively issued in Euros by Eurozone nations and distributed to individual governments. This collaborative approach aims to tackle complex issues related to free rider and force rider problems, fostering economic stability within the region.

4.5 Summary

International financial markets and instruments have embarked on a journey through a dynamic and interconnected realm of global finance. These markets serve as the lifeblood of the world economy, facilitating the exchange of financial assets across borders, transcending national boundaries, and connecting surplus and deficit entities.

Brigham and Eugene defined the financial market as a place where people andorganizations wanting to borrow money are brought together with those having surplusfunds. Financial market does not refer to a physical location. Market participants arelinked by formal trading rules and communication networks for originating and tradingfinancial securities link market participants. Transferring of funds from the surplus sectorto the deficit sector is the main function of the financial market. The credit requirementsof the corporate sector are greater than their savings. The savings of the householdsector are channelized into the corporate and public sectors for productive purposes.

The market participants in financial markets are investors or buyers of securities,borrowers or sellers of securities, intermediaries and regulatory bodies. Securities arefinancial instruments that represent the holder's claim on a stream of income or a fixedamount from a corporate or government.

4.6 Key Terms

Money market: Money market is the place where monetary assets, which areshort term in nature and less than one year, are traded.

• **Forex market**: It is the foreign exchange market where foreign currencytransactions take place.

• **Quotation**: A quotation is the amount of a currency necessary to buy or sell aunit of another currency.

• **Cross rate**: The exchange rate that is obtained by the cross product of twoexchange rates is called cross rate.

4.7 Review Questions

1. What is a financial market? What are the components?
2. Write a note on spot market.
3. What are the determinants of spread?
4. What is the importance of the foreign exchange market?
5. What is the eurobond market?
6. Write a note on eurocurrency market
7. Describe the functioning of a financial market.
8. What do you understand by international financial market? Explain.
9. Who are the main players of the foreign exchange market? Discuss each in
10. detail.
11. How has the euro market emerged as the important financial market? Discuss.

4.8 Suggested Readings

1. Rajwade, A. V. 1995. Foreign Exchange, International Finance and Risk Management, New Delhi: Academy of Business Studies.
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Dr. Nagaraju Battu

LESSON – 5
ARBITRAGE OPPORTUNITIES AND INTERGRATION OF MARKET

Learning Objectives: After completion of the Lesson on Arbitrage Opportunities and Integration of Markets, student is able to know

1. What Market Integration is and its Causes
2. Able to know the arbitrage opportunities a foreign trader will have
3. Market Integration Technique
4. Market Integration Definition
5. Market Integration in Global Economy

Lesson Structure

5.1 Introduction
5.2 Meaning of Arbitrage
5.3 TYPES OF ARBITRAGE
 5.3.1. Pure Arbitrage
 5.3.2. Merger Arbitrage
 5.3.3. Convertible Arbitrage
5.4 Market Integration
5.5 Primary Characteristics of Market Integration
5.6 Impact of Market Integration
 5.6.1 Market Integration and Economic Policy
 5.6.2 Examples of Market Integration
 5.6.3 Market Integration Example in Developed Economies
 5.6.4 Market Integration Example in Developing Economies
5.7 Factors Leading to Market Integration
 5.7.1 Market Integration Causes: Policy Factors
 5.7.2 Market Integration Causes: Technological Advancements
5.8 Improvements in Transportation
5.9 Approaches to Achieving Market Integration
 5.9.1. Market Integration Technique: Economic Policies
 5.9.2. Market Integration Technique: Trade TreatiesIntegration in the Global Economy
5.11 Challenges of Market Integration in the Global Economy
5.12 Summary
5.13 Technical Terms
5.14 Self-Assessment Questions
5.15 Suggested Readings

5.1 Introduction

Examining and understanding the key international parity relationships, such as interest parity and purchasing power paritythat have profound implications for international financial management is essential. Some of these are, in fact, manifestations of the law of one price that must hold in arbitrage equilibrium. An understanding of these parity relationships provides insights into – how foreign exchange rates are determined and – how to forecast foreign exchange rates.

Since **arbitrage** plays a critical role in the ensuing discussion, we should define it upfront. The term arbitrage can be defined as the act of simultaneously buying and selling the same or equivalent assets or commodities for the purpose of making certain guaranteed profits. As long as there are profitable arbitrage opportunities, the market cannot be in equilibrium. The market can be said to be equilibrium when no profitable arbitrage opportunities exist. Such well-known parity relationships as interest rate parity and purchasing power parity, in fact, represent arbitrage equilibrium conditions.

5.2 Meaning of Arbitrage

> **Arbitrage**
>
> *['är-bə-,träzh]*
>
> The simultaneous purchase and sale of the same asset in different markets in order to profit from tiny differences in the asset's listed price.

Arbitrage trading is a strategy that traders and investors adopt to secure the advantage of price discrepancies in different securities or markets. The main reason behind the popularity of this trading strategy is that it offers traders the opportunity to purchase at a low cost and sell at a high cost with the utmost precision.

Arbitrage is an investment strategy in which an investor simultaneously buys and sells an asset in different markets to take advantage of a price difference and generate a profit. While price differences are typically small and short-lived, the returns can be impressive when multiplied by a large volume. Arbitrage is commonly leveraged by hedge funds and other sophisticated investors.

These discrepancies occur when an asset – such as EUR/USD – is being differently priced by multiple financial institutions. This means that arbitrage involves buying an asset at one price from the first financial institution and then almost instantly selling it to a different institution to profit from the difference in quotes. The speed at which transactions are carried out means that the risk for the trader can be very low. However, there is always some risk with trading, particularly if prices are moving quickly or liquidity is low.

If you are a seasoned trader, you must be aware of arbitrage trading, but if you are a novice, the first question that will crop up is- what is arbitrage trading? This article will focus on answering all the queries related to arbitrage trading and how this works in India. Are you excited? Let's start by exploring arbitrage trading's meaning and definition.

5.3 TYPES OF ARBITRAGE

5.3.1. Pure Arbitrage

Pure arbitrage refers to the investment strategy above, in which an investor simultaneously buys and sells a security in different markets to take advantage of differences in price. As such, the terms "arbitrage" and "pure arbitrage" are often used interchangeably.

Many investments can be bought and sold in several markets. Whenever an asset is traded in multiple markets, it's possible prices will temporarily fall out of sync. It's when this price difference exists that pure arbitrage becomes possible.

For example, imagine a large multinational company lists its stock on the New York Stock Exchange (NYSE) and London Stock Exchange. On the NYSE, it's priced at $1.05, and on the London Stock Exchange, it's $1.10. If an investor were to buy it for $1.05 and sell it for $1.10, they'd make a small profit of five cents per share.

Pure arbitrage is also possible in instances where foreign currency exchange rates lead to pricing discrepancies, however small.

Ultimately, pure arbitrage is a strategy in which an investor takes advantage of market inefficiencies . As technology has advanced and trading has become increasingly digitized, it's grown more difficult to take advantage of these scenarios, as pricing errors can now be rapidly identified and resolved. This means the potential for pure arbitrage has become a rare occurrence.

5.3.2. Merger Arbitrage

Merger arbitrage, also called risk arbitrage, is a type of arbitrage related to merging entities, such as two publicly traded businesses.

Generally speaking, a merger consists of two parties: the acquiring company and its target. If the target company is a publicly traded entity, then the acquiring company must purchase the outstanding share of said company. In most cases, this is at a premium to what the stock is trading for at the time of the announcement, leading to a profit for shareholders. As the deal becomes public, traders looking to profit from the deal purchase the target company's stock—driving it closer to the announced deal price.

The target company's price rarely matches the deal price, however, it often trades at a slight discount. This is due to the risk that the deal may fall through or fail. Deals can fail for several reasons, including changing market conditions or a refusal of the deal by regulatory bodies, such as the Federal Trade Commission (FTC) or Department of Justice (DOJ).

In its most basic form, merger arbitrage involves an investor purchasing shares of the target company at its discounted price, then profiting once the deal goes through. Yet, there are other forms of merger arbitrage. An investor who believes a deal may fall through or fail, for example, might choose to short shares of the target company's stock.

5.3.3. Convertible Arbitrage

Convertible arbitrage is a form of arbitrage related to convertible bonds, also called convertible notes or convertible debt.

A convertible bond is, at its heart, just like any other bond: It's a form of corporate debt that yields interest payments to the bondholder. The primary difference between a convertible bond and a traditional bond is that, with a convertible bond, the bondholder has the option to convert it into shares of the underlying company at a later date, often at a discounted rate. Companies issue convertible bonds because doing so allows them to offer lower interest payments.

Investors who engage in convertible arbitrage seek to take advantage of the difference between the bond's conversion price and the current price of the underlying company's shares. This is typically achieved by taking simultaneous positions—long and short—in the convertible note and underlying shares of the company.

Which positions the investor takes and the ratio of buys and sells depends on whether the investor believes the bond to be fairly priced. In cases where the bond is considered to be cheap, they usually take a short position on the stock and a long position on the bond. On the other hand, if the investor believes the bond to be overpriced, or rich, they might take a long position on the stock and a short position on the bond.

5.4 Market Integration

Dive into the world of Macroeconomics with a focus on Market Integration, a key concept in this field. This comprehensive guide will provide a clear definition of Market Integration, explore its primary characteristics, and deliver real-world examples from both developed and developing economies. It delves into the pivotal factors leading to market integration, including policy changes and technological advancements. The guide further discusses various approaches to achieve Market Integration, its role and challenges in the global economy, and the theoretical frameworks underlying it. This is an ideal resource for anyone seeking to thoroughly understand and apply theories of Market Integration in contemporary economies.

What is market integration?

- Market Integration Is A Process Where Prices In A Single Market Become Completely Isolated From Prices In Other Locations Or Related Goods.

- Market Integration Refers To A Situation Where There Are Barriers To Trade Between Different Markets And Prices Are Not Harmonised.
- Market Integration Is A Concept That Refers To Multiple Markets Acting Independently From One Another With No Relation To Prices In Different Regions.
- Market Integration Refers To The Interconnectivity Of Prices Among Different Locations Or Related Goods. It Signifies That The Markets Are Working Collectively As One Broader Market Where Prices Are Likely To Move Together And Goods, Services, Or Assets Are Substituted Based On The Price Change.

Example

An interesting example of market integration is the European Coal and Steel Community (ECSC), formed after the Second World War. The countries agreed to control the steel and coal resources collectively, leading to the integration of these markets across the member states. This was one of the early steps leading to the formation of the European Union.

Market integration is a fascinating concept in the field of macroeconomics, associated with the changes in the barriers and obstacles between different markets across countries, cities, or regions. When you are looking into the buying and selling of goods and services, you'll often come across the term 'market integration'.

Market Integration Definition

Market integration is the interconnectivity of prices among different locations or related goods. Reduced transportation costs, the minimisation of trade barriers, and advancements in communication technology have all contributed to increased market integration. Higher market integration often leads to more competition, better product quality, and increased efficiency in the market.

Market integration refers to the closeness of association between prices in two or more markets. An increased integration essentially signifies that the markets are working collectively as one broader market. Here, prices are likely to move together and goods, services, or assets are substituted based on the change in prices.

5.5 Primary Characteristics of Market Integration

When assessing market integration, you might wonder what you should look out for. Here are some key characteristics of market integration:

- Harmonisation of Prices: Integrated markets often exhibit harmonised or similar price levels.
- Cross-Border Transactions: Integrated markets typically have a high volume of cross-border transactions.
- Competition: In an integrated market, firms compete not only with local companies but also with firms in other integrated areas.
- Varied Source of Supply: Market integration allows consumers to choose from a more extensive array of goods and services.

5.6 Impact of Market Integration

Market integration has a profound impact on global trade and economy. It leads to greater synchronisation in price movements, a wider range of suppliers and commodities, and improved market efficiency. It helps global trade flourish by making the entire world a single large market where suppliers can access a broader set of consumers, and consumers enjoy a wider choice of products.

5.6.1 Market Integration and Economic Policy

Market integration can also influence economic policies. Policymakers should be aware of the level of market integration when devisifying strategies to advance their national economy. If markets are highly integrated, any policy change will likely affect not just the local market, but also the markets in other connected regions. Market integration thus plays a crucial role in shaping global macroeconomic trends, influencing policy choices, and promoting competition among firms and economies.

Example

Consider this: a cheese manufacturer based in France wishes to sell its products in Germany. In a non-integrated market, he would face significant trade barriers, customs duties, paper works, etc., making the selling process overly complicated and expensive. However, with the EU Market Integration, the French manufacturer can effortlessly sell his cheese in Germany, just as he would in France. Consequently, consumers in both countries have access to a wider variety of products, fostering competition, and driving prices down.

5.6.2 Examples of Market Integration

When discussing the principle of market integration you'll find useful to pinpoint specific examples. By doing this, it will allow you to understand how this concept is both applied and operates in real-world scenarios. We'll explore examples from both developed and developing economies to give you a comprehensive understanding of market integration.

5.6.3 Market Integration Example in Developed Economies

A standout example of market integration in developed economies is the Single European Market (SEM) facilitated by the European Union (EU). The SEM is an ambitious project aiming to create a standardised system of laws applicable to all member states, ensuring free movement of people, goods, services, and capital across borders. This implies that a company in any EU member state can conduct business as easily in every other EU country as it can in its home country. This level of market integration simplifies trade significantly. For instance, if you want to purchase a product from Spain while residing in France, the product can be shipped easily across the border without additional import/export costs, thereby equalising the prices across different regions. Additionally, the EU works on integrating financial markets among member countries to ensure that financial transactions and services are not hindered by national boundaries. The Financial Services Action Plan and the European Common Currency, Euro, are key policies aimed at promoting this objective.

5.6.4 Market Integration Example in Developing Economies

Market integration is equally important in developing economies. A prime example is the ASEAN Free Trade Area (AFTA), a trade bloc agreement by the Association of Southeast Asian Nations supporting local manufacturing in all ASEAN countries. Much like EU's SEM, AFTA aims to ensure a freer flow of goods within ASEAN countries. It does so by reducing tariff barriers and promoting trade. The bloc includes countries like Indonesia, Malaysia, Philippines, Singapore, and Thailand – a collection of diverse economies, each at different stages of development.

5.7 Factors Leading to Market Integration Market integration results from a combination of numerous factors. Each of these influences the market's trajectory towards integration differently. From policy changes to technological advancements, we will explore the significant causes leading to market integration in this section.

5.7.1 Market Integration Causes: Policy Factors

Policies instituted by governments or governing bodies often serve as powerful catalysts for market integration. In numerous instances, conscious decisions have been made to create unified markets, particularly to streamline trade and foster economic growth. Here are a few key policy factors that contribute to market integration:

Trade Agreements: International, regional, and bilateral trade agreements open the market borders between countries. These agreements lessen or eliminate trade tariffs, set common standards and regulations, and make it easier for goods and services to move across borders.

Monetary Policies: Similar monetary policies among different economies can foster a unified market. A noteworthy example is the adoption of the euro by several countries in the European Union that boosted seamless trade across these countries.

Regulatory Harmonisation: Adoption of shared rules, regulations, and standards on issues like product safety, quality, and environmental impact can facilitate market integration. Common regulations reduce business uncertainty and smooth cross-border operations.

Infrastructure Development: Governments might invest in transport and logistical infrastructure, like roads, ports, and airports, to facilitate trade and connect markets physically.

> **Example**
>
> Consider a textile manufacturer in India who wants to sell products in Bangladesh. Before trade integration, the manufacturer faced high tariff barriers, making products expensive for Bangladeshi consumers. However, after the South Asian Association for Regional Cooperation (SAARC) agreement, these tariff barriers were significantly reduced. Consequently, it became easier and more profitable for the Indian manufacturer to trade across borders, which also translated into more variety and lower prices for Bangladeshi customers.

5.7.2 Market Integration Causes: Technological Advancements

In addition to policy factors, rapid technological improvements have contributed to market integration in significant ways. Technology has made it easier and cheaper to connect different markets, expand business operations, and source products from diverse origins. Here are a few ways in which technological advancements enhance market integration:

Advancements in Communication Technologies: Developments like the internet and mobile technology have interconnected the globe like never before. They facilitate real-time updates on prices and trends, vital for synchronised market movements.

5.8 Improvements in Transportation: Advancements in transportation technologies, be it faster ships, larger aircraft, or more efficient logistics, have helped to condense geographical distances and efficiently move goods across regions and countries, thus integrating markets.

Online Platforms and E-commerce: Websites and apps have allowed businesses to sell and consumers to buy from anywhere in the world. This cross-border commerce has effectively connected formerly isolated markets.

Financial Technology: Fintech has integrated financial markets, allowing seamless cross-border transactions, foreign exchange, and financial services.

5.9 Approaches to Achieving Market Integration

Achieving market integration is not a straightforward process. It requires the strategic implementation of various approaches and techniques. Two vital methods used to achieve market integration are through the formulation of economic policies and the execution of trade treaties. These two approaches work hand-in-hand, fostering an environment that promotes the free flow of goods and services across different markets.

5.9.1. Market Integration Technique: Economic Policies

Economic policies comprise of a set of strategies and actions that govern the economic behaviour of a country. For market integration, politicians and policymakers draft and implement policies that reduce barriers and restrictions to trade. Here, the goal is to promote domestic firms' competitiveness, facilitate fluid movement of goods and services, and create a better economic environment for both businesses and consumers. One major economic policy leveraged towards market integration is liberalisation. Primarily, liberalisation reduces state restrictions on trade. A liberalised economic environment lessens import and export controls, encouraging trade with foreign markets. By doing so, it fosters a unified global market where prices remain harmonised and competitive.

Another significant economic strategy used for market integration is initiating common economic policies. Countries seeking market integration often adopt similar economic strategies, ensuring synchronicity in their economic growth and action plans. Common strategies in industry regulations, financial markets, and intellectual property rights can diminish market discrepancies, fostering more integrated market movements.

Lastly, the development of infrastructure can significantly integrate markets. Investment in infrastructure signifies improving transport and logistical capabilities, drastically reducing the cost and time needed to move goods from one place to another.

5.9.2. Market Integration Technique: Trade Treaties

Trade treaties form another fundamental approach to achieve market integration. Essentially, a trade treaty is an agreement between two or more nations that fosters trade by lowering or eliminating tariffs, quotas, and other trade restrictions. They have a significant role in integrating markets by establishing a uniform set of rules for international trade. A prime example of a trade treaty facilitating market integration is the European Union (EU). The EU is a political and economic union of 27 member states located in Europe, integrating markets by setting common policies on issues ranging from agriculture and fisheries to a comprehensive system of laws for governing contract issues. The introduction of a common currency, the Euro, has further facilitated market integration among the EU countries by removing exchange rate fluctuations.

Trade treaties like NAFTA (North American Free Trade Agreement) and AFTA (ASEAN Free Trade Agreement) have also significantly contributed to market integration. These agreements eliminate most tariffs on products traded among the member countries, facilitating a seamless flow of goods. Finally, the adoption of World Trade Organization's policies by over 160 member countries has encouraged trade, promoted economic growth, and fostered market integration on a global scale. It aims to reduce and eliminate trade barriers, ensuring that trade flows smoothly, predictably, and freely.

> **Definition**
>
> The European Union (EU) is an international organization composed of 27 European countries. It operates through a system of supranational and intergovernmental decision-making processes, and it has a broad spectrum of policy areas, from climate, environment and health to external relations and security, justice, and migration.

5.10 Roles and Benefits of Market Integration in the Global Economy

Market integration plays several crucial roles in the global economy. It facilitates free trade, promotes competition, and enables economies of scale, which can lead to increased production and efficiency. One of the primary roles of market integration is the facilitation of free trade. By minimising trade barriers, market integration promotes the free flow of goods and services across borders, making it easier for businesses to access wider markets. Ultimately, this encourages economic growth and prosperity. Furthermore, market integration also leads to improved efficiency and increased competition. When markets are integrated, businesses must compete not only with local firms but also with international companies. This competition can drive innovation and encourage firms to improve their products and services, a development which ultimately benefits consumers. Besides, market integration enables economies of scale. When firms have access to larger markets, they can produce goods at a higher volume, which can lower the per-unit cost of production. The benefits of market integration in the global economy are manifold:

- **Access to Larger Markets**: Businesses can sell their products and services to a broader customer base, which can lead to increased revenues.
- **Greater Variety of Goods and Services**: Consumers have access to a wider array of goods and services, which can improve their standard of living.
- **Increased Competition**: Firms must compete with international companies, a development that can drive innovation, improve product quality, and lower prices.
- **Improved Efficiency**: Market integration can lead to increased production and efficiency as companies seek to compete in larger markets.

5.11 Challenges of Market Integration in the Global Economy

While the benefits of market integration are substantial, it also presents certain challenges. Here are some critical challenges that can arise from market integration in the global economy:

- **Unequal Distribution of Benefits**: While integration can lead to economic growth, the benefits derived might not be evenly distributed. Developed economies with strong, competitive industries might gain more than developing countries with underdeveloped industries.
- **Increased Vulnerability**: Highly integrated markets can spread economic shocks from one country to others. For instance, the 2008 financial crisis, which began in the United States, rapidly spread to other countries due to the high degree of market integration.
- **Loss of Sovereignty**: In some cases, market integration could pose a threat to national sovereignty as countries might have to align their policies with international standards and regulations.
- **Regulatory Challenges**: Market integration could lead to regulatory challenges as countries need to harmonise their laws and regulations to facilitate seamless cross-border transactions

5.12 Summary

- Market integration refers to the unification of different markets into one, allowing for the free movement of goods and services. This process is facilitated by reducing barriers, such as tariffs or quotas, between countries.
- The ASEAN Free Trade Agreement (AFTA) and the European Union's Single European Market (SEM) are examples of market integration. They reduce tariff barriers and promote trade amongst member countries, effectively creating a larger, unified market.

- Market integration can be caused by a combination of policy factors (including trade agreements, common monetary policies, regulatory harmonisation, and infrastructure development) and technological advancements (like communication technologies, improvements in transportation, online platforms and e-commerce, and financial technology).
- Two main techniques used to achieve market integration include the formulation of economic policies (including liberalisation and common economic policies) and the execution of trade treaties.
- Market integration in the global economy refers to the operation of distinct markets of different regions or nations as a single market, often indicated by similar prices and a high volume of cross-border transactions. It has numerous benefits, including facilitating free trade, promoting competition, and enabling economies of scale. However, it also presents challenges like unequal distribution of benefits, increased vulnerability to economic shocks, and potential loss of sovereignty.

5.13 Technical Terms

WTO: World Trade Organisation
Global Economy
Liberalization: Following Free Trade Policies
Globalization: Make our products available on the international platforms
Privatization:

5.14 Self-Assessment Questions

Q1. What is the impact of Market Integration on economic growth of a country?
Q2. Define what market integration is. How it influence the working of the financial sector of a nation
Q3. What is role of market integration in facilitating international trade in the UK
Q4. What are the potential challenges and benefits of Market Integration for a nation's business policy
Q5. Define Arbitration in the forex market. Explain its nature and scope
Q6. How many types of international arbitration is existing in today's international business?

5.15 Suggested Readings

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LESSON – 6
INTERNATIONAL CAPITAL MARKET AND MONEY MARKET INSTRUMENTS

Learning Objectives:

1. To describe the types of foreign exchange market functions and the major participants.
2. To understand the foreign exchange quotations of mechanism.
3. To trace the creation and growth of Euro – currency markets.
4. To discuss the composition of instruments death with in Euro markets.
5. To discuss the emergence of Global Currency Market
6. To provide an overview of the Major Instruments.

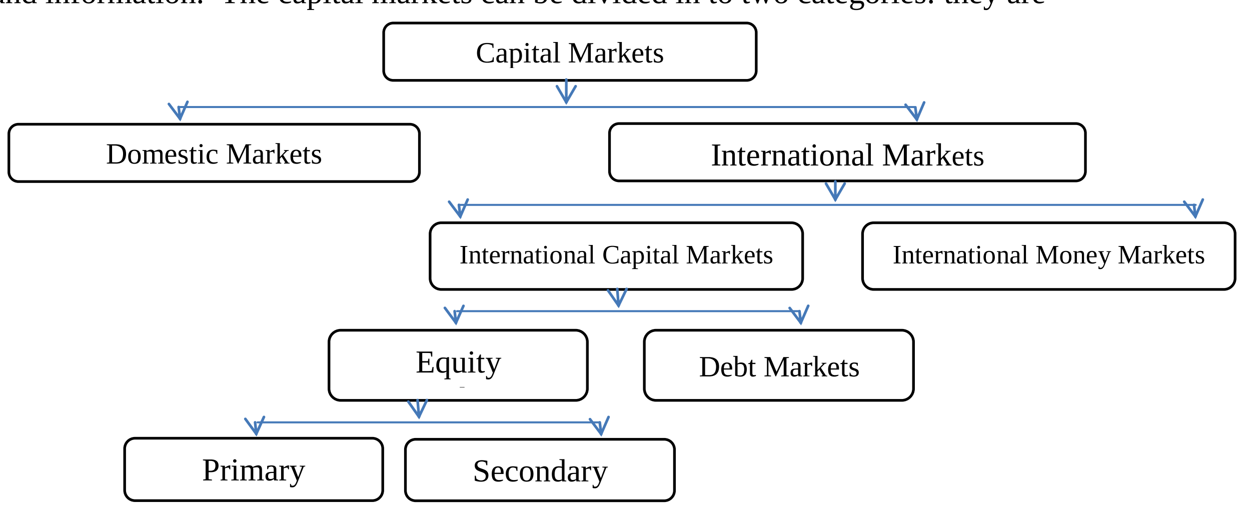
Lesson Structure

6.0 Introduction

International financial markets undertake intermediation by transferring purchasingpower from lenders and investors to parties who desire to acquire assets that they expecttop yield future benefits.

International financial transactions involve exchange of assets between residents ofdifferent financial centres across national boundaries. International financial centres arereservoirs of savings and transfer them to their most efficient use irrespective of where thesavings are generated.

There are three important functions of financial markets. First, the interactions ofbuyers and sellers in the markets determine the prices of the assets traded which is calledthe price discovery process. Secondly, the financial markets ensure liquidity by providing amechanism for an investor to sell a financial asset. Finally, the financial markets reduce thecost of transactions and information. The capital markets can be divided in to two categories: they are



6.1 What Are International Capital Markets?

A capital market is basically a system in which people, companies, and governments with an excess of funds transfer those funds to people, companies, and governments that have a shortage of funds. This transfer mechanism provides an efficient way for those who wish to borrow or invest money to do so. For example, every time someone takes out a loan to buy a car or a house, they are accessing the capital markets. Capital markets carry out the desirable economic function of directing capital to productive uses.

There are two main ways that someone accesses the capital markets—either as debt or equity. While there are many forms of each, very simply, debt is money that's borrowed and must be repaid, and equity is money that is invested in return for a percentage of ownership but is not guaranteed in terms of repayment.

In essence, governments, businesses, and people that save some portion of their income invest their money in capital markets such as stocks and bonds. The borrowers (governments, businesses, and people who spend more than their income) borrow the savers' investments through the capital markets. When savers make investments, they convert risk-free assets such as cash or savings into risky assets with the hopes of receiving a future benefit. Since all investments are risky, the only reason a saver would put cash at risk is if returns on the investment are greater than returns on holding risk-free assets. Basically, a higher rate of return means a higher risk.

For example, let's imagine a beverage company that makes $1 million in gross sales. If the company spends $900,000, including taxes and all expenses, then it has $100,000 in profits. The company can invest the $100,000 in a mutual fund (which are pools of money managed by an investment company), investing in stocks and bonds all over the world. Making such an investment is riskier than keeping the $100,000 in a savings account. The financial officer hopes that over the long term the investment will yield greater returns than cash holdings or interest on a savings account. This is an example of a form of direct finance. In other words, the beverage company bought a security issued by another company through the capital markets. In contrast, indirect finance involves a financial intermediary between the borrower and the saver. For example, if the company deposited the money in a savings account, and then the savings bank lends the money to a company (or a person), the bank is an intermediary. Financial intermediaries are very important in the capital marketplace. Banks lend money to many people, and in so doing create economies of scale. This is one of the primary purposes of the capital markets.

Capital markets promote economic efficiency. In the example, the beverage company wants to invest its $100,000 productively. There might be a number of firms around the world eager to borrow funds by issuing a debt security or an equity security so that it can implement a great business idea. Without issuing the security, the borrowing firm has no funds to implement its plans. By shifting the funds from the beverage company to other firms through the capital markets, the funds are employed to their maximum extent. If there were no capital markets, the beverage company might have kept its $100,000 in cash or in a low-yield savings account. The other firms would also have had to put off or cancel their business plans.

International capital markets are the same mechanism but in the global sphere, in which governments, companies, and people borrow and invest across national boundaries. In addition to the benefits and purposes of a domestic capital market, international capital markets provide the following **benefits:**

1. **Higher returns and cheaper borrowing costs.** These allow companies and governments to tap into foreign markets and access new sources of funds. Many domestic markets are too small or too costly for companies to borrow in. By using the international capital markets, companies, governments, and even individuals can borrow or invest in other countries for either higher rates of return or lower borrowing costs.
2. **Diversifying risk.** The international capital markets allow individuals, companies, and governments to access more opportunities in different countries to borrow or invest, which in turn reduces risk. The theory is that not all markets will experience contractions at the same time.

The **structure** of the capital markets falls into two components—**primary** and **secondary**. The primary market is where new securities (stocks and bonds are the most common) are issued. If a corporation or government agency needs funds, it issues (sells) securities to purchasers in the primary market. Big investment banks assist in this issuing process as intermediaries. Since the primary market is limited to issuing only new securities, it is valuable but less important than the secondary market.

The vast majority of capital transactions take place in the secondary market. The secondary market includes stock exchanges (the New York Stock Exchange, the London Stock Exchange, and the Tokyo Nikkei), bond markets, and futures and options markets, among others. All these secondary markets deal in the trade of securities. The term securitiesinclude a wide range of **financial instruments**. Investors have essentially two broad categories of securities available to them: equity securities, which represent ownership of a part of a company, and debt securities, which represent a loan from the investor to a company or government entity.

Creditors, or debt holders, purchase debt securities and receive future income or assets in return for their investment. The most common example of a debt instrument is the bond. When investors buy bonds, they are lending the issuers of the bonds their money. In return, they will receive interest payments usually at a fixed rate for the life of the bond and receive the principal when the bond expires. All types of organizations can issue bonds.

Stocks are the type of equity security with which most people are familiar. When investors buy stock, they become owners of a share of a company's assets and earnings. If a company is successful, the price that investors are willing to pay for its stock will often rise; shareholders who bought stock at a lower price then stand to make a profit. If a company does not do well, however, its stock may decrease in value and shareholders can lose money. Stock prices are also subject to both general economic and industry-specific market factors.

The key to remember with either debt or equity securities is that the issuing entity, a company or government, only receives the cash in the primary market issuance. Once the security is issued, it is traded; but the company receives no more financial benefit from that security. Companies are motivated to maintain the value of their equity securities or to repay their bonds in a timely manner so that when they want to borrow funds from or sell more shares in the market, they have the credibility to do so.

For companies, the global financial, including the currency, markets

(1) Provide stability and predictability,

(2) Help reduce risk, and

(3) Provide access to more resources.

One of the fundamental **purposes** of the capital markets, both domestic and international, is the concept of liquidity, which basically means being able to convert a noncash asset into cash without losing any of the principal value. In the case of global capital markets, liquidity refers to the ease and speed by which shareholders and bondholders can buy and sell their securities and convert their investment into cash when necessary. Liquidity is also essential for foreign exchange, as companies don't want their profits locked into an illiquid currency.

6.2 The functions of the capital market are as follows:

1. **Mobilization of** : The capital market allows individuals and institutions with excess funds to invest and channel their savings towards productive activities, fostering economic growth.
2. **Allocation of Capital**: This process connects borrowers, such as businesses and governments, with investors by using financial instruments to allocate capital effectively.
3. **Capital Formation**: The capital market allows businesses to acquire financial resources for growth, innovation, and investment in productive assets, resulting in the creation of new capital.
4. **Risk Management**: It offers risk management tools such as derivatives and insurance, enabling market participants to hedge against potential financial risks and uncertainties. The Financial Analysis, Valuation, & Risk Management course is a great option to learn more about these tools.
5. **Price Discovery**: The capital market functions as a marketplace where the prices of financial instruments are determined through supply and demand, allowing for fair valuation and price discovery.
6. **Liquidity Provision**: It provides liquidity to investors, allowing them to easily buy and sell financial assets, thereby enhancing market efficiency.

6.3 International Money Market

A money market is a market for instruments and a means of lending (or investing)and borrowing funds for relatively short periods, typically regards as from one day to oneyear. Such means and instruments include short term bank loans. Treasury bills, bankcertificates of deposit, commercial paper, banker's acceptances and repurchase agreementsand other short term asset backed claims.

As a key elements of the financial system of a country, the money market playsa crucial economic role that if reconciling the cash needs of so called deficit units (suchas farmers needing to borrow in anticipation of their later harvest revenues), with theinvestment needs of surplus units (such as insurance companies wanting to invest cashproductively prior to making long term investment choices). Holding or borrowing liquidclaims is more productive than holding cash balances. A smoothly functioning moneymarket can perform these functions very efficiently if borrowing lending spreads (or bidoffers spreads for traded instruments) are small (operational efficiency), and if funds arelent to those who can make the most productive use of them (allocation efficiency). Bothborrowers and lenders prefer to meet their short term needs without bearing the liquidityrisk or interest rate risk that characterizes longer term instruments, and money marketinstruments allow this. In addition money market investors tend not to want to spend muchtime analyzing credit risk, so money market instruments are generally characterized by ahigh degree of safety of principal. Thus the money market sets a market interest rate thatbalances cash management needs, and sets different rates for different uses that balancetheir risks and potential for productive use. Unlike stock or futures markets, the moneymarkets of the major industrial countries have no central location; they operate as atelephone market that is accessible from all parts of the world.

The international money market can be regarded as the market for short termfinancing and investment instruments that are issued or traded internationally. The core ofthis market is the Eurocurrency market, where bank deposits are issued and traded outsideof the country that issued the currency.

Other instruments to be discussed in this chapter such as Euro commercial paper andfloating rate notes, serve somewhat different purposes and attract a different investmentclientele. However, each is to a degree a substitute for each of the other instruments, andthe yield and price of each are sensitive to many of the same influences, se we may feeljustified in lumping them together in something called a market. The fact that many of theother instruments of the international money market are priced off LIBOR, the interestrate of Eurodollar deposits, suggest that market participants themselves regard the differentinstruments as having a common frame of reference.

Today many domestic cash and derivative instruments, such as US. Treasury billsand Eurocurrency futures contracts are traded globally and so are effectively parts of theinternational money market.

Euromarkets instruments simply represent part of a spectrum of financial claimsavailable in the money market of a particular currency, claims that are distinguished byrisk, cost and liquidity just like domestic money market instrument. However domesticmoney markets are called upon to play public as well as private roles. The latter include thefollowing **three functions**.

- ❖ The money market, along with the bond market, is used to finance the government deficit.
- ❖ The transmission of monetary policy (including exchange rate policy) is typically done through the money market, either through banks or through freely traded money market instruments.
- ❖ The government uses the institutions of the money market to influence credit allocation toward favored uses in the economy

6.4 Capital & Money Market Instruments

I. Global Depositary Receipts (GDRs):

A Global Depositary Receipt (GDR) is a form of equity or share certificate that represents ownership interest in a company based in one country which then holds and sells its share by a firm or organization located in another country. It is traded on international stock markets. GDRs are an instrument through which companies may raise funds overseas, that is, outside their home country markets, by providing their shares to investors. However, they do not need to be directly listed on foreign stock exchanges. This instrument helps an investor to invest in companies in various countries and, thus diversify his prime portfolios.

Being a part of the globalized world of finance, investors look for opportunities outside their local markets. So, to allow investors to extend their boundary of investment, Global Depositary Receipt (GDR) comes into the picture enabling them to invest internationally. GDRs are essential in helping companies get capital from around the world and also to the investors who can utilize their portfolios to invest in various companies.

Features of Global Depositary Receipt (GDRs)

The distinct features of separate instalment of the Global Depositary Receipts (GDRs) make these financial instruments unique. Such characteristics make them popular not only among issuers but also among the investors in the international financial institutions. Here are the key features of GDRs:

1. Denomination in Foreign Currency: GDRs are undated in a foreign currency. This foreign currency denomination, usually in dollars or euros that renders GDRs more salable and fungible for foreign investors.

2. Issued by Depositary Banks: Depositary banks serve as intermediaries between a foreign company and investors; they create and manage the GDRs. These banks enable the issuance, trading, and conversion to ordinary shares, which amounts to redemption of GDRs.

3. Underlying Shares Held in Custody: The depositary bank acts a custodian of the actual shares of the foreign company. These underlying shares remains safe and the bank issues GDR against them. The size of the arrangement at $2.5 billion is also adequate for the redemption of about 20% of gospel designated notes 9 in the first three years, which is a useful size of redeeming each year in the absence of 9 GDR, so that the redemption would not affect the GDP, neither be impracticable.

4. International Listing: GDRs are shown and traded on reputable world stock exchanges for the investors to buy and sell GDRs globally on the stock exchanges that are established well. This listing brings the liquidity and the visibility.

5. Sponsored and Unsponsored GDRs: Sponsored and unsponsored GDRs are possible. In the case of sponsored GDRs, companies help by cooperation and their endorsement when it comes to signing the documents, and for the case of unsponsored, companies are involved indirectly with the help of financial institutions which create GDRs without their interest or participation.

6. Dividend Payments and Corporate Actions: In some cases GDR holders are allowed to get benefits dividends and also able to participate in corporate actions like stock splits or mergers in manners similar to the underlying shareholders. The depositary bank oversees appropriate distribution dividends and that it ensures that GDR holders enjoy the advantages of ownership.

7**. Convertible to Underlying Shares**: As a general rule, GDRs may in most cases be converted into the issuing shares they reflect. The conversion feature presents the investors with a mechanism through which it enables them to shift from the holding of GDRs to direct premium in the foreign firm.

How GDRs Work?

1. Issuance: A foreign agency makes a decision to elevate capital from international markets. Instead of immediately list its shares on overseas exchanges, it troubles GDRs via a depositary financial institution.

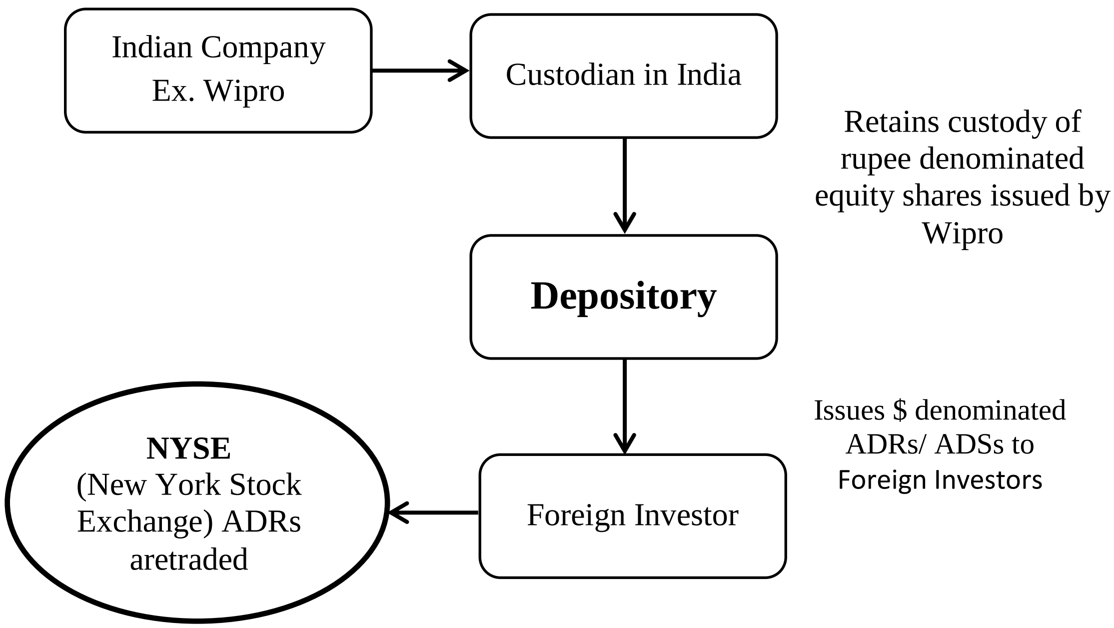
2. Depositary Bank: The depositary financial institution buys a bulk of the employer's shares and then offers GDRs in opposition to these stocks. These GDRs represent possession inside the organisation and are traded on worldwide inventory exchanges.

3. Listing and Trading: The GDRs are indexed and traded on stock exchanges in extraordinary countries, presenting worldwide traders with an oblique manner to invest in the foreign enterprise with out dealing immediately with its domestic marketplace.

4. Currency: GDRs are commonly denominated in a currency other than the currency of the issuing employer. This makes it greater handy for worldwide buyers to change them without demanding about forex issues.

5. Dividends and Voting Rights: GDR holders are entitled to receive dividends and can have positive vote casting rights, depending on the phrases of the GDR issuance. However, the balloting rights are frequently restricted compared to direct shareholders.

GDRs provide an opportunity to organizations to faucet into global capital markets and attract a broader base of international buyers. They also provide investors the opportunity to diversify their portfolios through making an investment in businesses from exclusive countries and areas



Advantages and Disadvantages of GDRs
Advantages
The following are the advantages of Global Depository Receipts:
a. GDR provides access to foreign capital markets.
b. A company can get itself registered on an overseas stock exchange or over the counter and its shares can be traded in more than one currency

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Advantages and Disadvantages of GDRs

Advantages: The following are the advantages of Global Depository Receipts:

a. GDR provides access to foreign capital markets.

b. A company can get itself registered on an overseas stock exchange or over thecounter and its shares can be traded in more than one currency

c. GDR expands the global presence of the company which helps in gettinginternational attention and coverage.

d. GDRs are liquid in nature as they are based on demand and supply which can beregulated.

e. With GDR,the non-residents can invest in shares of the foreign company.

f. GDR can be freely transferred.

g. Foreign Institutional investors can buy the shares of company issuing GDR intheir country even if they are restricted to buy shares of foreign company.
h. GDR increases the shareholders base of the company.
i. GDR saves the taxes of an investor. An investor would need to pay tax if he purchases shares in the foreign company, whereas in GDR same is not the case.

Disadvantages

The following are the disadvantages of Global Depository Receipts:
a. Violating any regulation can lead to serious consequences against the company.
b. Dividends are paid in domestic country's currency which is subject to volatilityin the forex market.
c. It is mostly beneficial to High Net-Worth Individual (HNI) investors due to theircapacity to invest high amount in GDR.
d. GDR is one of the expensive sources of finance.GDRs offer investors the opportunity to add the benefits of foreign investment totheir portfolio while bypassing the unnecessary risks of investing outside their ownborders. Furthermore, from a company's perspective, GDRs offer the opportunity forthe company to obtain greater exposure and to raise capital in the world markets fromamong a broader, international shareholder base. Indian GDRs are primarily sold to institutional investors.

II. American Depositary Receipts (ADRs)

American Depositary Receipts (ADRs) are securities issued by banks in the United States. ADRs serve as negotiable securities and indicate ownership in the equity of foreign corporations. These financial instruments are designated in United States dollars, are traded on prominent United States stock exchanges such as the New York Stock Exchange (NYSE) or the National Association of Securities Dealers Automated Quotations (NASDAQ), and are subject to regulation by United States securities regulations. The full form of ADR is American Depositary Receipts.

American Depositary Receipts (ADRs) provide US investors with a way to get investment exposure to non-US firms without engaging in foreign stock markets. They represent some of the most well-known names in the global industry, including Nokia, Royal Dutch Petroleum, and Unilever. These and many other companies with headquarters outside of the US use ADRs for trading their shares in US markets.

Functioning of ADRs

American Depositary Receipts (ADRs) are helpful instruments for Individuals in the United States who wish to invest in overseas companies but are concerned about complying with foreign exchange regulations. Imagine you want to invest in a faraway company but you have no idea how to do the necessary financial due diligence or how to acquire stock in the firm. ADRs help in this scenario. A giant American financial institution partners with an overseas company and promises: "We'll take care of all the confusing stuff." Shares of that foreign firm are purchased in order to create American Depositary Receipts (ADRs), which may then be traded on the New York Stock Exchange. You will receive a portion of the company's earnings through your financial institution if the business is profitable. It's a less complicated approach to investing in foreign businesses, although expenses may be associated.

The formal process of how ADR works is as follows:

1. Issuer Selection

A foreign company interested in accessing U.S. capital markets through ADRs selects a U.S. bank or financial institution to act as a depository bank. The depository bank serves an important role in issuing and managing the ADRs.

2. ADR Creation

In the foreign market, the depository bank purchases a specified number of shares of the foreign company's stock. The custodian of the depository bank in the foreign country holds these shares. The depository bank then issues ADRs in the United States, with each ADR reflecting a certain number of shares of the foreign company's stock.

3. Level of ADRs

There are various categories of ADRs, which indicate the extent of cooperation between the foreign company and the depository bank:

Level 1 ADRs are typically used by companies that have no intention of raising capital on the U.S. market. They have minimal reporting requirements and provide investors in the United States with rudimentary access.

Level 2 ADRs require more detailed reporting and disclosure to the Securities and Exchange Commission (SEC) in the United States. Companies that issue Level 2 ADRs frequently utilize them to raise financing in the US market.

Level 3 ADRs necessitate even stricter reporting requirements and are typically used by companies actively raising capital in the U.S. market.

4. Trading on U.S. Exchanges

ADRs are listed and transacted on U.S. stock exchanges, such as the New York Stock Exchange (NYSE) and the NASDAQ, once they are issued. ADRs can be purchased and sold by U.S. investors in a similar manner as any other U.S.-listed stock.

5. Dividends and Benefits

The foreign company pays dividends to the depository bank, which then converts them into U.S. dollars and distributes them to ADR holders. Also, ADR holders may also receive other corporate actions, such as rights offerings and stock splits, if the depository bank facilitates them.

6. Voting Rights

American Depositary Receipts (ADRs) typically confer certain privileges to ADR holders, such as the right to participate in crucial decision-making processes through exercising voting rights in the foreign company's shareholder meetings. The specific rights to vote are contingent upon the provisions outlined in the ADR program and the level of ADR.

7. ADR Fees and Costs

ADRs incur various fees and expenses, such as issuance fees, custody fees, and currency conversion fees. These costs are typically incurred by the ADR holders and might have an impact on their overall returns.

8. ADR Cancellation

ADR cancellation is a situation in which investors may elect to exchange their ADRs for the underlying foreign shares. Typically, this is done when investors want to hold shares directly on a foreign market.

Types of ADRs

There are two types of ADRs:

1. Sponsored ADRs

A sponsored American depositary receipt (ADR) is a depositary receipt (ADR) issued by a bank on behalf of a foreign company whose equity functions as the underlying asset. A sponsored ADR establishes a legal relationship between the ADR and the foreign company, which bears the cost of the security's issuance. Sponsored ADRs can be listed on prominent exchanges, whereas unsponsored ADRs can only trade on the over-the-counter market (OTC).

2. Unsponsored ADRs:

A depositary bank initiates an unsponsored ADR program without the company's contractual involvement. The establishment of an unsponsored ADR program is prompted by demand from brokers and investors. In the United States, ADRs are transacted on the over-the-counter (OTC) market.

Advantages of ADRs

1. Access to Larger Investor Base: ADRs enable foreign companies to gain access to a larger international investor base, particularly in the United States, without the complexities of listing on multiple foreign exchanges. ADRs are listed and transacted on the U.S. stock exchange, which frequently has greater trading volumes and liquidity than foreign markets. This can attract additional investors and increase the liquidity of the company's shares.
2. Diversification: ADRs permit investors to diversify their portfolios by investing in companies from various countries and industries, thereby mitigating risk.
3. Increased Investor Interest: ADR listings enhance the visibility and recognition of foreign companies on the global market, potentially resulting in increased investor interest and positive branding.
4. Additional Shares Issues: Sponsored ADRs, particularly Level 2 and Level 3, enable foreign companies to issue additional shares to investors and raise capital on the U.S. market.
5. Avoids Currency Conversion Hassles and Risk Associated with them: ADRs trade like regular stocks on U.S. exchanges, making it convenient for U.S. investors to buy and sell shares without navigating foreign market rules and currency conversions. Also, Dividends paid by the foreign company to the depository bank are converted into U.S. dollars and distributed to ADR holders, which simplifies the process of receiving dividend payments. ADRs provide investors with exposure to the equities of foreign companies without requiring them to deal directly with foreign currencies, thereby mitigating currency exchange rate risks.

To sum up, ADRs provide a variety of benefits to both foreign companies and U.S. investors, including increased market access and opportunities for capital financing, simplified trading, and exposure to global investments.

Disadvantages of ADRs

1. Longer Waiting Time Returns: ADRs, like any other investment, may need a considerable amount of time to earn profits. Nevertheless, the timeframe for producing profits is not exclusively controlled by the classification of the investment as an American Depositary Receipt (ADR). The determinants of stock prices are multifaceted, encompassing the financial performance of the underlying firm, prevailing market circumstances, and broader economic issues. While many American Depositary Receipts (ADRs) may require a longer period to earn returns, others may see more rapid appreciation.
2. Fluctuations in Foreign Exchange Market: The volatility of foreign exchange rates is a valid area of concern. American Depositary Receipts (ADRs) are designated in the currency of the United States, namely the U.S. dollar, despite their underlying purpose of representing ownership in a foreign corporation. Consequently, variations in the exchange rate between the United States dollar and the currency of the domicile nation of the firm might have an effect on the valuation of one's investment. The presence of these changes might potentially contribute to increased levels of risk and uncertainty within your investment.

3. Lesser Alternatives for Investment: Although it is accurate to acknowledge that not all foreign companies provide American Depositary Receipts (ADRs), there are only a few selections of ADRs accessible for investing purposes. Various internationally recognized companies have American Depositary Receipts (ADRs) listed on United States stock exchanges, therefore offering investors the opportunity to engage with a wide array of sectors and marketplaces. Nevertheless, it should also be noted that not all international companies can be accessed via American Depositary Receipts (ADRs).

When considering any investment, including American Depositary Receipts (ADRs), it is essential to conduct exhaustive research, assess one's risk tolerance, and consider one's investing objectives. If one is concerned about the previously mentioned disadvantages, it would be sensible to diversify their investment portfolio by including a variety of investment options, thereby reducing the associated risks. A consultation with a financial advisor might provide specialised insights tailored to your specific needs and goals.

Global Depositary Receipt (GDRs) vs. American Depository Receipts (ADRs)

GDRs and ADRs are the financial tools that enable investments in foreign companies by investors in international capital markets. Although to some extent there are overlapping elements, there are distinct differences between the two. Let's explore these distinctions:

Basis	**Global Depositary Receipts (GDRs)**	**American Depositary Receipts (ADRs)**
Geographical Origin	GDRs can be issued anywhere in the world and they are normally listed and traded on stock exchanges like the london stock exchange or the luxembourg stock exchange.	American Depository Receipts are issued in the United State and are traded on U.S stock exchanges such as the New York Stock Exchange (NYSE) and the NASDAQ.
Trading Market	Traded through various foreign stock markets.	Traded through U.S. stock markets.
Currency of Denomination	Except almost all denominated in a currency other than the currency of the country of the issuing company. For instance a GDR of a Russian company could be payments in rubles.	Mostly priced in U.S. dollar, by virtue of it being easier for trading and thus, available for U. S. investors.
Regulatory Environment	Where the market upon which they are listed is guided by regulatory requirements.	Subject to the laws of the United States Securities and in addition to other U.S. regulatory bodies.

Basis	Global Depositary Receipts (GDRs)	American Depositary Receipts (ADRs)
Conversion Ratio	The fraction or multiples of shares of the underlying stock may comprise. The conversion ration is provided by the issuer.	Resemble 1 out of the underlying stock for the given share, yet the proportion can differ.
Issuing Banks	They can also be listed on several exchanges and they are issued by international banks.	American banks to issue them most often, are traded on US stock exchanges.

III. Euro Bonds

The Eurobond market is one of the largest debt markets in the world. It comprises a large portion of the debt which is issued by multinational companies as well as governments. It is therefore important for any student of fixed income securities to be aware of what Eurobonds are.The fact that these bonds are called "Euro bonds" can be quite confusing to many investors. This is because a lot of these bonds are not necessarily originate in Europe, by European countries. Most of these bonds are not even denominated in the currency Euro. However, for many years, these bonds have been called Eurobonds. As a result, they are now referred to by that name even though governments of the European Union are planning to change that in the near future.

What is the Eurobond Market?

In order to understand the Eurobond market, we first need to understand what a domestic bond issue, as well as a foreign bond issue, is.

Domestic bonds issues are bonds that are sold by companies that operate in the same country where they are selling to investors. Also, these bonds are denominated in the home currency. For example, if an American company sells bonds to American investors in order to raise United States dollars, then the market is called a domestic market.

Foreign bonds are the opposite of domestic bonds. This means that in this case companies venture to a country that is different as compared to the country of their origin. These companies try to tap the investors in the foreign country and hence the bonds are issued in a foreign currency. For instance, if an American company sells bonds in the Japanese Yen to investors in Japan, then such a bond issue is said to have taken place in the foreign market.

Eurobonds are a type of bond issue wherein the issuer taps the currency which is not in its home market. For instance, United States dollars are typically supposed to be in the United States. However, there are some dollars that are sitting in accounts outside the United States.

When the issuer taps such funds, they are said to be dealing in the Euromarkets. Hence, Eurobonds are issued by a foreign company, in a different country and are denominated in a third currency! An example would be a British company borrowing United States dollars in the Amsterdam markets. Notice that the issuer, the investor, and the country are all different.

Benefits of Euro Bonds

Now that we are aware of what Eurobonds are, the next question is about why do such bonds exist? Some of the benefits of issuing these bonds have been explained below:

Cheaper Funds: The main reason behind the popularity of Eurobonds is that it allows issuers to raise funds in a country with a lower interest rate. It could also mean that companies get access to funds from markets where the compliance and regulation costs are lower.

Newer Markets: Eurobonds may also be useful for companies when they want to tap newer markets. For example, if an American company has already issued a lot of debt in America, it may want to tap newer markets and a different class of investors. The Eurobonds markets allow companies to diversify their list of investors and tap newer markets.

Fund International Investments: Eurobonds are very useful for companies that are looking to invest in international markets. For example, if an American company wants to expand its business in China, then it may need investment in the Chinese Yuan. In such cases, they can borrow in the Chinese Yuan. This will help them avoid transaction charges as well as currency spreads. Also, they can pay the interest rate which is compatible with the currency in which they are borrowing.

Avoiding Currency Risks: Lastly, it is also important to note that what issuers tap the Eurobond market, they end up completely avoiding the currency risks. This is because they borrow in the same currency in which they have to make their business transactions. Given the fact that a number of companies are expanding their global operations due to globalization, the market for Eurobonds is likely to expand greatly in the near future.

Benefits to Investors: From an investor's point of view also, Eurobonds tend to be quite beneficial. They are cheap and have an extremely liquid market.

The Eurobonds can be **differentiated** into various categories such as:

Trading

This instrument of debt can be traded. It can be bought or sold prior to its time of maturity. It isinitiated by the way of public offering and it can be listed on any stock exchange in the world.

Payments

There is no central register where holders of the issue are named, so therefore Eurobond isbearer instrument. The interest paid to the holder on the presentation of separable coupons, andthe principle amount is repaid on the presentation of the Eurobond itself.

How is a Eurobond Issued?

Typically, financial institutions, such as investment banks, issue bonds on behalf of the borrower. If a bank will be responsible for the underwriting process, it implies a guarantee to the borrower that the whole bond issue will be sold in the primary market during the initial debt offering process.

Please note that the term "Eurobond" refers only to the fact that the bond was issued in a different country and currency. It does not need to be a country in Europe. It can be whatever country in the world.

For example, Eurobonds can be issued in China and denominated in US dollars.

Eurobonds are issued by many **institutions**, such as:

- Corporations
- Governments
- Syndicates

The primary reason for issuing Eurobonds is a need for foreign currency capital. Since the bonds are fixed-income securities; they usually offer a fixed interest rate to investors.

Imagine, as an example, a US company aims to permeate into a new market and plans to erect a large factory, say, in China. The company will need to invest large sums of money in local currency – the Chinese yuan. As the company is a new entrant to the Chinese market, it may lack access to credit in China.

The company decides to go with yuan-denominated Eurobonds in the United States. Investors who hold yuan in their accounts will invest in the bonds, which will provide funds to a new facility in China. If a new factory is profitable, the cash flow will go to settling the interest to US-based bondholders.

Benefits to Issuers

A list of benefits to Eurobond issuers consists of the following:

Flexibility to choose a favorable country to originate bonds and currency

- A country choice with lower interest rates
- Avoidance of currency risk or forex risk by using Eurobonds
- Access to a huge range of bond maturity periods that can be chosen by the issuer

International bond trade despite being issued in a certain country that broadens potential investor base

Benefits to Investors

- The main benefit to local investors in purchasing a Eurobond is that it provides exposure to foreign investments staying in the home country. It also gives a sense of diversification, spreading out the risks.
- Eurobonds are pretty cheap, with a small face value and are highly liquid.
- If a Eurobond is denominated in a foreign currency and issued in a country with a strong economy (and currency), then the bond liquidity rises

IV. Dual Currency Bonds

Dual currency bond is a debt instrument offering a distinctive approach to overseas investments. In essence, these bonds have a dual nature: coupon payments are made in a currency other than a currency of the bond face value denomination (base currency). The amount of interest to be paid is decided by converting the due amount in the base currency into the payment currency based on a relevant exchange rate.

The dual feature introduces an element of flexibility, catering to both issuers and investors who seek a balance between their currency preferences. For instance, a dual currency bond might be issued in U.S. Dollars (USD), with interest payments made in Japanese Yen (JPY), creating a fusion of two different monetary realms.

Types of Dual Currency Bonds

1. **Traditional Dual Currency Bonds**. In this type, interest payments are made in the investor's domestic currency, while the principal amount is denominated in the issuer's domestic currency.
2. **Reverse Dual Currency Bonds**. Conversely, in reverse dual currency bonds, interest payments are made in the issuer's domestic currency, and the principal amount is denominated in the investor's domestic currency.

Features Benefits

a. **Diversification**. Issuers can diversify their investor base by tapping into multiple markets. Besides, if their domestic currency is relatively weak, dual currency bonds provide an opportunity to borrow in hard currencies while shifting major currency risks to the bond holders. Investors, on their part, can use such instruments to diversify their currency portfolio.

b. **Attracting Investors**. These bonds can attract a broader range of investors, including those who prefer returns in specific foreign currencies but prefer not to enter the overseas bond markets directly.

c. **Currency Matching**. Issuers can align debt obligations with specific currency revenue streams, reducing currency risk and exposure.
d. **Higher Coupon Rates**. Dual currency bonds often offer higher coupon rates than standard bonds, potentially providing investors with increased income.

Risks

a. **Foreign Exchange Risk**. Fluctuations in exchange rates between the base currency and the coupon currency can impact the value of coupon payments and the principal amount upon maturity.
b. **Complexity**. Dual currency bonds are more intricate than standard bonds, requiring investors to have a deeper understanding of currency dynamics and potential risks.
c. **Liquidity Concerns**. These bonds may have lower liquidity than major currency bonds, making them less suitable for certain investors seeking easy tradability.

Examples of Dual Currency Bond

a. **Yen-Linked Bonds**. The par value is indicated in yen while the coupon and redemption payments are made in currencies like the US dollar or Swiss franc.
b. **Masala Bonds**. Denominated in Indian Rupees with coupon and redemption proceeds usually paid in the US dollar, Euro, or Japanese Yen.
c. **Foreign Interest Payment Security (FIPS).** Specific to the Swiss capital market, FIPS bonds have coupon payments in foreign currency while the principal is repaid in Swiss frank.
d. **Multiple Currency Clause Bond**. Provides investors the right to select a currency from a pre-approved list for principal and sometimes coupon payments.
e. **Special Drawing Rights (SDR) Bonds**. Denominated in the IMF's composite currency based on a basket of major currencies, but traded exclusively in US dollars.

V. Euro Equity

Euroequity is newly-issued stock that is simultaneously sold to investors in more than one national market, rather than just in the country where the company is domiciled, as part of an initial public offering (IPO).Euroequity differs from a cross-listing, where company shares are floated in the home market and then listed in a different country.

- Euroequity is an initial public offering (IPO) that is sold to investors in more than one national market.
- This differs from a cross-listing, where company shares are floated in the home market and then listed in a different country.
- Listing on multiple exchanges provides access to a bigger pool of investors and capital, and can also help to increase brand awareness.
- However, complying with multiple regulatory bodies and reporting standards can also be costly.

Understanding Euroequity

Companies in need of funds can raise the necessary capital through debt financing, selling instruments such as bonds, or equity financing—issuing new shares. Equity can be raised not just in a company's home country but also overseas. When a firm opts to go public and sell its shares in different international markets, it is known as Euroequity.
The Euroequity path is generally taken by companies eager to raise more capital. Options might be limited in its home markets, prompting the company to look further afield and offer investors active in bigger exchanges, such as the New York Stock Exchange (NYSE), the opportunity to purchase a stake in it as well.

Euroequity IPOs are similar to dual-listed IPOs, where a foreign company issues shares simultaneously in its home market and abroad. America has historically been a popular second destination, due to the depths of its capital market and the protection the Securities and Exchange Commission's (SEC) regulations provide investors.

Example of Euroequity

As a historical example, in 1995, Investcorp, a holding company controlled by Bahraini investors, sold 49% of its stake in Gucci Group, the Italian luxury goods maker, in an IPO on the Amsterdam (AEX) and New York Stock Exchanges. In 1996 it sold its remaining 51% stake

The move initially worked out nicely for Gucci. By early 1999, the Italian fashion brand doubled the number of stores it owned and operated. New stores and upgrades on existing ones boosted revenues and helped the group to put its early 1990s flirtation with bankruptcy firmly in the rear-view mirror.

Disadvantage of Euroequity

There are plenty of benefits to Euroequity IPOs, as well as several negatives. Drawbacks include having to comply with multiple regulatory bodies and exchanges and synchronizing disclosures—hurdles that can come at a substantial cost.

VI. Euro Deposits

A Euro deposit is a fund deposited in a European account that allows foreign citizens to invest in euros and earn interest at the European Central Bank's (ECB) rate. The ECB's rate for reserves was negative between 2014 and 2022, but in 2023 it is higher than 3%. Some big banks have started charging customers for Euro deposits to pass along the costs.

Eurocurrency is currency held on deposit outside of its home market, such as a deposit of US dollars held in a bank in London. The term "eurocurrency" predates the creation of the euro and can apply to any combination of deposits in a foreign bank outside of its home market. For example, a deposit of South Korean won (KPW) deposited at a bank in South Africa would be considered eurocurrency.

Eurocurrency deposits are short-term fixed-rate time deposits denominated in a currency other than the local currency. For example, US dollars deposited in a London bank are Eurocurrency deposits.

Interest rates: The ECB offers negative rates for reserves between 2014 and 2022,but the rate in 2023 is now over 3%.

Deposit beta: The sensitivity of banks' deposit rates to changes in interest rates is called "deposit beta".

Eurocurrency market: Interest rates paid on deposits in the Eurocurrency market are typically higher than on the domestic market because the depositor is not protected by the same national banking laws and has no government insurance on deposits.

Eurocurrency loans: Loans in the Eurocurrency market can range up to 10 or more years, and the interest rate is usually stated as some spread over LIBOR (London Interbank Offered Rate). These adjustable interest rates serve to minimize the interest rate risk to the bank

6.5 Summary

1. When people are risk averse, countries can gain through the exchange of risky assets.The gains from trade take the form of a reduction in the riskiness of each country'sconsumption. International portfolio diversification can be carried out through theexchange of debt instruments or equity instruments.

2. The international capital market is the market in which residents of different countries trade assets. One of its important components is the foreign exchange market.Banks are at the center of the international capital market, and many operate offshore,that is, outside the countries where their head offices are based.
3. Regulatory and political factors have encouraged offshore banking. The same factorshave encouraged offshore currency trading, that is, trade in bank deposits denominated.

To have a clear understanding of the functioning the Euro-Currency, it is imperativeto know the meaning and concept of "Euro-Dollar", because all transactions up to 1960 werein Euro-Dollar only. A strict line of demarcation will only be artificial.

An American Dollar, outside America is called as Euro-Dollar. But presently the non-dollar denominated deposits have a widespread existence in the Euro-Currency markets.Also much of the market is new located outside Europe.The term Euro-Dollar refers to all such financial assets and liabilities denominatedin U.S. Dollars, but which are transacted outside the territory of the U.S.A. It was preciselyto overcome the difficulties arising out of the monetary regulations which did not becomeapplicable on such markets outside the geographical transitory of U.S.A. that these marketshave come into existence and are making tremendous growth since then 1960.

There were many restrictions imposed by the Federal Reserve Board of U.S.A. on theU.S. commercial Banks on payment of interest takes on deposits received from individuals.Such instructions could, no longer, be imposed on the Euro-Dollar deposits.Another regulation which got amended in 1969 was responsible for a rapid growthof Euro-Dollar market. The regulation (Similar to the concept of cash Reserve Ratio in theIndian contest) required that only U.S. banks situated in its territory required to maintain a"Reserve against deposits" whereas their foreign branches as well as foreign banks depositsin U.S. banks need not keep any such reserve.

The policy to tighten the domestic availability of credit with the Banks, made theposition of U.S.'S domestic bank to find themselves in a difficult situation.
Added to this, a nearly double the interest – rate prevailing abroad in the foreignbranches of U.S. Banks encouraged the depositors to move away from the banks – domesticto foreign branches. Due to the non-availability of adequate credit domestically, the banksin U.S.A. were forced to borrow from the other European Banks, to meet their domesticdemand from their customers, such increased demand pushed up the interest – rates inEuro Banks.The other restrictions aimed at (a) controlling the capital outflows from U.S. and (b)improving the BOP situation were equally responsible for the rapid growth of Euro – Dollarmarket.

6.6 Examples

Let's consider a hypothetical example of a Global Depository Receipt (GDR) issuance to illustrate how it works:

Company XYZ, an Indian Technology Firm, Issues GDRs:

Company Background: XYZ Company is one of the best technology companies in India. While it emerges as a leading brand in the domestic market, its intention revolves around impinging its reach into the global scenario and buliding interest from overseas investors.

Decision to Issue GDRs: With an interest in capitalizing from the international capital markets, Company XYZ opt to issue GDRs. This would enable the company to tap into investor and capital market from around the world without the hassle of reaching directly overseas stock exchange.

Engaging with a Depositary Bank: Company XYZ works with a depository bank say, Global Bank to enable the GDR issuance. Global Bank will be the middleman to release, list, and administer the GDRs.
Creation of GDRs: Global Bank acquires a shareholder mandate share block of Company XYZ and takes the custody. To these shares, Global Bank issues GDRs, each equal to several Company XYZ shares.
Listing on an International Exchange: GDRs are then listed on a big bourse, for instance, the London Stock Exchange or the New York Stock Exchange. This lets investors globally, to buy and sell the GDRs at the exchange.
Currency Denomination: The GDRs are issued in a currency not related to the Indian rupee; may be in dollars to attract investors globally. The selection of this currency makes GDRs much more tradable as well as capital changeable to the international investors.
Investor Participation: This allows investors abroad to purchase shares of Company XYZ, as the share is available through the international exchange. The GDRs are trading within the international market. Through this investment, these investors effectively hold a claim on a part of Company XYZ's ownership without interacting with the Indian stock market itself.
Corporate Actions and Dividends: GDR holders are eligible to receive dividend as well as participate in any corporate action such as stock splitting and merger in Indian market just the same shareholders of the actual shares. The depositary bank runs the dividend dispensary and makes certain that the GDR holders enjoy the perks of possession.
Liquidity and Trading: These include GDRs which trade internationally and liquidate investing the market. The trading that is taking place in the GDRs plays a role on the Company XYZs standing valuation and liquidity on the global markets.

6.7 Questions

1. What are the different types of international financial markets and instruments traded thereof?
2. What is International Money Market? Explain the Euro Currency Market
3. What is GDR? Explain with examples
4. What is ADR? Differentiate it with the GDRs
5. What are the debt instruments available in the international euro market?
6. Write down the procedure or modes operandi in International Capital Marekts.
7. Who are the players in the International Financial Market?

6.8 Further Readings

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LESSON-7
FOREIGN EXCHANGE MARKET

OBJECTIVES:

- To study on Foreign Exchange Market
- To understand the Foreign Exchange Market Functions and Characteristics
- To know on various Foreign Exchange Market Participants

STRUCTURE:

7.1 INTRODUCTION ON FOREIGN EXCHANGE MARKET

One of the important components of the international financial system is the foreign exchange market. The foreign exchange market facilitates such operations. The demand for goods and services from one country to another is the basis for demand for currencies in the market. Thus basically, demand for and supply of foreign currencies arises from exporters or importers or the public having some transactions with foreign countries. When foreign exchange markets operate in a free manner, the assumption is that the exchange rates between various currencies would be quoted at the same level at all the trading centers throughout the world.

The first true forex market was in Amsterdam, approximately 500 years ago. The exchange allowed people to freely trade currencies to stabilize exchange rates.7 In 1875, the gold standard was implemented, meaning countries were only allowed to print currency equal to the amount of their gold reserves. Gold was the metal of choice due to it being rare, malleable, tough to corrode, and hard to obtain.

In 1913, in London, there were 71 forex trading firms, an increase from three in 1903.But the gold standard could not hold up during the world wars, due to countries having to print more money to finance expenses. After World War II, the Bretton Woods system was established. It called for most currencies to be pegged to the U.S. dollar, which was backed by gold reserves. In 1971, President Nixon announced a freeze on the dollar's convertibility to gold due to rising inflation and a possible gold run.

In 1973, the gold standard was completely abolished and the U.S. dollar was no longer backed by gold reserves, and foreign exchange switched to a free-floating system. Currencies were free to peg to any currency they chose or to remain unpegged and allow the supply and demand of the currency to determine its value.

The foreign exchange market is the mechanism by which currencies are valued relative to one another, and exchanged. An individual or institution buys one currency and sells another in a simultaneous transaction. Currency trading always occurs in pairs where one currency is sold for another and is represented in the most liquid trading pairs are, in descending order of liquidity:

- **EUR/USD**
- **USD/JPY**
- **GBP/USD**
- **CHF/YEN.**

The exchange rate is determined through the interaction of market forces dealing with supply and demand. Foreign exchange markets are made up of banks, forex dealers, commercial companies, central banks, investment management firms, hedge funds, retail forex dealers, and investors.

In India, commercial and most of the co-operative banks have been authorized to deal in foreign exchange. Banks finance huge amount of foreign trade. This trade is conducted on daily basis through purchase and sale of foreign currencies. The demand and supply of active currencies is matched by the banks from their own stock. There are cases when the bank needs some currencies or has a surplus of such currencies. These needs are met by buying or selling such currencies to the RBI. The Foreign Exchange Market is, therefore, also referred to as an "Interbank" or "Over the Counter (OTC)" market.

The foreign exchange market is a market in which currencies are bought and sold against each other. In other words, foreign exchange market is the market where the currency of one country is exchanged for the currency of another country. The market is an over the counter market. There is no single market place or an organized exchange (like a stock exchange) where traders meet and exchange currencies. The dealers sit in their dealing room of major commercial banks around the world and communicate with each other through telephones, computer terminals and SWIFT mechanism. The forex market is a wholesale market called the inter-bank market. Commercial banks are the market makers. Corporations use the foreign exchange market for a variety of purposes relating to their operation like payment for imports, conversion of export receipts, hedging of receivables and payables, payment of interest on foreign currency loans, placement of surplus funds etc.

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.

7.1.1 FACTORS INFLUENCE THE FOREIGN EXCHANGE MARKET

Several factors influence the foreign exchange market, including:

- **Economic indicators:** Economic indicators such as inflation, GDP, and employment data can influence currency values, as they affect a country's economic outlook.
- **Central bank policies:** The monetary policies of central banks, including interest rates and quantitative easing measures, can influence currency values.
- **Geopolitical events:** Political events such as elections, wars, and trade agreements can cause significant currency volatility.

- **Market sentiment:** Market sentiment, including investor confidence and risk appetite, can influence currency values.
- **Natural disasters:** Natural disasters can disrupt economic activity and cause currency values to fluctuate.
- **Speculation:** Speculative trading activity can also influence currency values, as traders buy or sell currencies based on their expectations of future price movements.

7.1.2 RISKS OF FOREX MARKET

It is evident that the foreign exchange rates are subject to change from time to time. Some of the variations may be unanticipated and have nothing to do with the fundamentals. A business firm dealing in import and export has to often deal with the foreign exchange rates and market. Normally, such a firm always has an exposure to such exchange risk, which may arise due to change in exchange rates. Foreign exchange exposure is present whenever a firm‘s current assets and current liabilities are denominated in terms of currency other than the domestic currency. In case a firm owns assets or projects that create cash flows in a foreign currency, then change in exchange rates can affect the value of these assets and projects. However, if the cash flows are expressed in local currency, then this type of exchange risk will not be present.

Operations in the forex market are exposed to a number of risks. These risks are as follows:

- Credit risk arising out of lending to a foreign borrower whose credit rating is not known for certainty.
- Currency risk of trading in a currency whose stability and strength is known to fluctuate. Currency risk, often known as exchange-rate risk, derives from changes in the price of one currency in comparison to another currency. Currency risk exposes investors and firms with assets or commercial activities across national borders to unpredictability in profits and losses.
- Country risks involved in dealing in the currency of a country that’s political and economic stability is uncertain.
- Solvency risks due to mismatch between current assets and liabilities of dealers and resultant default in meeting forward commitments.
- Transaction risk is the simplest and most common foreign exchange risk. It occurs when the actual transaction takes place. The risk comes from the possibility of the rates changing so that the value of the currency is different than when the transaction started. Transaction risk is directly related to the delay between committing to a deal and actually making payment. The longer the time period between the agreement to make payment and the payment actually occurring, the greater the risk of the value of currency going down, so that end up paying more than what initially intended.
- Economic risk, the risk that a company's market value will be damaged by inevitable exposure to exchange rate swings is known as economic risk, sometimes known as forecast risk. This type of risk is typically caused by macroeconomic variables such as geopolitical instability and/or government laws.
- Translation risk, also known as translation exposure, refers to the risk faced by a firm headquartered in the United States but conducting business in a foreign jurisdiction whose financial performance is reported in the company's home currency. When a company keeps a larger proportion of its assets, liabilities, or stocks in a foreign currency, the risk of translation grows.

7.2 FOREIGN EXCHANGE MARKET FUNCTIONS

The various functions of the Foreign Exchange Market are as follows:

- **Transfer Function:** The basic and the most obvious function of the foreign exchange market is to transfer the funds or the foreign currencies from one country to another for settling their payments. The market basically converts one's currency to another.
- **Credit Function:** The FOREX provides short-term credit to the importers in order to facilitate the smooth flow of goods and services from various countries. The importer can use his own credit to finance foreign purchases.
- **Hedging Function:** The third function of a foreign exchange market is to hedge the foreign exchange risks. The parties in the foreign exchange are often afraid of the fluctuations in the exchange rates, which mean the price of one currency in terms of another currency. This might result in a gain or loss to the party concerned.

7.3 FOREIGN EXCHANGE MARKET CHARACTERISTICS

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

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

7.4 FOREIGN EXCHANGE MARKET -ADVANTAGES AND DISADVANTAGES

Advantages of the Foreign Exchange Market

There are fewer rules than in other markets, which mean investors aren't held to the strict standards or regulations found in other markets. There are no clearing houses and no central bodies that oversee the forex market. Most investors won't have to pay the traditional fees or commissions that they would on another market. Because the market is open 24 hours a day, trade at any time of day, which means there's no cut-off time to be able to participate in the market (except if you're heading into the weekend). Finally, if worried about risk and reward, can get in and out whenever want, and buy as much currency as can afford based on account balance and broker's rules for leverage.

- **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 the Foreign Exchange Market

Though the market being unregulated brings advantages, it also creates risks, as there is no significant oversight that can ensure risk-free transactions. Leverage can help magnify profits but can also lead to high losses. As there are no set limits on leverage, investors stand to lose a tremendous amount of money if their trades move in the wrong direction. Unlike stocks that can also provide returns through dividends and bonds through interest payments, FX transactions solely rely on appreciation, meaning they have less residual returns than some other assets. Lack of transparency in the FX market can harm a trader as they do not have full control over how their trades are filled, may not get the best price, and may have a limited view of information, such as quotes.

- **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.

7.5 TYPES OF FOREIGN EXCHANGE MARKETS

- **Spot Forex Market:** The spot market is the immediate exchange of currencies at the current exchange. On the spot. This makes up a large portion of the total forex market and involves buyers and sellers from across the entire spectrum of the financial sector, as well as those individuals exchanging currencies. 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.
    - The fastest currency transactions occur in this market.
    - This forex market provides immediate payment to buyers and sellers based on the current exchange rate.
    - Nearly one-third of all currency exchange takes place on the spot market, with trades usually settling in one or two days
- **Forward Forex Market:** The forward market involves an agreement between the buyer and seller to exchange currencies at an agreed-upon price at a set date in the future. No exchange of actual currencies takes place, just the value. The forward market is often

used for hedging. 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.

- ❖ In the forward market, two parties agree to exchange currencies at a set price on a future date.
- ❖ They don't actually swap money right away, just the value of the currency.
- ❖ This is often used to protect against future price changes.

- ➢ **Futures Forex Market:** The futures market is similar to the forward market, in that there is an agreed price at an agreed date. The primary difference is that the futures market is regulated and happens on an exchange. 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.
  - ❖ **Similar to the forward market, it's regulated and happens on an official exchange. This reduces the risk.**
  - ❖ **People use futures contracts for hedging, too.**
- ➢ Option Market
  - ❖ An option is like a contract that gives an investor the choice (but not the obligation) to buy or sell something like a stock, ETF, or index at a specific price over a certain period.
  - ❖ People trade options in this market.
- ➢ Swap Market
  - ❖ The swap contract involves two parties exchanging cash flows or liabilities arising from two different financial instruments.
  - ❖ Typically, swaps involve these cash flows based on a principal amount.

7.6 FOREIGN EXCHANGE MARKETS -ORGANISATION AND PARTICIPANTS

The Foreign Exchange Dealers Association of India (FEDAI) is an association of commercial banks that specializes in the foreign exchange (forex) markets in India. These institutions are also called Authorised Dealers or ADs. Created in 1958 and incorporated under Indian law, Section 25 of The Companies Act of 1956, the Association regulates the rules that determine commissions, fees, and charges that are attached to the interbank foreign exchange business. Some core functions of the FEDAI include advising and supporting member banks, representing member banks on the Reserve Bank of India (RBI), and announcing rates to member banks. FEDAI also help stabilize markets through its cooperation with the RBI and the Fixed Income Money Market and Derivatives Association of India (FIMMDA)

The FEDAI determines many of the rules that oversee the day-to-day forex transactions in India. In addition to creating rules, FEDAI assists member banks by acting as an advisor, training personnel about Foreign Exchange Business, and accrediting foreign exchange brokers. The FEDAI's core functions include:

- ❖ Advising and supporting member banks with issues that arise in their dealings
- ❖ Representing member banks on the Reserve Bank of India (India's central bank)
- ❖ Announcement of daily and periodical interest rates to member banks
- ❖ Guidelines and Rules for Forex Business.

- ❖ Training of Bank Personnel in the areas of Foreign Exchange Business.
- ❖ Accreditation of Forex Brokers

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.

7.7 SUMMARY

The foreign exchange market is an over-the-counter (OTC) marketplace that determines the exchange rate for global currencies. It is, by far, the largest financial market in the world and is made up of a global network of financial centers that transact 24 hours a day, closing only on the weekends. Currencies are always traded in pairs, so the "value" of one of the currencies in that pair is relative to the value of the other.The foreign exchange market or the forex market, is the largest and most liquid financial market in the world. In simple words, it is a market in which buying and selling of foreign currencies take place. In this market buyers and sellers constitute people who wish to buy or sell foreign exchange. The buyers can be individuals, firms, commercial banks (like the State Bank of India), the central bank(Reserve Bank of India), commercial companies, and investment brokers.

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.These foreign exchange markets are consisting of banks, forex dealers, commercial companies, central banks, investment management firms, hedge funds, retail forex dealers, and investors. In our prevailing section, it will widen our discussion on the ‘Foreign Exchange Market’.

There are fewer rules than in other markets, which mean investors aren't held to the strict standards or regulations found in other markets. There are no clearing houses and no central bodies that oversee the forex market.Though the market being unregulated brings advantages, it also creates risks, as there is no significant oversight that can ensure risk-free transactions. Leverage can help magnify profits but can also lead to high losses. And also in this lesson covered types of Foreign Exchange Markets and Foreign Exchange Markets -Organization and Participants.

7.8 KEY WORDS

- ❖ **Foreign Exchange Market:** Every nation has a unique currency that it uses for commerce and business, in India; it’s Indian Rupee, but what about the global market? The lack of flexibility of the currencies makes them a barrier to international trade. The Foreign Exchange Market was formed to solve this problem. This is a specific kind of market where the currency exchange rates are fixed. In absence of a foreign exchange market, the global economy would suffer greatly. The Foreign Exchange Market is the market in which the national currencies are traded for one another.

- **Economic indicators:** Economic indicators such as inflation, GDP, and employment data can influence currency values, as they affect a country's economic outlook.
- **Currency risk:** Currency risk of trading in a currency whose stability and strength is known to fluctuate. Currency risk, often known as exchange-rate risk, derives from changes in the price of one currency in comparison to another currency. Currency risk exposes investors and firms with assets or commercial activities across national borders to unpredictability in profits and losses.
- **Credit Function:** The FOREX provides short-term credit to the importers in order to facilitate the smooth flow of goods and services from various countries. The importer can use his own credit to finance foreign purchases.
- **Low transaction costs:** The cost of trading in the forex market is relatively low compared to other financial markets.
- **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.
- **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.
- **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.
- **Commercial banks:** Banks are the most active participants in the forex market, trading on behalf of their clients and for their own accounts.

7.9 SELF-ASSESSMENT QUESTIONS

1. What is Foreign Exchange Market? Explain factor in various inforeign exchange market?
2. Discuss the Foreign Exchange risks?
3. Explain Foreign Exchange Market Functions in brief?
4. What are the advantages and disadvantages of the Foreign Exchange Market?
5. Explain Foreign Exchange Markets Organization and various Participants in markets**?**

7.10 FURTHER READINGS

- Foreign Exchange & Forex Risk Management by Thakur Publication Inhouse Book, Thakiur Publication PVT LTD, 2023
- International Finance/Foreign Exchange Management by BimalJaiswal, New Royal Book Co,2020.
- Foreign Exchange Facilities for Individu, by Indian Institute of Banking and Finance, Macmillan Publishers India Private Limited; Second edition , 2017

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LESSON-8
ARBITRAGE IN FOREIGN EXCHANGE MARKET

OBJECTIVES:
- To study on Arbitrage Concept.
- To understand the pros and cons of Arbitrage
- To know the various types in Arbitrage

STRUCTURE:

8.1 INTRODUCTION OF ARBITRAGE

Arbitrage is the technique of gaining small profits by purchasing and selling shares on separate markets or exchanges at the same time. A spread is a difference in price between two markets or exchanges for a particular security, currency, or commodity; it is also known as the arbitrageur's profit. Arbitrageurs are in business to take advantage of a discrepancy between prices in two different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

When foreign exchange markets operate in a free manner, the assumption is that the exchange rates between various currencies would be quoted at the same level at all the trading centers throughout the world. But it seldom happens and at the best of times, there are discernible differences in exchange values across centers. Banks and other dealers take advantage of these differences and profit from the rate difference. This operation is called arbitrage. For example, if the Dollar-Euro parity is 1.00 in New York and 1.05 in Frankfurt, then a dealer can sell Euros in Frankfurt, purchase Dollars and with the Dollars, buy Euros again in New York thereby profiting from the deal.

Forex arbitrage opportunities occur because the forex market is decentralized. As a result, a situation like negative spread appears under certain circumstances. Price of one currency can be different in two markets, allowing arbitrageurs to purchase low and sell at a high price, locking a profit in doing so.Forex arbitrage is a risk-free trading strategy that allows retail forex traders to profit without open currency exposure. This type of arbitrage trading involves buying and selling currency pairs to exploit pricing inefficiencies.Arbitrage opportunities often arise during news events, when price quotes experience volatility. Exploiting pricing inefficiencies could rapidly close a price disparity, so traders must act quickly when using these strategies.Because of the artificial intelligence-driven trading algorithms major institutional trading firms use, these opportunities often last only a fraction of a second, making it nearly impossible for individual traders to participate.

The importance of arbitrage lies in its ability to correspond foreign exchange rates in all the major foreign exchange markets. The arbitraging involves the transfer of foreign exchange from the market with a lower exchange rate to the market with a higher exchange rate. Hence, arbitraging equates the demand for foreign exchange with its supply, thereby acting as a stabilizing factor in the exchange markets.

In India, arbitrage trading is associated with several risks; these are:

- Challenges concerning the time of execution
- Cost of transactions that poses a huge impact on the profit margin
- Limited opportunities as a result of enhanced efficiency in the market and increased competition
- Risks concerning compliance and regulations
- Issues with liquidity in the market
- Risk concerning technology
- Scalability is limited

8.2 TYPES OF ARBITRAGE

Though there are many types of arbitrage, this trading strategy typically takes one of three main forms:

- **Locational:** Through this common type of arbitrage, an investor can capitalize on a scenario in which one bank's buying (or "bid") price for a given currency is higher than another bank's selling (or "ask") price for that currency. By way of illustration, let’s assume that the exchange rate at Bank A between the euro and U.S. dollar is $1.25; in other words, have to spend $1.25 to get one euro. Bank B has the exchange rate at $1. An investor can take one euro and convert it into dollars at Bank A (getting $1.25), then take that money to Bank B and convert it back to euros at the 1:1 exchange rate. This would mean $1.25 converted back to euros at the 1:1 exchange rate, or 1.25 euros. Thus, an investor made a profit of $0.25 per euro.
- **Triangular:**Some investors have been known to deploy a “triangular” arbitrage strategy involving three currencies and banks. For example, it could exchange U.S. dollars for euros, then euros into British pounds, then British pounds back into dollars, taking advantage of small discrepancies in currency exchange rates along the way.
- **Covered Interest:**Covered interest-rate arbitrage is a trading strategy in which an investor can utilize a “forward contract” (an agreement to buy or sell an asset on a certain date in the future) to capitalize on an interest rate discrepancy between two countries and eliminate their exposure to changes in exchange rates. For example, let's say that the 90-day interest rate for the British pound is higher than that for the U.S. dollar. might borrow money in dollars and convert it into pounds. It would then deposit that amount at the higher rate, and at the same time enter into a 90-day forward contract where the deposit would be converted back into dollars at a set exchange rate when it matures. When settle the forward contract and later repay the loan in dollars, it makes a profit.
- **Other Types of Forex Arbitrage**

- Currency arbitrage involves the exploitation of the differences in quotes rather than movements in the exchange rates of the currencies in the currency pair.
- A cross-currency transaction is one that consists of a pair of currencies traded in forex that does not include the U.S. dollar. Ordinary cross-currency rates involve the Japanese yen. Arbitrage seeks to exploit pricing between the currency pairs, or the cross rates of different currency pairs.
- In covered interest rate arbitrages the practice of using favorable interest rate differentials to invest in a higher-yielding currency, and hedging the exchange risk through a forward currency contract.
- An uncovered interest rate arbitrage involves changing a domestic currency that carries a lower interest rate to a foreign currency that offers a higher rate of interest on deposits.
- Spot-future arbitrage involves taking positions in the same currency in the spot and futures markets. For example, a trader would buy currency on the spot market and sell the same currency in the futures market if there is a beneficial pricing discrepancy.
- Pure arbitrage is a swift, no-risk strategy. The arbitrageur promptly executes buy or sell decisions without waiting for funds to clear. This technique relies on exploiting instantaneous price discrepancies, ensuring that profits are secured immediately.
- A prevalent activity in e-commerce, retail arbitrage involves purchasing a product from a local merchant at a lower price and subsequently offering it for a higher price on an online marketplace. This approach leverages the convenience and accessibility of online platforms to capture price differentials.
- In risk arbitrage, investors anticipate a stock's price increase in the future, leading them to buy and hold the stock. This strategy is based on the belief that the stock's value will rise in another market, resulting in profit for the investor.
- Convertible arbitrage entails holding a long position in convertible securities while simultaneously shorting the underlying stock. By doing so, arbitrageurs aim to capitalise on price disparities between the convertible security and the stock into which it can be converted.
- Merger arbitrage is a tactical manoeuvre employed when anticipating an acquisition or merger. Arbitrageurs purchase the target company's stock, expecting the prices to rise post-merger. They subsequently sell the shares to book the profits.
- Traders employing dividend arbitrage strategically buy stocks just before the ex-dividend date, which is the last day for a buyer to be entitled to the dividend payout. By timing their purchases, investors aim to capture the dividend payout, further enhancing their overall return on investment.
- Futures arbitrage is a technique that involves purchasing a stock with cash and then selling it in the futures market. Typically, futures are priced higher than the cash market to account for future premiums. However, as the expiration date approaches, both prices tend to converge, presenting an arbitrage opportunity.

These various types of arbitrage showcase the versatility and complexity of this financial strategy. Each type targets specific market inefficiencies, offering arbitrageurs unique avenues for profit. However, it is important to note that successful arbitrage requires meticulous research, swift execution, and a deep understanding of the underlying market dynamics.

Moreover, regulatory constraints and transaction costs can impact the feasibility and profitability of arbitrage strategies. Traders and investors must carefully evaluate the risks and rewards associated with each type of arbitrage before engaging in these sophisticated financial practices. By doing so, they can navigate the complexities of arbitrage and potentially unlock significant opportunities for profit in the dynamic world of finance.

8.3 METHODS OF FOREX ARBITRAGE

When it comes to price arbitrage, many usually think of a trading method that allows making an immediate profit without the trader having to take any risks. In general, however, any trade that is based on the use of price inefficiency with “immediate” profit but also the trade combined with other factors that help it achieve profit in time can be both understood in terms of arbitrage. The three most common methods of Forex arbitrage

- **Multi-pair arbitrage trades**: The first arbitrage method, which if successful results in the immediate profit, is the rapid realization of a multi-pair trade. It is precisely this method that benefits from the above-mentioned price inefficiency, which occurs when the market is not able to "balance" exchange rate differences to an optimal / equilibrium state quickly enough.
- **Arbitrage of undervalued and overvalued markets:** This method of arbitration is much more complicated than the previous type. It requires considerable market experience from traders, as it is based on the search for business opportunities that result from the relative undervaluation or overvaluation of one of the markets. This means that, in this case, it is rather fundamental than technical arbitration and as such it is based on important market reports, analyzes and predictions.
- **Arbitrage of positive swaps:** The last very common way of arbitrage is trading positive swaps. Probably every trader already knows well that when trading can come across positive and negative swaps, which are charged in case hold a position overnight.

  This type of arbitrage consists in the fact that at one moment a specific currency pair is traded, more precisely a purchase or sale in the direction of a positive swap, and at the same time a fiat currency is purchased in the same volume, for example in an exchange. The profit here is therefore the income from positive swaps, from which, in addition, all fees must be deducted.

8.4 PROS AND CONS

Arbitrage, a fundamental strategy in finance, encompasses various approaches for capitalising on price discrepancies across markets. These opportunities arise from variations in asset prices, interest rates, or currency values. In this guide, it will explore the diverse types of arbitrage and their significance in the world of finance.

Arbitrage is a financial strategy that capitalises on price differentials for the same asset in distinct markets or at different times. It is akin to astutely identifying and selling undervalued items for a profit. However, arbitrageurs must act swiftly and judiciously to minimise risks. These financial professionals, known as arbitrageurs, function as astute analysts seeking lucrative opportunities. Their goal is to generate profits while mitigating unnecessary exposure to risk.

What makes arbitrage compelling is its versatility, encompassing various techniques. It could involve exploiting price gaps between stocks on different exchanges, interest rate variations, or currency value disparities. By executing such strategies, arbitrageurs play a pivotal role in ensuring market efficiency and equilibrium. They contribute to the alignment of prices, ultimately enhancing market stability and efficiency.

❖ Pros of arbitrage are:

- **Risk-free profits:** The profits derived from arbitrage executed correctly can be considered risk-free, because the buying and selling price are known in advance. In contrast to trading stocks or bonds through a traditional strategy of buying a security now and selling it at some point in the future, arbitrage doesn't require betting on the future performance of a security.
- **No capital investment:** If merely capitalizing on pricing mistakes or discrepancies (for example, through locational arbitrage), don't even have to invest capital of own to take advantage of an arbitrage opportunity.

❖ Cons arbitrage include:

- **Fleeting opportunity:** Arbitrage affects supply and demand in such a way that prices eventually realign, diminishing the opportunity for arbitrage in the future.[3] For example, the more arbitrageurs who buy a stock in U.S. dollars and sell it in euros, the more the U.S. dollar will rise and the euro will fall. This will have the effect of decreasing the disparity between the two currencies until there is none, and no profit can be made.
- **Potential price or rate fluctuations, fees, and taxes:** Prices and exchange or interest rates change frequently and rapidly, so there's always a chance that may execute a trade at a time when it may not be profitable. The odds of this happening increase if don't or can't simultaneously buy and sell a security because don't have the knowledge, experience, or high-speed technology infrastructure to do so. Other potential risks include transaction fees, which can cut into overall profit, and taxes, including the possibility of different tax treatments in foreign countries.

8.5 BENEFITS AND LIMITATIONS OF ARBITRAGE TRADING

❖ **Benefits of Arbitrage trading**

- Risk free profit potential
- Price inefficiency exploitation
- Portfolio diversification
- Provision for generating quick profits
- Hedging against the volatility in market
- Market neutral strategies

❖ **Limitations of Arbitrage trading**

- Challenges concerning the timing of executions
- Cost of transactions
- Opportunities are limited
- Risk concerning regulations and compliance
- Issues regarding liquidity in market
- Scalability is limited

8.6 ARBITRAGE TRADING TIPS

Trading might seem easy, but it is not. One requires years of practice and learning to master a strategy. If intend to step into arbitrage trading, here are a few tips that will benefit in the long run. While engaging in arbitrage trading, considering all the tips mentioned below can help in improving the chances of securing profits.

Some specific considerations must be taken into account, which is as follows:

- **Segmentation of the Market:** Indian markets are usually segmented on the basis of different exchanges, including BSE and NSE, along with various other derivative markets. Discrepancies in price between these platforms offer arbitrage traders ample opportunities for generating profit.
- **Cash-Futures Arbitrage:** Frequent arbitrage opportunities between futures and cash markets can be found. Traders can engage in purchasing and selling stocks in the cash market and, at the same time, take opposite positions in futures contracts, thereby securing the differential in price.
- **Regulatory and Tax Considerations:** Indian arbitrage traders must consider the implications of taxes and several regulatory requirements. They must comply with market manipulation guidelines, insider trading and exchange regulations, and applicable securities. Knowledge of capital gain regulations and tax laws is also essential for appropriately calculating profits.
- **Liquidity and Volatility In The Market:** One of the most concerning impacts on arbitrage trading is the volatility and liquidity of Indian markets. High liquidity makes the execution of trade easier and captures profit. Additional risks are often introduced by volatility as there might be a rapid change in the price along with an increase in the transaction cost during periods of stress in the market.
- **Connectivity and Technology:** Technology plays one of the most crucial roles in arbitrage trading. This is not an exception in India. Traders require high-speed connectivity, various algorithmic trading systems, and data feeds for capturing and exploiting discrepancies in price. Therefore access to advanced tools and reliable trading platforms is essential for making the best of arbitrage trading.
- **Currency Arbitrage:** Considering the use of multiple currencies in India, traders can also consider opportunities concerning currency arbitrage through their engagement in foreign exchange or futures currency trading transactions.
- **Other Arbitrage Trading Tips**
    - Conduct extensive research and always stay informed
    - Identify sources of data that are reliable
    - Engage in a deep understanding of the market dynamics
    - Develop effective strategies for managing risk
    - Take into account the costs of transactions
    - Monitor liquidity in the market
    - Ensure patience and discipline
    - Conform to the regulations
    - Make use of advanced trading platforms and tools for automation
    - Learn and adapt constantly

8.7 SUMMARY

Forex arbitrage opportunities occur because the forex market is decentralized. As a result, a situation like negative spread appears under certain circumstances. Price of one currency can be different in two markets, allowing arbitrageurs to purchase low and sell at a high price, locking a profit in doing so. The importance of arbitrage lies in its ability to correspond foreign exchange rates in all the major foreign exchange markets. The arbitraging involves the transfer of foreign exchange from the market with a lower exchange rate to the market with a higher exchange rate.Spot-future arbitrage involves taking positions in the same currency in the spot and futures markets. For example, a trader would buy currency on the spot market and sell the same currency in the futures market if there is a beneficial pricing discrepancy.In this lesson also discussed various other types of arbitrage, methods of forex arbitrage, pros and cons of arbitrage and limitations of arbitrage trading with arbitrage trading tips.

8.8 KEY WORDS

- **Arbitrage in Foreign Exchange Markets**: When foreign exchange markets operate in a free manner, the assumption is that the exchange rates between various currencies would be quoted at the same level at all the trading centers throughout the world. But it seldom happens and at the best of times, there are discernible differences in exchange values across centers. Banks and other dealers take advantage of these differences and profit from the rate difference. This operation is called arbitrage.
- **Arbitrageur's profit**: Arbitrage is the technique of gaining small profits by purchasing and selling shares on separate markets or exchanges at the same time. A spread is a difference in price between two markets or exchanges for a particular security, currency, or commodity; it is also known as the arbitrageur's profit.
- **Triangular arbitrage strategy:**Some investors have been known to deploy a "triangular" arbitrage strategy involving three currencies and banks. For example, it could exchange U.S. dollars for euros, then euros into British pounds, then British pounds back into dollars, taking advantage of small discrepancies in currency exchange rates along the way.
- **Pure arbitrage:** It is a swift, no-risk strategy. The arbitrageur promptly executes buy or sell decisions without waiting for funds to clear. This technique relies on exploiting instantaneous price discrepancies, ensuring that profits are secured immediately.
- **Futures arbitrage**: It is a technique that involves purchasing a stock with cash and then selling it in the futures market. Typically, futures are priced higher than the cash market to account for future premiums. However, as the expiration date approaches, both prices tend to converge, presenting an arbitrage opportunity.
- **Multi-pair arbitrage trades**: The first arbitrage method, which if successful results in the immediate profit, is the rapid realization of a multi-pair trade. It is precisely this method that benefits from the above-mentioned price inefficiency, which occurs when the market is not able to "balance" exchange rate differences to an optimal / equilibrium state quickly enough.
- **Risk-free profits:** The profits derived from arbitrage executed correctly can be considered risk-free, because the buying and selling price are known in advance. In contrast to trading stocks or bonds through a traditional strategy of buying a security now and selling it at some point in the future, arbitrage doesn't require betting on the future performance of a security.
- **Cash-Futures Arbitrage:** Frequent arbitrage opportunities between futures and cash markets can be found. Traders can engage in purchasing and selling stocks in the cash market and, at the same time, take opposite positions in futures contracts, thereby securing the differential in price.
- **Connectivity and Technology:** Technology plays one of the most crucial roles in arbitrage trading. This is not an exception in India. Traders require high-speed connectivity, various algorithmic trading systems, and data feeds for capturing and

exploiting discrepancies in price. Therefore access to advanced tools and reliable trading platforms is essential for making the best of arbitrage trading.

8.9 SELF-ASSESSMENT QUESTIONS

1. WhatismeantbyarbitrageinForeign Exchange Market? Explainwithsuitable examples.
2. Discuss methods of forex arbitrage?
3. What are the different types of Arbitrage in trading?
4. Write about benefit of Arbitrage trading and give some limitations?
5. Explain Arbitrage trading tips in Indian Foreign Exchange Market?

8.10 FURTHER READINGS

- Foreign Exchange Management by ManishaPaliwal, ISBN 9789354512995, Nirali Prakashan,2021.
- Commentary On The Foreign Exchange Management Act Edition 2023 by S K Sarvaria, Lexis Nexis, 2023
- Foreign Exchange Risk Management System (An Indian Perspective) by Anshul Vera, Hindustan Publishing Corporation

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LESSON-9
MECHANICS OFFOREIGN PAYMENTS

OBJECTIVES:

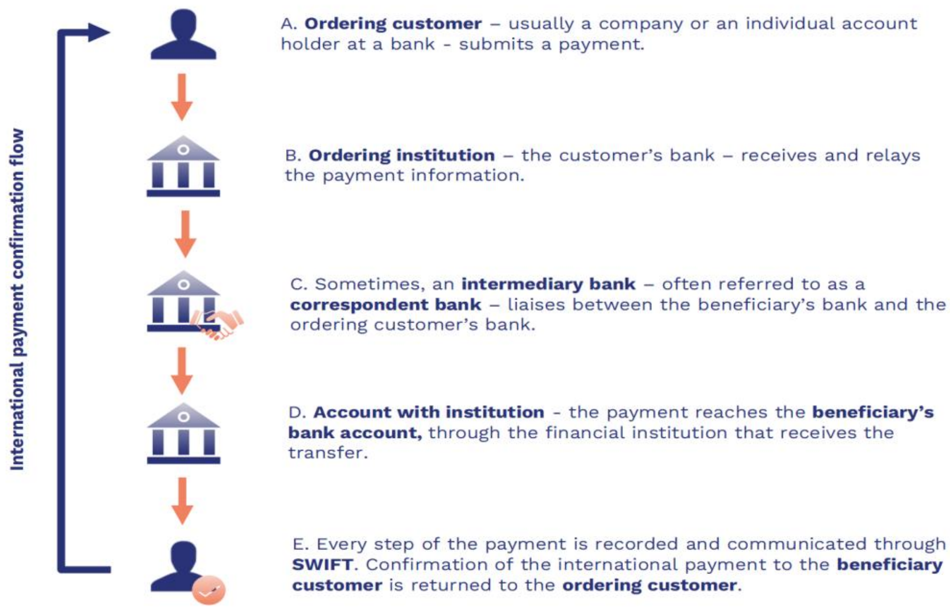
- To study on Mechanics of foreign payments
- To understand the different foreign payments
- To know various cost associated with international payments

STRUCTURE:

9.1 INTRODUCTION -FOREIGN PAYMENTS

Foreign payments, also known as cross-border payments, are transactions in which the payer and the payee are based in different countries. These payments are key for businesses that have international suppliers, contractors, employees, customers or partners. These transactions frequently involve the transfer of money from one currency to another. Given the global nature of these transactions, businesses that send or receive international payments must carefully adhere to the regulations, banking practice and exchange rates of both the originating and receiving countries. A foreign transaction fee is imposed by a credit card issuer on a transaction that takes place overseas or with a foreign merchant. These fees are typically 1%–3% of the value of the transaction and are paid by U.S. travelers in dollars. Online purchases that take place with overseas vendors may also be subject to such a fee. Several banks or credit card issuers now offer certain customers waivers on these fees, or fee-free cards. Foreign transaction fees are not always the same as currency conversion fees and may be tacked on to foreign transaction charges. International payments encompass a broad spectrum of financial transactions involving the movement of money across national borders. These transactions serve as the lifeblood of global trade, investment, and various economic activities, fostering economic growth and collaboration on an international scale.

International payments are crucial to global commerce as they facilitate trade between countries and enable businesses to expand their operations beyond domestic borders. These payments encompass a wide range of business activities, including paying overseas suppliers for goods, compensating international employees and receiving payments from foreign customers. International payments play an increasingly important part in today's globalised economy. The growth of technology and the interconnection of economies have changed the dynamics of financial transactions, making foreign payments an essential component of company and personal financial operations. In this extensive guide, will delve into the nuances of international payments, exploring their definition, types, importance, differences from domestic payments, various international payment systems, and why they are indispensable in the current trend of global commerce.



Export payments are the financial transactions that occur when a country or entity sells goods, services, or assets to foreign customers or buyers. For example, an Indian fashion house that sells luxury Indian clothing and apparel to the UK would receive an export payment.

Import payments refer to the financial transactions that occur when a country or entity purchases goods, services, or assets from foreign sources. For example, a company in the United States, without any Indian entity, that sells software to Indian customers would receive an import payment.

9.2 IMPORTANCE OF INTERNATIONAL PAYMENTS

The significance of international payments extends to the core of global commerce, acting as a linchpin for trade activities between nations and providing businesses with the means to expand their footprint beyond domestic borders. These payments span a diverse spectrum of business functions, ranging from compensating overseas suppliers for goods to remunerating international employees and receiving payments from clients located in foreign territories. Understanding the importance of international payments is paramount for both businesses and individuals engaged in cross-border transactions. Here, delve into critical reasons why international payments matter, exploring various facets that underscore their significance:

- **Currency Coverage:** One of the foundational advantages of international payments lies in the ability to transact in diverse currencies. This flexibility is particularly advantageous for businesses operating on a global scale. The capacity to navigate the intricacies of different currency markets allows businesses to adapt to changing economic landscapes and capitalise on favourable exchange rates.
- **Success Rate:** International payments, when executed through reputable channels, boast a high success rate. This reliability is crucial for businesses, ensuring that transactions are completed smoothly and without disruptions. A dependable international payment system

contributes to the overall stability of global commerce, fostering trust among businesses and stakeholders.

- ❖ **Local Payment Methods:** To cater to the diverse preferences of consumers worldwide, international payments support a spectrum of local payment methods. Whether through credit cards, digital wallets, or specific regional payment systems, this flexibility enhances the overall customer experience. Adapting to local payment preferences is pivotal for businesses seeking to establish a strong presence in varied markets.
- ❖ **Risk Mitigation:** International payments offer a robust risk mitigation strategy for businesses involved in global transactions. By diversifying transactions across multiple currencies, companies can offset the risks associated with currency fluctuations. This proactive approach contributes to the overall financial stability of international operations, safeguarding businesses from potential economic uncertainties.
- ❖ **Access to Global Markets:** For businesses, international payments serve as a gateway to new markets. The ability to transact in different currencies and navigate diverse regulatory environments empowers businesses to expand their reach. This access to global markets opens up opportunities for growth, enabling companies to tap into the vast potential offered by regions across the globe.
- ❖ **Facilitation of Global Collaboration:** International payments play a pivotal role in fostering collaboration between businesses, irrespective of geographical distances. With seamless financial transactions, companies can engage in joint ventures, partnerships, and collaborative projects. This facilitation of global collaboration not only nurtures innovation but also contributes to economic growth on a worldwide scale as businesses leverage each other’s strengths and expertise.

The other purposes International payments in global commerce:

- ➢ Purchasing goods and services. Many businesses source goods, raw materials or services from overseas suppliers to take advantage of cost efficiencies, quality or other benefits.
- ➢ Paying salaries to international employees or contractors. With the popularity of remote work, companies often work with employees or independent contractors located in different countries.
- ➢ Paying dividends or interest**.** When a corporation has international investors or borrows money from international lenders, it needs to make international payments.
- ➢ Investment activities**.** Companies might invest in businesses, projects or real estate in foreign countries.
- ➢ Acquiring assets**.** Companies may purchase assets in other countries as part of their operations or expansion strategies.
- ➢ Financial market transactions. When trading in foreign financial markets, companies often need to make cross-border payments.
- ➢ Payment for travel and expenses. When employees travel abroad for business reasons and incur expenses that the company needs to cover, the company can settle those payments with an international transaction.

In essence, the importance of international payments extends beyond the mere facilitation of transactions. It serves as a cornerstone for businesses looking to thrive in a globalised economy, offering them the tools and flexibility needed to navigate diverse markets and forge meaningful collaborations.

9.3 TYPES OF INTERNATIONAL PAYMENTS

International payments can take many forms, and the choice depends on factors such as cost, transaction size, speed of transfer and the specific requirements of the sender and recipient.

Here are some common types of international payments:

- **Wire transfers**: Wire transfers are a reliable and secure method for sending large amounts of money internationally. Typically, wire transfers are used for significant transactions such as purchasing property or paying overseas suppliers. Banks and financial institutions usually handle these transfers, which are direct bank-to-bank transfers.
- **International checks**: Although less common due to their slower processing time, international checks are another option for cross-border payments. These are physical checks drawn on a bank in one country that can be cashed in another country. They can be used for a variety of purposes, such as paying suppliers or sending money to individuals.
- **Foreign exchange (forex) brokers**: Forex brokers can help businesses and individuals convert and transfer money internationally at competitive exchange rates. These services are often used for recurring or large transfers, such as paying overseas staff or suppliers, as they can provide cost savings compared to traditional bank transfers.
- **International money orders**: International money orders, which are prepaid and therefore considered more secure than some other payment options, are often used for sending smaller amounts of money overseas (such as for personal gifts or small purchases).
- **Online payment platforms**: Online payment platforms like Stripe are widely used for international payments, particularly for e-commerce transactions. These platforms are commonly used for smaller transactions due to their ease of use and speed, but can also handle larger transactions.
- **Cryptocurrency transfers**: While cryptocurrencies such as Bitcoin and Ethereum are not universally accepted, they offer the potential for low-cost, quick international transfers without the need for a traditional banking system. They are typically used in peer-to-peer transactions or by businesses that have adopted cryptocurrency as a form of payment.

Each type of international payment has its strengths and weaknesses, and the best option depends on the specific needs and circumstances of the businesses involved. Factors to consider include the size and frequency of the transaction, the countries involved, the cost and speed of the method and the preferences or requirements of both the sender and the recipient.

9.4. TYPES OF PAYMENT TERMS IN EXPORTS

There is no one payment option that is appropriate for all situations. Although cash in advance offers the lowest level of risk for exporters, many customers engaged in international trade cannot afford to pay in advance or do not want to do so. Even those customers willing to provide payment in advance may not be able to buy as much as they want or need under those terms. As a result, cash-in-advance payment terms can hamper an exporter’s ability to attract and retain customers. In some cases, exporters may lose business to competitors that are willing and able to offer more favorable terms of payment in international trade. The good news is that there are other payment terms available for international trade.

The first step in choosing the right one is to monitor a customer's ability to pay and any factors that might influence or change that ability.

The second step is to use this information to identify the range of payment terms the company is willing to accept in order to accommodate customer needs. Each payment option has its pros and cons so companies should choose carefully based on the customer's country, industry, creditworthiness, the length and strength of the relationship, and any other relevant criteria.

The most common methods of payment in international trade include:

❖ **Cash in advance:** With cash in advance terms of payment in international trade, exporters can eliminate the credit risk because payment is received before the products are shipped to the customer. For international sales, wire transfers and credit cards are the most commonly used cash in advance export payment method. The safest method of payment in international trade is getting cash in advance of shipping the goods ordered, whether through bank wire transfers, credit card payments or funds held in escrow until a shipment is received. While cash in advance is the most desired by exporters, especially in situations where the risks of non-payment are high, it is often much less desired by customers. Exporters prefer cash in advance before shipping orders because there is no risk of default. They will also have the cash in hand if there is any problem with the order or the customer is unhappy or a shipment is damaged. If the exporter needs to provide a refund or credit in these cases, it can do so without worrying whether the buyer will withhold payment until the issue is settled. The main drawback of cash in advance is that many customers may not want or be able to afford to pay in advance.

Paying cash in advance for goods can harm cash flow and buyers may be concerned that they may not receive the shipment. As a result, an exporter that requires cash in advance may receive fewer orders from its customers and may even lose customers to sellers with less stringent payment terms. Payment in international trade is a balancing act. Exporters may insist on cash in advance to secure their balance sheets. As a result, however, their sales and potential growth may suffer if customers seek out vendors with more flexible payment terms.

Pros:

➢ This export payment method is beneficial for exporters as they would receive full payments securely before shipment.
➢ No risk of non-payment from the foreign buyer is associated.

Cons:

➢ Foreign buyers may be concerned about the risk of not receiving good quality products after the payment is made in advance.
➢ Exporters who consider cash in advance payment method in international trade may lose out on business opportunities to competitors who offer more attractive payment terms in exports.

❖ Letter of Credit: This is one of the safest and most commonly opted modes of payment in international trade. In this, the customer's bank gives a written commitment to the exporter, which is called as a Letter of Credit (LC). It states a commitment by the bank on behalf of the importer that the payment will be settled to the exporter as per the timeline mentioned and will be subject to agreed terms and conditions.

Letters of credit guarantee payment from one bank to another on behalf of the buyer and seller. The buyer's bank releases payment to the exporter as soon as it receives proof that all of the terms and conditions of the transaction have been satisfied by both buyer and seller. Letters of credit can be important ways to ensure payment when a buyer has little obtainable credit history. Buyers benefit because they do not have to pay until they have received the goods ordered.

Although they provide more balanced risk mitigation for both buyers and sellers, there is one major drawback of using documentary collection and letters of credit as a mode of payment in international trade. These options can be expensive, time consuming and cumbersome to manage.

Pros

- Beneficial to the exporter as they are satisfied with creditworthiness of the customer's foreign bank prior to the shipment of products.

Cons:

- This is a time-consuming process and involves payment and fees.

- Documentary collection: In this term of payment in international trade, both parties involve their respective banks to complete the payment. The remitting bank represents the exporter while the collecting bank works on the behalf of the customer or importer. Once the exporter ships products to the importer, they need to submit the shipping documents and collect orders to the remitting bank. Documents are sent from remitting bank to the collecting bank along with instructions of payment. This is then passed to the buyer on which the payment from the collecting bank is transferred to the remitting bank. Finally, the exporter receives the amount from the remitting bank.

  Documentary collection involves having a bank collect payment on the exporter's behalf once the buyer has received the goods ordered. Title to the goods does not transfer until the payment is completed. However, documentary collection does not verify the shipment or receipt of the goods involved and the exporter still has little recourse if the buyer still does not make the required payment.

  Pros

  - This export payment method is more economical than Letters of Credit. User is associated.

  Cons

  - Here, there is no verification of the importer. With no commitment of payment from importer's bank, there is no protection against cancellations of products by the importer.

- Open Account:An open account payment method in international trade is where the goods are shipped to the importer before the payment is due. Payment is agreed on the fixed credit period which can extend typically to 30, 60 or 90 days.

At the other end of the payment risk spectrum is open account payment in international trade. Exporters can offer open account terms for payment in international trade by shipping goods to international customers before they receive payment for those goods with payments generally due in 30 to 90 days.

Open account terms can help to maximize potential sales volume because it is most advantageous and convenient to the customer. However, it is the highest risk type of payment in international trade for the exporter. Therefore, exporters need to consider whether the additional sales volume is worth the risk of payment default and take steps to manage that risk. This can include routinely conducting customer credit checks and looking for ways to minimize the impact of any payment default.

Pros

- As the importer has the power to set the credit period, this enables cash flow management. For exporters, this mode of payment in international trade can help attract customers in the competitive market.

Cons

- Open account methods involve high risk for exporters. To minimize the risk, this payment mode is usually beneficial for buyers and sellers who have an already established and trusting relationship.

- Consignments: The consignment mode of payment in international trade is the variation of open account in which the payment is sent to the exporter after the products have been sold by the foreign or third-party distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages and sells goods to the exporter who retains title to the goods until they are sold.

  Similar to open account terms, consignment is an agreement that the buyer will pay for the shipment after the buyer sells the goods. The seller retains title to the goods until the goods are sold and the unsold goods are returned to the seller in a timeframe agreed to in the purchase contract. This is a very low-risk method of trade for the international buyer, but highly risky for the seller.

  Pros

  - This method is more competitive and reduces the direct cost of storing and managing inventory.

  Cons

  - There is a lack of access to the end management of merchandise and no guarantee of payment after the sales to the exporter.

9.5 DIFFERENT INTERNATIONAL PAYMENT SYSTEMS

Various international payment systems facilitate the smooth international bank transfer of funds across borders. International payment systems are necessary to facilitating cross-border transactions. These systems provide the infrastructure for transferring funds between financial institutions, often spanning different countries and currencies. Here are some of the major international payment systems:

- **Society for Worldwide Interbank Financial Telecommunication (SWIFT):** SWIFT is a global messaging network that enables banks and economic establishments to securely send and acquire information, which includes international cash transfers. It provides a standardized and stable environment for financial communication. SWIFT is a member-owned cooperative that provides secure messaging services used by more than 11,000 financial institutions in over 200 countries. While SWIFT doesn't transfer funds itself, it sends payment orders that are settled by accounts that institutions have with each other for this purpose. SWIFT is used for different types of international transactions, including money transfers, letters of credit and securities transactions.
- **Single Euro Payments Area (SEPA)**: SEPA is a European Union initiative that simplifies euro payments, making cross-border transactions within the SEPA zone as easy as domestic transactions. This initiative aims to create a unified payments market, eliminating

differences between national and cross-border payments. SEPA streamlines the way cashless payments are made throughout Europe. European consumers, businesses and public administrations are able to send and receive credit transfers, direct debit payments and card payments under the same basic conditions, rights and obligations, regardless of their location within Europe.

- **Clearing House Automated Payment System (CHAPS)**: CHAPS is a same-day electronic funds transfer system used in the United Kingdom. It ensures timely and secure payments for businesses and individuals, particularly in scenarios where real-time transactions are crucial. A CHAP is a UK-based payment system providing same-day fund transfers for high-value transactions. While it primarily serves domestic transfers, it can also be used for certain types of international transactions in sterling or euros.
- **Federal Reserve Wire Network (Fedwire)**: Fedwire, or the Federal Reserve Wire Network, is a real-time gross settlement system managed by the United States Federal Reserve. It functions as a crucial platform for financial institutions engaging in high-value, time-sensitive electronic fund transfers, both domestically and internationally, specifically in US dollars. Operated by the United States Federal Reserve, the Fedwire is a real-time gross settlement system for electronic fund transfers. Financial institutions use Fedwire for high-value, time-critical domestic and international payments in US dollars.
- **TARGET2**: TARGET2, which stands for Trans-European Automated Real-time Gross Settlement Express Transfer System, operates as a real-time gross settlement (RTGS) system tailored for the euro. Primarily utilised for substantial euro transfers between banks within European Union countries, TARGET2 plays a pivotal role in facilitating seamless and secure transactions. This is the real-time gross settlement (RTGS) system for the euro. It's used for large-value euro transfers between banks in European Union countries.
- **Continuous Linked Settlement (CLS)**: it serves as a specialised system strategically designed to eliminate foreign exchange settlement risk. The unique capability to simultaneously settle both ends of a foreign exchange transaction in the countries of its 18 members confining few of the world's most extensive economies. This is a specialised system designed to eliminate foreign exchange settlement risk. It simultaneously settles both sides of a foreign exchange transaction in the currencies of its 18 members, which include many of the world's largest economies.
- **China International Payment System** (**CIPS**): It was founded by the People's Bank of China. This system is dedicated to expediting the clearing and settlement processes for both cross-border and offshore Renminbi (RMB) transactions. Hence, it fosters the internationalisation of the Chinese currency. Launched by the People's Bank of China, CIPS facilitates the clearing and settlement of both cross-border and offshore Renminbi (RMB) transactions, aiming to internationalise the Chinese currency.

These systems are fundamental to the operation of the global financial system and allow funds to flow across borders quickly, securely and efficiently. Each has its own focus, whether it's a particular type of transaction (like SWIFT), a specific currency (like TARGET2 for euros) or a geographical region (like SEPA for Europe). These systems, especially SWIFT, are essential elements of the global financial infrastructure for permitting the quick, secure, and efficient international bank transfer of payments across borders. These systems are invented for a particular goal, such as a specific type of transaction, a single currency, or coverage of a particular geographical region, like SEPA for Europe.In a nutshell, international payment is a wide and dynamic landscape. It plays a critical function in shaping the worldwide financial system. To allow seamless and steady global financial operations, businesses and people navigating the intricacies of cross-border transactions ought to stay updated on the current developments, technology, and regulatory changes. The importance of knowing and handling international payments cannot be stressed as the globe grows more interconnected.

9.6 COST ASSOCIATED WITH INTERNATIONAL PAYMENTS

International payment transfers are processed broadly in a four-body payment system with a lot of intermediaries in between to facilitate the transactions. The intermediaries have their processing fees in addition to the conversion costs. There may be other costs associated with availing this facility based on the payment method of choice, such as account opening fees, or withdrawal costs.

- **Exchange rate markups:** Exchange rate markups occur when financial institutions offer rates that differ from the mid-market rate. The difference between the offered and mid-market rates represents the markup and acts as a hidden fee. Typically, this ranges from 2% to 5% of the transaction amount.
- **Transfer fees and commissions**: Banks and money transfer services often charge fees and commissions for facilitating international transfers. These fees can vary widely depending on the service provider and the transfer amount but are usually in the range of $15 to $50.
- **Correspondent bank fees:** Correspondent banks act as intermediaries in international money transfers. While their role is vital for facilitating cross-border transactions, they may charge fees for their services. Depending on the ticket size, this may be anywhere between $15 – $30.
- **Account opening or set up fees:** Depending on the mode of payment, there is an additional set up or account opening charge associated. The account opening process typically involves charges for documentation, verification, and processing. Additionally, some banks may require a minimum deposit or maintain a monthly average balance, which may vary based on the type of account and the bank's policies.For cards in India, these ranges from INR 500 to 10000 depending on the bank. Most multicurrency accounts via banks or payment platforms have a minimum balance requirement. Usually this is to account for currency exchange volatility.
- Maintenance fees: Maintenance fees are usually charged to cover account management services and other administrative expenses. These too, depend on the mode of payment.

Transparency in money transfers empowers to make well-informed decisions, resulting in significant savings and better control over finances. Seeking transparency in money transfer options is essential for understanding the true cost of transfers as well as deciding which option is best.

9.7 SUMMARY

Foreign payments, also known as cross-border payments, are transactions in which the payer and the payee are based in different countries. These payments are key for businesses that have international suppliers, contractors, employees, customers or partners. These transactions frequently involve the transfer of money from one currency to another. The growth of technology and the interconnection of economies have changed the dynamics of financial transactions, making foreign payments an essential component of company and personal financial operations. One of the foundational advantages of international payments lies in the ability to transact in diverse currencies. This flexibility is particularly advantageous for businesses operating on a global scale. The capacity to navigate the intricacies of different currency markets allows businesses to adapt to changing economic landscapes and capitalise on favourable exchange rates.

Each type of international payment has its strengths and weaknesses, and the best option depends on the specific needs and circumstances of the businesses involved. Factors to consider include the size and frequency of the transaction, the countries involved, the cost and speed of the method and the preferences or requirements of both the sender and the recipient.

Paying cash in advance for goods can harm cash flow and buyers may be concerned that they may not receive the shipment. As a result, an exporter that requires cash in advance may receive fewer orders from its customers and may even lose customers to sellers with less stringent payment terms.Open account terms can help to maximize potential sales volume because it is most advantageous and convenient to the customer. However, it is the highest risk type of payment in international trade for the exporter.In this lesson also discuss the various types of payment terms in exports, different international payment systemsandcost associated with international payments.

9.8 KEY WORDS

- **Foreign Payments**: Foreign payments, also known as cross-border payments, are transactions in which the payer and the payee are based in different countries. International payments are crucial to global commerce as they facilitate trade between countries and enable businesses to expand their operations beyond domestic borders. These payments encompass a wide range of business activities, including paying overseas suppliers for goods, compensating international employees and receiving payments from foreign customers. International payments play an increasingly important part in today's globalised economy.
- **Success Rate:** International payments, when executed through reputable channels, boast a high success rate. This reliability is crucial for businesses, ensuring that transactions are completed smoothly and without disruptions. A dependable international payment system contributes to the overall stability of global commerce, fostering trust among businesses and stakeholders.
- **Access to Global Markets:** For businesses, international payments serve as a gateway to new markets. The ability to transact in different currencies and navigate diverse regulatory environments empowers businesses to expand their reach. This access to global markets opens up opportunities for growth, enabling companies to tap into the vast potential offered by regions across the globe.
- **Wire transfers**: Wire transfers are a reliable and secure method for sending large amounts of money internationally. Typically, wire transfers are used for significant transactions such as purchasing property or paying overseas suppliers. Banks and financial institutions usually handle these transfers, which are direct bank-to-bank transfers.
- **Letter of Credit:** This is one of the safest and most commonly opted modes of payment in international trade. In this, the customer's bank gives a written commitment to the exporter, which is called as a Letter of Credit (LC).
- **Society for Worldwide Interbank Financial Telecommunication (SWIFT):** SWIFT is a global messaging network that enables banks and economic establishments to securely

send and acquire information, which includes international cash transfers. It provides a standardized and stable environment for financial communication.

- **Federal Reserve Wire Network** (Fedwire)**:** Fedwire, or the Federal Reserve Wire Network, is a real-time gross settlement system managed by the United States Federal Reserve. It functions as a crucial platform for financial institutions engaging in high-value, time-sensitive electronic fund transfers, both domestically and internationally, specifically in US dollars.
- **Transfer fees and commissions**: Banks and money transfer services often charge fees and commissions for facilitating international transfers. These fees can vary widely depending on the service provider and the transfer amount but are usually in the range of $15 to $50.

9.9 SELF-ASSESSMENT QUESTIONS

1. Defineforeignpayments? Explaintheimportanceofforeignpaymentsinglobe?
2. What are the different types of international payments?
3. Explain various types of payment terms in exports?
4. What are the different international payment systems in business?
5. Discuss the Cost associated with international payments in global business?

9.10 FURTHER READINGS

- Reporting & Compliances Under Indian Foreign Exchange Laws Fema& Allied Laws by sudhirkochhar, Bloomsbury Professional India; 4th edition 2021, Bloomsbury India.
- Commentary On The Foreign Exchange Management Act By S K Sarvaria And ApoorvSarvaria, Lexis Nexis, 2023

Dr.SADHIK SAYYED

LESSON – 10
FOREIGN EXCHANGE RATES AND ITS DETERMINATION

Learning Objectives

After careful understanding of the lesson, student will be in a position to

1. Understand the Forex Market and how it functions
2. To know about how the exchange rate is determined?
3. To know the types of exchange rates prevailed in the foreign exchange market and their usages.
4. Able to know the difference between the various exchange rates and their application

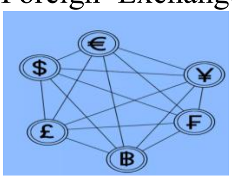
Lesson Structure

10.0 Introduction

The exchange rate is the price of a currency in comparison to another currency. It is either fixed by the central bank or determined by the market demand of demand and supply. When the central bank fixes the exchange rate, it is known as the fixed exchange rate. On the other hand, when the rate is fixed by demand and supply, it is known as a floating exchange rate.

1.1 Meaning & Definition of Foreign Exchange Rate:

Foreign exchange refers to foreign currency. For example, for an Indian resident 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".



"The rate at which the domestic currency can be exchanged for the foreign currency is known as Foreign Exchange Rate".

"An Exchange Rate is a rate at which one currency will be exchanged for another currency and affects the trade and the movement of money between the countries" – IkisChanj Rat

10.2 Characteristics of Exchange Rate

An exchange rate is an indispensable tool in facilitating international trade.

- It also shows the comparative value of the currency. By making it easier to make transactions with international partners, exchange rates help countries to trade without any barriers. Therefore, in terms of functions, exchange rates are invaluable.
- By checking the exchange rates, economists also determine the economic well-being of a country. If too much of fluctuations in the currency exchange rate occurs, the authorities must intervene to make the rates fixed. This helps the economy stay stable and any chance of an economic downturn could be thwarted.
- When a country imports goods in bulk, the demand usually pushes up the exchange rate for that country. This makes the imported goods more expensive to consumers in that country. When the goods become increasingly expensive, demand drops, and the country's money becomes cheaper in comparison to other countries' money. Therefore, the country's commodities become cheaper to buyers abroad, demand goes up, and exports from the country increases.
- World trade now depends on a hybrid system of the exchange rate which can be called managed floating exchange system. In such as system, governments intervene to stabilize their countries' exchange rates by stimulating exports, limiting imports, or devaluing the currencies.

Although a very important concept for international trade, the establishment of exchange rates is not a very old phenomenon. It was established after the second world war in the 20th century.

10.3 Exchange Rate Determination

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

The flexible exchange rate is determined by the forces of demand and supply of foreign exchange in the market. Under this, the equilibrium is established at a point where the quantity demanded is equal to the quantity supplied of foreign exchange, i.e., Demand for foreign exchange is similar to the supply of foreign exchange. This can be shown in Fig 1.

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.

1.3.1. 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

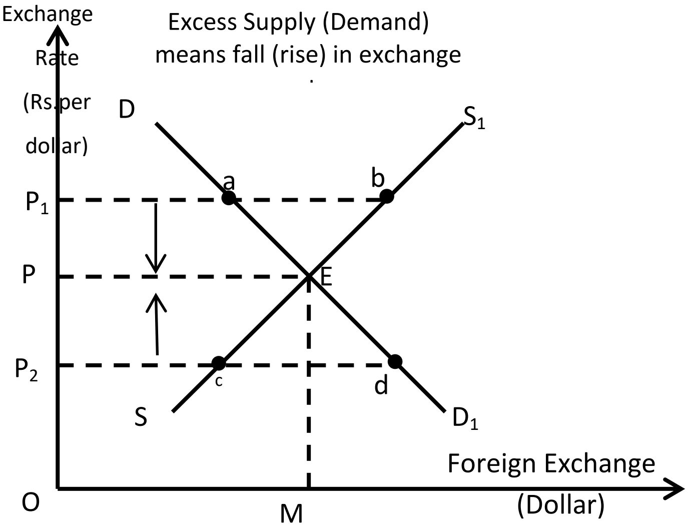
- **Import of Goods:** Consumer as well as capital goods are imported from other countries. Foreign exchange is demanded by people who import these goods. Higher the value of Imports, higher is the demand for foreign currency.
- **Import of services:** Services rendered by other countries which include 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.

10.3.2. 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. Expert 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.

Now we can bring both demand and sup-ply curves together to determine foreign ex-change rate. The equilibrium exchange rate is determined at that point where demand for foreign exchange equals supply of foreign ex-change. In Fig. 5.4, DD1 and SS1 curves inter-sect at point E. The foreign exchange rate thus determined is OP. At this rate, quantities of foreign exchange demanded (OM) equals quantity supplied (OM). The market is cleared and there is no incentive on the part of the players to change the rate determined.

Suppose that at the rate OP, Rs. 50 = $1, demand for foreign exchange is matched by the supply of foreign exchange. If the current exchange rate OP1 exceeds the equilibrium rate of exchange (OP) there occurs an excess supply of dollar by the amount 'ab'. Now the bank and other institutions dealing with for-eign exchange—wishing to make money by exchanging currency—would lower the ex-change rate to reduce excess supply.



Thus, exchange rate will tend to fall until OP is reached. Similarly, an excess demand for for-eign exchange by the amount 'cd' arises if the exchange rate falls below OP, i.e., OP2. Thus, banks would experience a shortage of dollars to meet the demand. Rate of foreign exchange will rise till demand equals supply.

The exchange rate that we have deter-mined is called a floating or flexible exchange rate. (Under this exchange rate system, the government does not intervene in the foreign exchange market.) A floating exchange rate, by definition, results in an equilibrium rate of exchange that will move up and down accord-ing to a change in demand and supply forces. The process by which currencies float up and down following a change in demand or change in supply forces is, thus, illustrated in Fig. 5.5.

1. Change in Demand

Let us assume that national income rises. This results in an increase in the demand for imports of goods and services and, hence, de-mand for dollar rises. This results in a shift in the demand curve from DD1 to DD2. Conse-quently, exchange rate rises as from OP1 to OP2 determined by the intersection of new demand curve and supply curve. Note that dollar appreciates from Rs. 50 = $1 to Rs. 53 = $1, while rupee depreciates from $1 = Rs. 50 to $1 = Rs. 53.

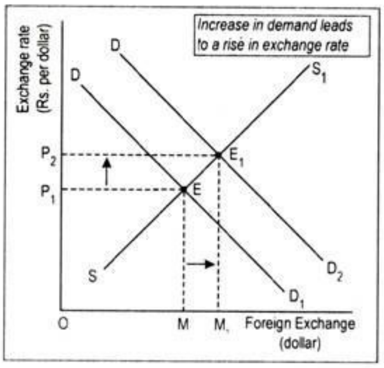


Fig. 5.5: Equilibrium Exchange Rate

2. Change in Supply

Similarly, if supply curve shifts from SS1 to SS2, as shown in Fig. 5.6, new exchange rate thus determined would be OP2. If Indian goods are exported more, following an in-crease in national income of the USA, the sup-ply curve would then shift rightward. Con-sequently, dollar depreciates and rupee appre-ciates. New exchange rate is settled at that point where the new supply curve (SS2) inter-sects the demand curve at E2.This is the balance of payments theory of exchange rate determination. Wherever gov-ernment does not intervene in the market, a floating or a flexible exchange rate prevails. Such system may not necessarily be ideal since frequent changes in demand and supply forces cause frequent as well as violent changes in exchange rate. Consequently, an air of uncertainty in trade and

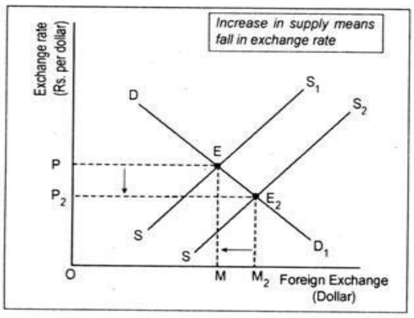


Fig. 5.6 : Equilibrium Exchange Rate

business would prevail.

Such uncertainty may be damaging for the smooth flow of trade. To prevent this situation, government intervenes in the for-eign exchange rate. It may keep the exchange rate fixed. This exchange rate is called a fixed exchange rate system where both demand and supply forces are manipulated or calibrated by the central bank in such a way that the ex-change rate is kept pegged at the old level.

10.4 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.

10.4.1. 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.

Foreign exchange of a domestic currency with a foreign currency allows traders to easily transact a good or service in standard currency. The spot exchange rate is the cost incurred when a product is traded immediately on the spot.

Cash delivery after spot exchange transactions is normally settled within two business working days from the date of transaction. Forex markets are responsible for setting spot rates. However, some countries influence their currency markets through different strategies like a currency peg.

During the transaction process, the two parties involved agree on the transaction value of either currency, settlement date, or transfer of banking information where currency delivery is involved. Spot investments in the international markets involve huge financial transactions, and spot exchange transactions constitute 43% of the total forex transactions.

Factors Influencing the Spot Rate: Spot rates are highly dynamic and can fluctuate within seconds due to various factors. Some key influencers of spot rates include:

1. Economic Factors: One of the key factors influencing the spot rate in foreign exchange is the overall economic conditions of the countries involved. Economic indicators such as gdp growth, inflation rates, interest rates, and employment levels play a significant role in determining the value of a currency. For example, if a country's economy is experiencing robust growth and low inflation, its currency is likely to strengthen against other currencies, resulting in a higher spot rate. Conversely, if a country's economy is struggling and facing high inflation, its currency may weaken, leading to a lower spot rate.

2. Political Stability: Political stability is another crucial factor that affects the spot rate. Investors tend to favor countries with stable political environments as they provide a sense of security for their investments. Any political unrest or uncertainty can lead to a decline in the value of a currency. For instance, if a country is facing political turmoil or a change in government, it can lead to a decrease in investor confidence, resulting in a lower spot rate.

3. Monetary Policy: The monetary policy of a country's central bank also has a significant impact on the spot rate. Central banks use various tools, such as adjusting interest rates and implementing quantitative easing, to control inflation and stimulate economic growth. When a central bank raises interest rates, it attracts foreign investors seeking higher returns, leading to an appreciation in the currency's value and a higher spot rate. Conversely, lowering interest rates can result in a depreciation of the currency and a lower spot rate.

4. Trade Balance: The trade balance between countries plays a crucial role in determining the spot rate. A trade surplus occurs when a country exports more goods and services than it imports, resulting in a higher demand for its currency. This increased demand leads to an appreciation in the currency's value and a higher spot rate. On the other hand, a trade deficit, where a country imports more than it exports, can lead to a depreciation of the currency and a lower spot rate.

5. Market Sentiment: Market sentiment, or investor perception, can have a significant impact on the spot rate. Factors such as geopolitical tensions, global economic conditions, and market speculation can influence how investors perceive a currency's value. For example, if there is a heightened sense of uncertainty in the global markets, investors may flock to safe-haven currencies, such as the US dollar or the Swiss franc, resulting in an increase in their spot rates.

The Role of Central Banks in Determining Spot Rates

1. Central banks play a crucial role in determining spot rates, which are the exchange rates at which currencies can be bought or sold for immediate delivery. These rates are of significant importance to individuals and businesses engaged in foreign exchange transactions. In this section, we will explore the various ways in which central banks influence spot rates and the implications for the foreign exchange market.

2. Monetary policy is one of the primary tools used by central banks to affect spot rates. By adjusting interest rates, central banks can influence the demand and supply of currencies. When a central bank raises interest rates, it makes holding that currency more attractive, leading to an increase in demand and a potential appreciation in its value. Conversely, lowering interest rates can decrease demand for a currency and potentially lead to depreciation.

3. Let's take a look at a real-life example. In 2015, the swiss National bank (SNB) surprised the markets by removing the floor on the Swiss franc's exchange rate against the euro. This sudden policy change caused the Swiss franc to appreciate significantly, as investors rushed to buy the currency. The SNB's decision to remove the floor was driven by its desire to combat deflationary pressures and protect the Swiss economy. The move had far-reaching implications for businesses and individuals who had exposure to the Swiss franc, as their purchasing power in other currencies diminished overnight.

4. In addition to interest rates, central banks also engage in direct market interventions to influence spot rates. These interventions involve buying or selling currencies in the foreign exchange market to alter their value. Central banks may intervene to stabilize their currency or to counter excessive volatility. For example, if a central bank believes that its currency is overvalued, it may sell its own currency to increase its supply and drive down its value.

10.4.2. Forward Exchange Rate:

The forward rate, in simple terms, is the calculated expectation of the yield on a bond that, theoretically, will occur in the immediate future, usually a few months (or even a few years) from the time of calculation. The consideration of the forward rate is almost exclusively used when talking about the purchase of Treasury bills, more commonly known as T-bills.

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 form 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

There are numerous methods of calculating the exchange rate of currencies. Some popular methods are -

- Floating Exchange Rate
- Fixed Exchange Rate
- Flexible Exchange Rate.

Floating Exchange Rate: An exchange rate that is not fixed is called a flexible exchange rate. The flexible exchange rate fluctuates from one value to another. The market determines whether the exchange rate moves or not. The term "floating currency" is used to indicate any currency subject to a floating regime.For example, the US dollar is an example of a floating exchange currency. Floating rates are notable and are very popular among economists. The believers in a free market are of the mindset that markets should determine the currency value. The USD values usually decline when crude oil prices rise, for example. So, the crude oil prices and USD currency value are inversely related. Therefore, the USD value fluctuates freely because oil prices fluctuate daily.

Economists are of the point of view that markets generally correct themselves frequently. Most major economies are generally dependent on floating exchanges because of little government intervention. These countries are popularly known as 'First World Countries'.

Flexible Exchange Rate: The flexible exchange rate is called pegged exchange rate system because of government intervention. The value of a currency is maintained either to certain currencies’ values–either collectively or individually–or to the reserves of gold and foreign currencies available in the given country.

Fixed Exchange Rate: China is probably the most famous example of fixed exchange regimes. A fixed-rate regime also used to exist under the former Soviet Union. It must be noted that the flexible exchange rate is not solely determined by market forces. If the foreign exchange market fluctuates widely, the central banks will have to sell or buy currency reserves.

Speculation: Money is an asset for every nation. Therefore, citizens of one country may hold reserves of foreign exchange from another country as an asset. Therefore, Indians will be more interested in the value of the USD if they think that the value of their own currency will fluctuate in the near future. When people hold foreign exchange to get a benefit from the changing values, the currency values are affected by it.

Interest rates: The difference in interest rates of different countries also plays a major role in the determination of the value of exchange rates. In order to get more returns, banks, MNCs, and affluent investors invest money around the globe. This also affects the exchange rates to a large extent for a country.

Exchange Rates in the Long Run

To make long-term predictions of the exchange rate, purchasing power parity or PPP can be used in an exchange rate structure that is flexible. According to theory, if a business does not have any frontier to cross such as quotas (quantitative controls on imports), and taxation (tariffs on business), then exchange rates will gradually adjust so that the same products cost the same price regardless of location.

Therefore, whether one is transferring it into rupees in India, yen in Japan, or dollars in the US, the value of the currency must be the same in terms of exchange rates.

Pegged Floating Exchange Rates: There are three hybrid domains in this system. Governments and Central Banks are capable of controlling foreign exchange rates by intervening in the markets. However, the rates are mostly determined by existing market forces.

Crawling Bands: In such a regime, the central bank allows fluctuations in a currency exchange rate until a specific range that is usually set in advance is reached. The authorities intervene in the system once the range is breached. These ranges are generally determined by monetary and economic policies.

Crawling Pegs: In this system, the Central Bank of a country allows its currency exchange rate to appreciate or depreciate gradually on international markets. The currency will float if there are any market uncertainties. However, the authorities will interfere if appreciations or depreciations are swiftly followed by one another. Such instances have already happened in Vietnam, Argentina, and Costa Rica.

Horizontally Pegged Bands: It resembles the crawling bands to some extent. In such a case, the Central Bank allows the currencies to fluctuate increasingly freely until the exchange rate does not go above 1% of the gross value of the currency.

Benefit:

- Provides certainty to the buyer regarding the cost of a future purchase
- It can be tailored to the exact requirements of the client

Disadvantages:

- Clients are bound to honour the contract and cannot benefit from advantageous movements in currency prices
- Should the market move against the client, bank or broker, margin requirements may adversely impact the borrower's cash flow

10.4.3 Spot Rate Vs Forward Rate

The main difference between spot rate and forward rate in foreign exchange is that the spot rate is the current rate for immediate currency exchanges, whereas the forward rate is a pre-agreed rate for exchanging currencies on a specified future date.

Aspect	**Spot Rate**	**Forward Rate**

Definition	The current market rate for immediate currency exchange.	A pre-agreed rate for currency exchange at a future date.
Time of Transaction	Instant, usually settled within two business days.	Set for a future date, can be days, months, or even years ahead.
Purpose	Used for immediate or very short-term transactions.	Used to hedge against future currency fluctuations and risks.
Price Determination	Based on current market supply and demand.	Based on the spot rate, adjusted for interest rate differentials.
Usage	Common in tourism, immediate payments, and short-term trading.	Widely used in international trade, investments, and risk management.
Volatility	Subject to real-time market fluctuations.	Fixed once the contract is made, providing price certainty.
Settlement	Immediate or within a short period.	On a predetermined future date as per contract.

10.4.4. Cross Exchange Rates

A cross rate is a foreign currency exchange transaction between two currencies that are both valued against a third currency. The U.S. dollar (USD) is the currency that's usually used in foreign currency exchange markets to establish the values of the pair being exchanged.

As the base currency, the U.S. dollar always has a value of one. Some USD pairs are reciprocal and the dollar is not the base currency.

Two transactions are involved when a cross-currency pair is traded. The trader first trades one currency for its equivalent in U.S. dollars. The U.S. dollars are then exchanged for another currency.

- A cross rate can be any exchange of any two currencies that aren't the official currency of the country in which the quote is published.
- Any currency exchange in which neither of the currencies is the U.S. dollar is considered a cross rate in practice.
- One of the most common cross-currency pairs is the euro and the Japanese yen.
- Foreign exchange traders use the term cross rate to refer to price quotes between any pair of currencies in which neither is the U.S. dollar.

The U.S. dollar is usually used to establish the value of each of the two currencies being traded. You would first determine that the British pound was valued at maybe 1.25 to one U.S. dollar and that the euro was valued at 1.07 to one U.S. dollar if you were calculating the cross rate of the British pound versus the euro Foreign exchange (forex) traders use the term cross rate to refer to price quotes between currencies in which neither is the U.S. dollar.

Most transactions on the forex are in major currency pairs. If one of the currencies being swapped is the U.S. dollar, it would mean that one U.S. dollar is equal to 1.28 Canadian dollars if you see on a financial news site that USD/CAD is quoted at 1.28.An exchange rate between the euro and the Japanese yen is considered to be a commonly quoted cross rate because it doesn't include the U.S. dollar. But in the pure sense of the definition, it's considered a cross rate if it's referenced by a speaker or writer who isn't in Japan or one of the countries that use the euro as its official currency.

10.5 Conclusion

Exchange rate determination is a very important part of macroeconomics. As the currency is the moving force of an economy, changes in its rates affect everyone. Therefore, governments try to increase the value of their currencies so that the balance of payments could be managed at a satisfactory level.

The balance of payment is the net difference between aggregated imports and net exports of a country. So, when exchange rates are high, less currency can buy more in the international markets. This helps countries to manage a good level of economic growth and, in turn, offers more value to their citizens.

The foreign exchange market is the mechanism, by which a person of 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 arbitragers, 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.

10.6 Case Study Illustrations

1. Traveler to Germany from the U.S. wants 200 USD worth of EUR when arriving in Germany. The sell rate is the rate at which a traveler sells foreign currency in exchange for local currency. The buy rate is the rate at which one buys foreign currency back from travelers to exchange it for local currency.

If the current exchange rate is 1.05, $200 will net €190.48 in return.

In this case, the equation is: dollars ÷ exchange rate = euro

$200 ÷ 1.05 = €190.48

After the trip, suppose €66 is remaining. If the exchange rate has dropped to 1.02, the change from euros to dollars will be $67.32.

€66 x 1.02 = $67.32

The Japanese yen is calculated differently. In this case, the dollar is placed in front of the yen, as in USD/JPY.

The equation for USD/JPY is: dollars x exchange rate = yen

If a traveler to Japan wants to convert $100 into yen and the exchange rate is 110, the traveler would get ¥11,000. To convert the yen back into dollars one needs to divide the amount of the currency by the exchange rate.

$100 x 110 = ¥11,000.00-or-¥11,000.00/110= $100

2. An Australian firm will receive 10 million Euros from a German firm 90 days from now. The firm can lock in the current forward rate by entering into a forward agreement. For example, the forward covers 10 million Euros at the 90-day forward rate of 1.5597 AUD/EUR.

3. Example: A U.S. business plans to sell €2 million of products to a European company and receive the revenue in 12 months. The U.S. business is concerned that the dollar may strengthen against the euro and reduce the value of its exports. It enters into a FX forward to sell €2 million in 12 months to lock in the rate at $1 = €0.90 and protect its income. If, a year later, the spot price of one dollar is €1.10, the company will benefit from the contract. If the dollar has dropped to €0.80, the company will lose out under the contract by receiving fewer dollars for the euros than it would have at the spot rate.
Q1. Today, Baha Mar has ordered from Belgium some specialize equipment for a new restaurant, the price of which is denominated in Euros. It will receive the equipment in 90 days and will need to make payment of 20,000 Euros at that time. Baha Mar expects the Euro to increase in value, by 5.5% over the next 90 days, so it desires to hedge its payables in Euros in 90 days. Meanwhile, Baha Mar, will receive 500,000 Mexican Pesos in 180 days because of an upcoming conference for Mexican company booked today. It expects that the peso will decrease in value, by 12.25%, over this period and wants to hedge these receivables. Thus Baha Mar sells a forward

10.7 Key Terms

Forward rate: A forward rate is the settlement of a transaction cost that will be cleared on a future date. Forward rates are generally expressed by indicating a premium/discount for the forward period.
Cross rate: A cross rate is an exchange rate that is calculated by reference to a third currency. For example, if you want to calculate how many AUD you would receive for each euro (EUR) (EUR/AUD), then you can use the AUD/USD and EUR/USD rates.
Cross-currency swap: A cross-currency swap is used to lock in exchange rates for set periods of time. Interest rates can be fixed, variable, or a mix of both.
Hedging: Hedging is a method of covering risk arising from a change in the exchange rate.
Interest rate parity: Interest rate parity is important because it signifies the relationship between interest rates, spot rates, and forward rates
Exchange rate: The price of one currency in relation to another currency
Bid price: The maximum amount a buyer is willing to pay for a currency
Offer price: The price at which a seller is willing to sell a currency, also known as the ask price
Spread: The difference between the bid and offer price
Interbank rate: A wholesale rate that is usually only available to large financial institutions
Currencypair: The assets used in the trading process, where people buy and sell base currency quote currency combinations to generate payouts
Leverage: A key concept in forex trading that allows traders to open larger positions than they would otherwise be able to afford
Margin: The amount of money a trader needs to deposit to open a position in the market
Pips: A unit of measurement used to measure the change in the value of a currency pair
Bid and ask: The price that buyers and sellers in the marketplace are willing to buy and sell
Floating rates: One of the primary reasons for fluctuation of currency in foreign exchange market
Position trading: A long-term strategy that involves taking long-term positions to maximize profits from major shifts in the currency rates

10.8 Review Questions

1. What is an exchange rate determined by?
2. How Foreign Exchange Rate is Determined?
3. What are the factors that affect the exchange rate?

4. What is the difference between a spot rate and a forward rate?
5. What is a forward premium?
6. What is a cross rate?
7. What is a bid and ask price?

10.9 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

LESSON 11
FOREX TRADING & FINANCING OF INTERNATIONAL TRADE

Learning Objectives:

After studying this lesson you are able to

- Comprehend the nature of International Trade
- Understand the Need and Significance of International Trade
- Understand the need for and method of trade credit
- Know the impact of international finance
- explain different payment terms used in international trade
- describe documents and procedures related to export-import trade financing
- highlight various financing techniques in international trade

Lesson Structure

11.0 Introduction

For the developing countries, specifically a country like India, growth requires asteady in flow of imported capital and intermediate goods, and this, in turn necessitatesforeign exchange to pay for them. To this end, this lesson explains in detail the frameworkof International Trade, its characteristics, limitations and international corporations intrade finance, practices and the international situations that assist the international tradeoperations.

What? International trade is an exchange involving a good or service conducted between at least two different countries. The exchanges can be imports or exports. An import refers to a good or service brought into the domestic country. An export refers to a good or service sold to a foreign country.

How? International trade is a method of economic interaction between international entities and is an example of economic linkage. Other forms of economic linkages include (1) foreign financial investment, (2) multinational corporations, and (3) foreign employees. The growth in these forms of economic linkages is known as globalization.

Why? International trade occurs because one country enjoys a comparative advantage in the production of a certain good or service, specifically if the opportunity cost of producing that good or service is lower for that country than any other country. If a country opts not to trade with other countries, it is considered to be an autarky.

If we consider a two-country model, both countries can gain from specialization and trade. Specialization and trade will allow each country to produce the product they possess a comparative advantage in and then trade, and ultimately consume more of both goods. Therefore, there are gains from trade.

11.1 Basis of International or Foreign Trade

Foreign trade is based on the theory of comparative cost advantage.It states thatevery nation exercises certain kinds of benefits from the production of a particular type ofcommodity whose resources are exclusively available in that nation or available in othernations in very less amounts. For example, Iraq and the similar nations have comparativeadvantage over the production of crude oil. Hence, it can export it to other nations and earnhuge profits. Similarly, India specializes in the production of sugarcane and tobacco. Nocountry is self-sufficient and it has to depend on other nations to obtain the required inputsbe it machines, labor, raw materials or even finished products.

Thus, the need for foreign trade arises due to the following **factors**:

1. All nations of the world have to depend on the other nations as it cannot produce everything by itself in a lower cost.
2. A country may get the resources and manpower to produce all types of commodities but it may be able to get that commodity at a cheaper rate from the other nation who specializes in the production of that commodity.
3. Similarly, a country may produce some goods at a cheaper rate than the other nation and may try to export it to other nations at a higher rate if there is a surplus.

11.2 Difficulties in International Trade

- **Distance**: Due to long geographical distances between the nations, goods are either sent through rail, road or sea or air. All these modes of transport are expensive and may face the dangers of sea or air perils such as explosions or accidents etc. There may be a delay in the delivery of goods that may lead to the spoilage of certain perishable goods. Distance creates higher transport costs as well as more risks.
- **Different languages:** Different languages are spoken in different nations. Hence, the buyers and the sellers may not be able to communicate with each other effectively. They may have to depend on the translators that are not always reliable.
- **Risk in transit**: Foreign trade involves high risks than the home trade. Many of the risks can be covered by insurance but still, the danger persists.
- **Lack of information about foreign businessman**: A seller is always worried about the credit-worthiness and the financial standing of the prospective buyer as there is no strong proof of the buyers' ability to pay. Thus, there is the risk of bad debt for the seller.
- **Import and export restrictions**: Every country charges a high rate of custom taxes and duties on the import of the goods. Also, businessman are required to fill various documents and formalities to complete the transactions. Foreign trade policies and procedures vary from nation to nation and also from time to time.
- **Study of foreign markets**: Every foreign market has its own features. There are different price interactions, demand supply interactions, government policies, marketing methods, customs laws, weights etc. It is very difficult to collect all the information accurately about the foreign markets.
- **Problems in payments**: Every country has its own currency and exchange rates with which the transactions can completed. These exchange rates keep on changing. Remittance of money in foreign trade involves much time and expense. There are also huge risks of bad debt.

- **Intense competition**: There is a huge competition between the sellers of the different nations involved in exporting the same commodity. The one who succeeds in influencing the buyers from the advertisements and other incentives stands out as the winner of the market. Thus, heavy and useless expenses are incurred in these activities

11.3 Characteristics of International Trade

a) **Territorial Specialization:** International trade among the countries is possible only because each country has certain resources that can be well utilized for the production of certain type of commodity that is not available in other countries or available in very less quantities. Hence, each country has some sort off comparative cost advantage that means each country can produce a good at a lower price than the other country and hence, can export that.

b) **International Competition:** Producers from different nations are always in a race with one another to sell their products in as much quantity as possible. Thus, advertisements, sales promotion activities are very helpful in these types of selling techniques.

c) **Separation of Sellers from Buyers:** Each country is separated by a large geographical distance and hence, the buyers and the sellers are unable to meet each other physically. They contact each other through mass communication devices such as telephones, internet, video conferencing etc.

d) **Long Chain of Middleman:** Since the buyers and the sellers are unable to meet each other, they have to rely on long chain of middleman to complete their international transactions. It does increases the cost of the goods of the buyers and hence, the imported goods are much expensive.

e) **Mutually Acceptable Currency:** All the nations, except countries of Europe, have their own currencies and other modes of payment. Hence, it is not possible to have a common currency for exchange between nations. Thus, dollars, pounds are selected for this purpose and hence, they are called “hard currencies”. These currencies are acceptable all over the world.

f) **International Rules and Regulations:** Each buyer and seller involved in the international trade have to complete the guidelines and norms set up the custom authorities of the others country. They have to follow the restrictions of that nation.

g) **Government Control:** The government of every nation exercises effective control over the export and import trade of the nation. Hence, various types of formalities and documents have to be submitted to the government.

11.4 International Trade Theories

A number of theories have been developed by economists as basis of InternationalTrade, some of these are as follows:

1. **Theory of Comparative Cost Advantage**: According to this theory, a country tends to specialize in the production of those goods for which it has got a comparative cost advantage, or where it costs are lower than in other countries.
2. **Factor Proportions Theory**: This theory is also known as Factor Endowment Theory; which was developed by Heckcher and Ohlin. This theory suggests that a country will specialize and export that product which is more intensive in that factor (a two-country, two commodity and two-factor model) which is more abundant. It will import those goods which, on the other hand, are more intensive in that factor of production which is scarce in that country.

3. **Human Capital Approach Theory**: This theory also known as Skills Theory of International Trade, advocated by Becker, Kennen and Kessing. According to this theory, labour can be classified into skilled and unskilled labour. A developing country which has more abundant supply of unskilled labour will specialize and export labour intensive products. Imports, on the other hand, will consist of goods which are more skill intensive.
4. **Natural Resource Theory**: This theory was proposed by Vanek, J. The basic hypothesis of this theory is that a county will export those products which are more intensive in that natural resource with which it is more relatively endowed.
5. **Research and Development, and Product Life-Cycle Theories**: A number of economists, especially Vernon have contributed the development of this theory. It suggests that industrial countries allocate more resources to R and D programme, to develop new products. These countries will enjoy monopoly benefits in the initial stages of production, and will access to foreign markets, leading to trade between the developed and developing countries as well as trade among the industrialized countries themselves.
6. **Economies of Large–scale Theory**: A company operating in a country where the domestic market is large; will be able to reach a high out-put level, by reaping the benefits of large-scale production. The lower cost of production will increase the competitiveness of the company enabling it to make an easy entry into the export markets.

11.5 Financing International Trade

Trade finance represents the financial instruments and products that are used by companies to facilitate international trade and commerce. Trade finance makes it possible and easier for importers and exporters to transact business through trade. Trade finance is an umbrella term meaning it covers many financial products that banks and companies utilize to make trade transactions feasible.International trade finance refers to the financial support given by banks or other financial institutions using a variety of financial tools, like bank guarantees, letters of credit, to importers and exporters to enable them carry out commercial transactions without experiencing financial hardships.

- Trade finance represents the financial instruments and products that are used by companies to facilitate international trade and commerce.
- Trade finance makes it possible and easier for importers and exporters to transact business through trade.
- Trade finance can help reduce the risk associated with global trade by reconciling the divergent needs of an exporter and importer.

11.6 How it Works?

The function of trade finance is to introduce a third-party to transactions to remove the payment risk and the supply risk. Trade finance provides the exporter with receivables or payment according to the agreement while the importer might be extended credit to fulfill the trade order. The **parties** involved in trade finance are numerous and can include:

- Banks
- Trade Financial Institutes
- Importers and exporters
- Insurers
- Export credit agencies and service providers

Trade financing is different than conventional financing or credit issuance. General financing is used to manage solvency or liquidity, but trade financing may not necessarily indicate a buyer's lack of funds or liquidity. Instead, trade finance may be used to protect against international trade's unique inherent risks, such as currency fluctuations, political instability, issues of non-payment, or the creditworthiness of one of the parties involved.

Below are a few of the **financial instruments** used in trade finance:

- Lending lines of credit can be issued by banks to help both importers and exporters.
- Letters of credit reduce the risk associated with global trade since the buyer's bank guarantees payment to the seller for the goods shipped. However, the buyer is also protected since payment will not be made unless the terms in the LC are met by the seller. Both parties have to honor the agreement for the transaction to go through.
- Factoring is when companies are paid based on a percentage of their accounts receivables.
- Export credit or working capital can be supplied to exporters.
- Insurance can be used for shipping and the delivery of goods and can also protect the exporter from nonpayment by the buyer.

Although international trade has been in existence for centuries, trade finance facilitates its advancement. The widespread use of trade finance has contributed to international trade growth.

11.7 The Parties Involved:

International trade finance transactions involve multiple parties, each with their own set of roles and responsibilities. In most international trade finance transactions, the following parties are involved:

1. Importers: The party who buys goods or services from a foreign provider and imports them into their own nation. The importer is in charge of making all arrangements for delivery and shipping as well as payment for the products or services.

2. Exporters: The party who sells goods or services to a foreign customer/buyer/importer and get paid for the goods or services they have provided.

3. Freight forwarders: Specialize in arranging the transportation of goods from one country to another. They can handle all aspects of shipping, including customs clearance, insurance, and documentation.

4. Banks: Banks are key players in transactions involving the financing of global trade. In addition to processing payments and issuing letters of credit, they can offer financing of foreign trade to importers and exporters and offer other financial services that support global trade.

5. Insurance: Insurance companies offer trade credit insurance to shield exporters from the possibility of nonpayment by international clients. Also, they can offer additional insurance to guard against other dangers involved with global trade, like damage to products during shipping.

11.8 Types of International Trade Finance

While general funding is frequently used to ensure solvency or liquidity, international trade financing can shield buyers and sellers from the hazards of international trade, and can be extended through various forms.Following are the various types of International trade finance:

11.8.1 Letter of Credit: A letter of credit is a document that verifies the availability of funds and is issued by a financial institution on behalf of the buyer, assuring the seller that they will promptly receive the total amount due in exchange for the goods and services they have delivered.The financial institution will pay the seller in part or in full when the terms and conditions of the issued letter of credit are met, but the buyer cannot do so.

Many different types of LC are used in international trade, including:

Confirmed letter of credit – a letter of credit which includes an additional guarantee of payment from a second bank (the confirming bank).

Revolving letter of credit – a single letter of credit that can be used to cover multiple transactions over a period of time.

Standby letter of credit – a letter of credit that provides assurance the buyer is able to pay the buyer, in the expectation that the LC will not need to be used.

Back-to-back letter of credit – two letters of credit used to connect the buyer and seller via an intermediary.

Sight letter of credit – payment is made immediately once the necessary documents have been reviewed by the bank.

11.8.2 Bank Guarantee: International businesses can obtain international trade finance services from home or foreign banks, small or large.A bank may give this type of guarantee, acting as a security if the importer or exporter cannot uphold their end of the agreement. Hence, businesses can seek financial assistance in the form of bank guarantees.

11.8.3 Factoring: Factoring is a financial tool that businesses and organizations can use in need of immediate cash.Factoring is a practice of selling business account receivables to a third party, known as a factor.The trade financer or the factor purchases the exporter's invoices at a discounted price. The factor receives the entire purchase price from the business customer or client.

11.8.4 Export Credit: Export credit is a guarantee, insurance, or credit that enables a foreign buyer of products or services to postpone payment over time. Companies that conduct business abroad might obtain these financial services via export credit agencies.

11.8.5 Forfaiting: The exporter exchanges cash for all their accounts by selling them to a forfaiter at a reduced price. Forfaiting is a method by which the right to claim export receivables of an exporter is sold to a forfaiter without recourse.

11.8.6 Insurance: Risks like loss of cargo, damage to goods, and non-payment from the buyer’s side are fairly common in international trade, and can negatively impact exporters.

Insurance plays a huge role in the delivery and shipping of the items and in safeguarding the exporter from these risks.

11.8.7 Pre Shipment Export Finance: Pre shipment loan is provided by banks and financial institutions to an exporter even before the exporter has exported goods. Basically the loan is nothing but a working capital loan. The exporter uses the loan to:

- Procurement of raw materials
- Incur expenses towards manufacturing and other expenses
- Process and pack the goods
- Ship the goods to the overseas importer
- Meet other financial cost of the business

Pre shipment loan is normally given to parties having confirmed export orders in their name in hand. Sometimes, even without a confirmed order in their name, financial institutions may grant loan but only when the exporter is a third party supplier to another exporter having a confirmed order in their name. For example, manufacturer A is a supplier to manufacturer B. Manufacturer B has got a confirmed export in its name. In this case, both manufacturer A and B are eligible to get pre shipment export credit.

Pre shipment credit can be two types.

Packing Credit

Advance against Cheques/Draft received by the exporter as Advance Payments: Packing credit is the generic term used to provide loans to finance the activities related to exporting goods. Packing credit is provided only when the exporter produces documents. These are:

- The confirmed order received from the overseas importer and should have detailed information about the overseas importer, description, quantity and value of goods (FOB or CIF etc.), destination port and the last date of payment.

- Firm order or irrevocable L/C or original cable / fax / telex message exchange between the exporter and the overseas importer.
- License issued by DGFT (Directorate General of Foreign Trade) if the goods to be exported fall under the restricted category. If the item falls under quota system, proper quota allotment proof needs to be submitted.

11.9 Benefits of International Trade Finance

11.9.1 Enables financial assistance: International trade finance enables various businesses to raise money to support smooth international transactions, assisting them in avoiding any disruption due to sales made on credit or any other issue.Businesses, importers, and exporters turn to international factoring or forfaiting to eliminate any financial risks on account of sales made on credit.

11.9.2 Improved relations between buyers and sellers: International trade finance helps businesses by providing immediate cash to enable trade.By ensuring that both buyers and sellers are able to meet their financial obligations with each other, allowing buyers and sellers to maintain healthy and stress-free trade relations.

11.9.3 Expand their global operations: With international trade finance, businesses can increase or expand their global operations and make money through trade by providing financial assistance.Expanding global operations will come with ease when working capital is not disturbed or blocked due to sales made on credit to overseas buyers.Since international trade finance can also aid businesses in lowering the dangers of financial non-payment from overseas buyers, expansion of global operations can be initiated.

11.9.4 Improves Cash Flow and Efficiency of Operations: Trade finance helps companies obtain financing to facilitate business but also it is an extension of credit in many cases. Trade finance allows companies to receive a cash payment based on accounts receivables in case of factoring. A letter of credit might help the importer and exporter to enter a trade transaction and reduce the risk of nonpayment or non-receipt of goods. As a result, cash flow is improved since the buyer's bank guarantees payment, and the importer knows the goods will be shipped.

In other words, trade finance ensures fewer delays in payments and in shipments allowing both importers and exporters to run their businesses and plan their cash flow more efficiently. Think of trade finance as using the shipment or trade of goods as collateral for financing the company's growth.

11.9.5 Increased Revenue and Earnings: Trade finance allows companies to increase their business and revenue through trade. For example, a U.S. company that can land a sale with a company overseas might not have the ability to produce the goods needed for the order.However, through export financing or help from private or governmental trade finance agencies, the exporter can complete the order. As a result, the U.S. company gets new business that it might not have had without the creative financial solutions that trade finance provides.

11.9.6 Reduce the Risk of Financial Hardship: Without trade financing, a company might fall behind on payments and lose a key customer or supplier that could have long-term ramifications for the company. Having options like revolving credit facilities and accounts receivables factoring can not only help companies transact internationally but also help them in times of financial difficulties.

11.10 Summary

When an international sales contract is negotiated both buyer and seller pay attention tothe shipping terms go as to the sales price. To make it clear, an 'International set of tradeterns (Incoterms) has been adopted by most countries that defines exactly theresponsibilities and liabilities of both buyer and seller while the merchandize in transit.Incoterms make international trade easier and help trades in different countries tounderstand one another. These standard definition are protected by international chamberof commerce, Paris. There are 13 incoterms 2000. When it comes to arrangement ofpayment, it can be advance payment or open account terms. There are various types ofdocuments used in international trade. There are (a) transport documents (b) invoices (c)insurance policy (d) certificate of origin (e) bill of exchange. In a trade transaction fundsare needed. Trade finance involves provision of funds to one or more parties. Tradefinance is provided in the short, medium and long terms. It can be pre-shipment financeand post-shipment finance. There are a wide range of financial engineering tools such asfactoring, B.A., forfeiting, countertrade, joint venture etc.

ICC has codified a standard set of rules for operation of credits. These rules are knownas uniform custom and practice for documentary credits. These rules are subsequentlyrevised from time to time. The latest rules are called UCP 500. UCP 500 set out themanner in which documentary credit-work will be conducted. Documentary creditrepresents a commitment of a bank to pay the seller of goods or services a certainamount provided he presents stipulated documents evidencing the shipment of goods orperformance of session within a stipulated period of time. Forfaiting means the surrender of rights. It is the purchase, without recourse to any provision holder of the instrumentsof debt instruments due to nature in near future and arising from the provision of goodsand services. It has many advantages like payment is guaranteed and received in time,100 percent finance is possible and it frees the exporter from any risk.

11.11 Key Terms

Importer: Typically the buyer of goods looking to secure financing for importing. This is generally the person on the receiving end of a shipment (ie consignee).

Supplier: The person manufacturing or selling the goods is on the supply side. In some cases, like if they are shipping under the EXW incoterm, this person would also be responsible for shipping.

Financing: The capital, the money, the dollar. Call it what you want. This is the cash which directly funds the production, shipping and other immediate costs.

Letter of Credit: An important document in trade financing. A letter issued by the buyer's bank, which guarantees the seller they will receive payment later.

Forfaiting: Selling your receivable to a bank (at a discount) for immediate payment, passing the burden of collection onto them. The party who buys the receivable (the bank) is known as the forfaiter.

Assignment of policy: Transferring a policy from the exporter to a lender.

Bid Bond: A bond issued by a company tendering for a contract to assure theprospective buyer that he will comply with the terms of the tender should it be accepted.

Buyer Credit: A financial agreement in which a bank, other financial institution, or anexport credit agency in the exporting country extends a loan directly to a foreign buyer orto a bank in the importing country.

Performance Bond: A guarantee to a buyer that the exporter will comply with the termsof contract.

Soft loan: A loan made at a concessional rate.

Supplier Credit: A financing arrangement under which the supplier(exporter) extendscredit to the buyer in the importing country.

Acceptance Credit: AnI/c which includes a term bill of exchange in its'requireddocumentation. The bill will be accepted by the drawee/bank on which it is drawn,discounted and the proceeds paid to the beneficiary.
Commercial Risk: The risk of non-payment by a non-sovereign or private, sector buyeror borrower in his home currency arising from default, insolvency, and/or failure to takeup goods that have been shipper, according to the supply contract .
Constructive Delivery: The process of handing over documents to an applicant m adocumentary credit.
DIA: Document against acceptance. The commercial documents will be released to thedrawee against acceptance of the term bill of exchange accompanying them.
DIP: Documents against payment. The documents will be released to the drawee againstpayment.
Political Risk: The risk of borrower-country government actions which prevent, or delay,the repayment of export credits. Many ECAs also include war, civil war, revolution, orother military or civil disturbances. Some also include physical disasters such ascyclones, floods or earthquakes.
Revolving Credit: A credit where the amount of available drawings is reinstatedautomatically after a stated period of time. Transferable Credit: A credit which allows the beneficiary to transfer part, or all, of thecredit rights to a third party, or parties , if part shipments are allowed.
Trust Receipt: A security document for goods, issued by a customer to his bankers.
FIATA: International Federation of Forwarding Agents Associations.
Incoterms: A code of shipping tens published by the International Chamber ofCommerce which govern foreign trade contracts.
Irrevocable: An obligation which cannot be cancelled unless all parties concerned agreeto cancellation.
Red Clause: A credit where the advising bank makes pre-shipment advance payments tothe beneficiary.

11.12 Questions

MCQs

Q1. Trade between two countries can be useful if cost ratios of goods are:
A. Undetermined B. Decreasing C. Equal D. Different
Answer: D

Q2. The term Euro Currency market refers to
A. The international foreign exchange market B. The market where the borrowing and lending of currencies take place outside the country of issue
C. The countries which have adopted Euro as their currency
D. The market in which Euro is exchanged for other currencies
Answer: B

Q3. Which of the following theories suggests that firms seek to penetrate new markets over time?
A. Imperfect Market Theory B. Product cycle theory
C. Theory of Comparative Advantage D. None of the above
Answer: D

Q4.Dumping refers to:
A. Reducing tariffs B. Sale of goods abroad at a lower price, below their cost and price in their home market C. Buying goods at low prices abroad and selling at higher prices locally D. Expensive goods selling for low prices
Answer: B

Q5. International trade and domestic trade differ because of:

A. Different government policies B. Immobility of factors

C. Trade restrictions D. All of the above

Answer: D

Q6. The margin for a currency future should be maintained with the clearing house by

A. The seller B. The buyer

C. Either the buyer or the seller as per the agreement between them

D. Both the buyer and the seller

Answer: D

Q7.The following statement with respect to currency option is wrong

A. Foreign currency- Rupee option is available in India

B. An American option can be executed on any day during its currency

C. Put option gives the buyer the right to sell the foreign currency

D. Call option will be used by exporters

Answer: D

Q8. Govt. policy about exports and imports is called:

A. Commercial policy B. Fiscal policy

C. Monetary policy D. Finance policy

Answer: A

Q9.Which of the following is international trade?

A. Trade between countries B. Trade between regions

C. Trade between provinces D. Both (b) and (c)

Answer: A

Essay Question

1. What do you mean by international trade? Explain its features
2. How international trade works? Explain its functions
3. What are the difficulties of international trade? How you can solve it?
4. What is difference between the international trade and domestic trade?
5. Who are the parties involves in international trade and finance?
6. What is Letter of Credit? Elaborate its varieties
7. How international trade finance in India?

11.13 Suggested Readings

1. Ryan Baird, (2009) "The Importance of Country Risk in Determining Trade Flows: The Preference for a Sure Thing" http://www.allacademic.com/meta/p_mla_apa_research_citation/1/6/7/9/6/p167964_index.html
2. BRIEF SPECIMEN CONTRACT FORM FOR SALE PURCHASE TRANSACTIONShttp://www.indiandata.com/trade_policy/export_procedures.html#
3. INCOTERMS, Source: FEDAI Handbook on " Documentary Credits & Standby Credits".
4. Exim Bank of India: Source: http://www.eximbankindia.com/objective.asp
5. Grape exporters get ECGC compensation: Pays Rs 60 lakh as buyers default
6. payment, Source: http://www.business-standard.com/india/news/grape-exporters-get-ecgc-compensation/236961/
7. http://www.infodriveindia.com/Exim/Guides/Export-Finance/Default.aspx

Dr. G.Davidraju

LESSON – 12
FOREIGN EXCHANGE RISK

OBJECTIVES:

- To know the concept of Foreign Exchange Risk
- To study how to reduce foreign exchange risk
- To understand the Hedging Techniques
- To identifyvariousswaps options

STRUCTURE:

12.1 CONCEPT OF FOREIGN EXCHANGE RISK

Foreign exchange risk, also known as exchange rate risk, is the risk of financial impact due to exchange rate fluctuations. In simpler terms, foreign exchange risk is the risk that a business' financial performance or financial position will be impacted by changes in the exchange rates between currencies.

Foreign exchange risk can be caused by appreciation/depreciation of the base currency, appreciation/depreciation of the foreign currency, or a combination of the two. It is a major risk to consider for exporters/importers and businesses that trade in international markets.Foreign exchange risk arises when a company engages in financial transactions denominated in a currency other than the currency where that company is based. Any appreciation/depreciation of the base currency or the depreciation/appreciation of the denominated currency will affect the cash flows emanating from that transaction. Foreign exchange risk can also affect investors, who trade in international markets, and businesses engaged in the import/export of products or services to multiple countries.

The proceeds of a closed trade, whether it is a profit or loss, will be denominated in the foreign currency and will need to be converted back to the investor's base currency. Fluctuations in the exchange rate could adversely affect this conversion resulting in a lower-than-expected amount.An import/export business exposes itself to foreign exchange risk by having account payables and receivables affected by currency exchange rates. This risk originates when a contract between two parties specifies exact prices for goods or services, as well as delivery dates. If a currency's value fluctuates between when the contract is signed and the delivery date, it could cause a loss for one of the parties.

Foreign exchange risk is caused by fluctuations in international currencies. There are several causes of these fluctuations

- Macroeconomic factors such as significant swings in exchange rates
- Government policies-Changes in inflation, interest rates, import-export duties and taxes impact the exchange rate
- Sovereign risk that a government is unable to repay its debt and defaults on its payments can have a direct impact on investment rates as repercussions can trigger other business-related troubles. And includes political unrest and even a change in government policies, which can impact the exchange rate and, in turn, affect business transactions.
- Collapse of a foreign government
- Credit risk that the counterparty will default in making the obligations it owes

12.2 TYPES OF FOREIGN EXCHANGE RISK

Foreign Exchange Risk, or currency risk, is the potential for financial variations arising from changes in currency exchange rates. In a globalised economy, where businesses and investors frequently cross borders, this risk is an ever-present challenge, demanding astute strategies and keen foresight.Consider an artist who sources materials from various countries. A sudden change in currency values can either inflate costs or reduce profits from international sales, directly impacting the artist's bottom line.The risk occurs when a contract between two parties specifies exact prices for goods or services as well as delivery dates. If a currency’s value fluctuates between the date the contract is signed and the delivery date, a loss for one of the parties could result.

There are three types of foreign exchange risk:

1. **Transaction risk**: This is the risk that a company faces when it's buying a product from a company located in another country. The price of the product will be denominated in the selling company's currency. If the selling company's currency were to appreciate versus the buying company's currency then the company doing the buying will have to make a larger payment in its base currency to meet the contracted price.This immediate risk arises from time lags between entering a contract and settling it.

   For example a US company buying French wine, if the euro strengthens against the dollar between order and payment, the wine becomes pricier in dollar terms. Occurs when a company buys products from a supplier in another country, and price is provided in the supplier’s currency. If the supplier’s currency appreciates vs. the buyer’s currency, the buyer will have to pay more in its base currency to meet the contracted price. The risk of transaction exposure typically impacts one side of a transaction: the business that completes the transaction in a foreign currency. The company receiving or paying a bill using its home currency is not subjected to the same risk. While a high level of exposure to exchange rates can lead to major losses, savvy finance professionals hedge or mitigate those risks.
2. **Translation risk**: Refers to how a foreign exchange transaction will impact financial reporting; i.e., the risk that a company’s equities, assets, liabilities or income will change in value as a result of exchange rate changes.This risk occurs because subsidiaries of a parent company in another country denominate their currency in the countries where they are located. The parent company faces potential losses when it must translate the subsidiaries’ financial statements into its own country’s currency. A parent company owning a subsidiary in another country could face losses when the subsidiary's financial statements, which will be denominated in that country's currency, have to be translated back to the parent company's currency.When

consolidating financial statements of foreign subsidiaries, this risk emerges. If a US company's Brazilian subsidiary sees the Brazilian real depreciate, its assets and earnings, when converted, might diminish in dollar terms, potentially affecting the parent company's stock price.

3. **Economic risk**: Also called forecast risk, refers to when a company’s market value is continuously impacted by an unavoidable exposure to currency fluctuations.This long-term risk affects a company's market value. A US tech firm might manufacture gadgets in Taiwan. If the Taiwanese dollar appreciates significantly over the years, production costs might rise, potentially reducing the firm's competitiveness and market value.

   It’s Also known as operating exposure; this refers to the impact on a company’s market value from exposure to unexpected currency fluctuations. This can affect a company’s future cash flows, foreign investments and earnings. Economic exposure can have a substantial impact on a company’s market value:
   - Exposure is greater for multinational companies with many overseas subsidiaries and a large number of transactions involving foreign currencies.
   - Globalization has increased economic exposure for all companies.
   - Effects are far-reaching and long-term in nature.
   - Economic exposure is difficult to measure precisely.

12.3 REDUCE FOREIGN EXCHANGE RISK

There’s no way to entirely avoid foreign currency risk in international business. However, there are many strategies used to reduce it so that can protect profits and protect bottom line. These strategies are known as hedging. They can help to reduce exposure to exchange rate fluctuations and manage risk. Investing in foreign assets has proven the merits of diversification, and most individual investors take advantage of the benefits of international assets. However, unless the foreign securities have been issued in U.S. dollars, the portfolio will experience currency risk. Currency risk is the risk that one currency moves against another currency, negatively affecting an investment's overall return. In other words, the exchange rate between the two currencies can move adversely and erode the returns of a foreign investment. Investors can accept currency risk and hope for the best, or they can employ hedging strategies to mitigate or eliminate the risk.They can be used alone or in combination with others, and can be tailored to fit the business. Some examples of hedging strategies are:

- ❖ **Establish a forward contract with a bank or foreign exchange service provider:**As the most direct and common method for managing foreign exchange risk, this option ensures that a U.S. exporter will receive a predetermined payment in U.S. dollars even if the rate fluctuates. To set one up, the exporter must know three things: the foreign currency amount; date the importer will pay and the currency exchange delivery date.Setting up a forward contract involves several steps:
  - Exporter agrees to accept payment in a different currency, such as Euros.
  - Exporter contacts a bank or foreign exchange service provider to negotiate a 60-day forward rate. (Fees for forward contracts, along with their rates and terms, vary.)
  - Exporter and importer finalize sales price and payment terms with a commitment from the bank.
  - Exporter then enters into a forward contract with its bank to lock in the rate and commit to a delivery date to exchange Euros for U.S. dollars.
  - Finally, the importer pays the exporter on time.
  - Exporter delivers the Euros to its bank in exchange for U.S. dollars.

If the exporter is uncertain when the importer will pay, an alternative is to request a window forward contract with the bank or service provider. This gives the exporter a window of delivery between the two dates.

- **The exporter accepts foreign currency payments only with cash in advance:** This option is ideal for small transactions as well as for new relationships with importers. It is simple, ensures full payment, and is most risk-free. But some importers may balk, as cash in advance is their least desirable method of payment.
- **Match foreign currency receipts with expenditures:** Here, the exporter sets up a foreign currency bank account to conduct transactions and eliminate currency conversion fees. This is ideal for U.S. exporters that use the same foreign currency with different trading partners. With this option, it's important to assess the cost and effort required to maintain a banking account in a foreign currency and record gains and losses resulting from currency conversions in financial statements. These can be fairly significant drawbacks.

12.4 HEDGING TECHNIQUES

Hedging meaning in the stock market is a risk management strategy used by investors to reduce potential losses from adverse price movements. It involves taking an offsetting position in a related asset or security to minimize the impact of market fluctuations.The concept of hedging can be applied to various types of investments, including stocks, bonds, commodities, and currencies. In the stock market, hedging is typically achieved by using derivatives such as options, futures, and swaps.

While hedging can help investors reduce their downside risk, it also involves additional costs, such as premiums for options and other derivatives. It requires careful consideration and analysis to determine the appropriate level of hedging for a particular portfolio and investment strategy.Overall, hedging is a useful tool for investors who want to manage their portfolio risk and protect themselves from potential losses in the stock market.Hedging in stock market is a strategy used by investors to reduce the risk of adverse price movements in an asset. It involves taking an offsetting position in a related security or financial instrument, with the goal of minimizing potential losses from market volatility.

The most common way to hedge in the stock market is through the use of options contracts. An options contract gives the holder the right, but not the obligation, to buy or sell an underlying asset at a predetermined price (known as the strike price) on or before a specified date.For example, an investor who owns shares of a company may buy a put option with a strike price slightly below the current market price of the stock. This put option would increase in value if the stock price were to decline, effectively offsetting some of the losses from the original stock position. In India, regulation has been steadily eased and turnover and liquidity in the foreign currency derivative markets have increased, although the use is mainly in shorter maturity contracts of one year or less. Forward and option contracts are the more popular instruments. Initially only certain banks were allowed to deal in this market however now corporate can also write option contracts. Indian companies are actively hedging their foreign exchanges risks with forwards and currency swaps and different types of options. Introduction of Cross-Currency Futures and Exchange Traded Option Contracts by the RBI will further enhance the companies' ability to effectively manage foreign exchange exposure.

12.4.1External Techniques

External hedging techniques use third-party financial instruments in the open market to manage risks. This includes transactions with other entities like buying futures contracts from a trade or entering into interest rate swaps with a bank. Outer hedging provides a more accurate review of current market prices and forces. While it shares some risk to external parties, it may involve higher costs.

- **Forward Contracts:** Forward contracts involve an agreement between two parties to buy/sell a specific quantity of an underlying asset at a fixed price on a specified date in the future. In other words, Forward contracts are those where counterparty agrees to exchange a specified quantity of an asset at a future date for a price agreed today. These are the most commonly used foreign exchange risk management tools. The corporations can enter into forward contracts for the foreign currencies which it need for payment or which it will receive in future. Since the rate of exchange is already fixed for the future transaction, there will be no variability in the cash flows. Hence, changes that take place between the contract date and the actual transaction date does not make any impact. This will eliminate the foreign exchange exposure. The future settlement date can be an exact date or any time between two agreed dates.
- **Currency Futures:** Currency futures contract involves a standardized contract between two parties to buy/sell an amount of currency at a fixed price on a specified date in the future and are traded on organized exchanges. Futures contracts are more liquid than forward contracts as they are traded in an organized exchange. A depreciation of currency can be hedged by selling futures and currency appreciations can be hedged by buying futures. Thus, inflow and outflow of different currencies with respect to each other can be fixed by selling and buying currency futures, eliminating the Foreign Exchange Exposure.
- **Currency Options:** Currency options are contracts which provides the holder the right to buy or sell a specified amount of currency for a specified price over a given time period. Currency options give the owner of the agreement the right to buy or sell but not an obligation. The owner of the agreement has a choice whether to use or not to use the option based on the exchange rates. He/she can choose to sell or buy the currency or let the option lapse. The writer of the option gets a price for granting this option. The price payable is known as premium. The fixed price at which the owner can sell or buy the currency is called as strike price or the exercise price. Options giving the holder a right to buy are called call options and Options giving the holder a right to sell is called put options. It is possible to take advantage of the potential gains through currency options. For example, If an Indian business firm has to purchase capital goods from the USA in US$ after three months, the company should buy a currency call option. There are two possibilities. First, if the dollar depreciates, then the exchange rates will be favorable as spot rate will be less than the strike price and the company can buy the US$ at the prevailing spot rate, as it will cost less. Second, if the dollar appreciates, then the exchange rates will be unfavorable as spot rate will be more than the strike price and the company can opt to use its right and buy the US$ at the strike price. Hence, in both the cases the company will be paying the less to buy the dollar to pay for the goods.
- **Currency Swaps:** A currency swap involves an agreement between two parties to exchange a series of cash flows in one currency for a series of cash flows in another currency, at agreed intervals over an agreed period. Thisis done to convert a liability in one currency to some other currency. Its purpose is to raise funds denominated in other currency. One party holding one currency swaps it for another currency held by other party. Each party would pay the interest for the exchanged currency at regular interval of time during the term of the loan. At maturity or at the termination of the loan period each party would reexchange the principal amount in two currencies.
- **Foreign Debt:** Foreign debts are an effective way to hedge the foreign exchange exposure. This is supported by the International Fischer Effect relationship. For

example, a company is expected to receive a fixed amount of Euros at a future date. There is a possibility that the company can experience loss if the domestic currency appreciates against the Euros. To hedge this, company can take a loan in Euros for the same time period and convert the foreign currency into domestic currency at the spot exchange rate. And when the company receives Euros, it can pay off its loan in Euros. Hence the company can completely eliminate its foreign exchange exposure.

- **Cross Hedging:** Cross Hedging means taking opposing position in two positively correlated currencies. It can be used when hedging of a particular foreign currency is not possible. Even though hedging is done in a different currency, the effects would remain the same and hence cross hedging is an important technique that can be used by companies.
- **Currency Diversification:**it means investing in securities denominated in different currencies. Diversification reduces the risk even if currencies are non-correlated. It will give the company global exposure, minimize foreign exchange exposure and capitalize on exchange rate disparities.

12.4.2 Internal Techniques

Internal hedging techniques use financial tools built within the firm to offset risks. This has trades among various divisions of the same firm. For example, a firm can lay off excess inventory to other divisions at a fixed price to hedge against price fluxes. Internal hedging relies on the firm's resources and expertise. It offers more flexibility but applies greater risks due to the lack of external market forces.

- **Netting:**It implies offsetting exposures in one currency with exposure in the same or another currency, where exchange rates are expected to move high in such a way that losses or gains on the first exposed position should be offset by gains or losses on the second currency exposure. It is of two types of bilateral netting & multilateral netting. In bilateral netting, each pair of subsidiaries nets out their own positions with each other. Flows are reduced by the lower of each company’s purchases from or sales to its netting partner.
- **Matching:**It refers to the process in which a company matches its currency inflows with its currency outflows with respect to amount and timing. When a company has receipts and payments in same foreign currency due at same time, it can simply match them against each other. Hedging is required for unmatched portion of foreign currency cash flows. This kind of operation is referred to as natural matching. Parallel matching is another possibility. When gains in one foreign currency are expected to be offset by losses in another, if the movements in two currencies are parallel is called parallel matching.
- **Leading and Lagging:** These involve adjusting the timing of the payment or receivables. Leading is accelerating payment of strengthening currencies and speeding up the receipt of weakening currencies. Lagging is delaying payment of weakening currencies and postponing receipt of strengthening currencies. In these the payable or receivable of the foreign currency is postponed in order to benefit from the movements in exchange rates.
- **Pricing Policy:** There can be two types of pricing tactics: price variation and currency of invoicing policy. Price variation can be done as increasing selling prices to offset the adverse effects of exchange rate fluctuations. However, it may affect the sales volume. So proper analysis should be done regarding customer loyalty, market position, competitive position before increasing price. Secondly, foreign customers can be insisted to pay in home currency and paying all imports in home currency.
- **Government Exchange Risk Guarantee:** Government agencies in many countries provide insurance against export credit risk and introduce special export financing

schemes for exporters in order to promote exports. In recent years a few of these agencies have begun to provide exchange risk insurance to their exporters and the usual export credit guarantees. The exporter pays a small premium on his export sales and for this premium the government agency absorbs all exchange losses and gains beyond a certain level.

12.5 ADVANTAGES AND DISADVANTAGES OF HEDGING

Hedging offers several advantages which include:

- Reduced risk: The primary benefit of hedging is that it helps reduce risk. By employing hedging strategies, investors can offset losses that may arise from unfavorable price movements in the market, which can help minimize potential damage to their portfolios or businesses.
- Increased stability: Hedging can also help provide a level of stability to investors and businesses. By reducing the impact of market volatility, hedging can help ensure that the value of assets or revenue streams remains stable, which can help create more predictable returns.
- Improved cost control: Hedging can also provide businesses with more control over their costs. By locking in prices for inputs or other expenses, businesses can better forecast their expenses, which can help them better manage their budgets and improve overall financial performance.
- Potential for higher returns: While hedging is often associated with risk reduction, it can also provide opportunities for higher returns. By using options or other derivative instruments to hedge, investors can benefit from favorable price movements in the market, which can help improve overall portfolio returns.
- Flexibility: Hedging also provides investors and businesses with flexibility. By using different hedging strategies and instruments, they can tailor their approach to fit their specific needs and risk tolerance, which can help ensure that they achieve their financial goals.

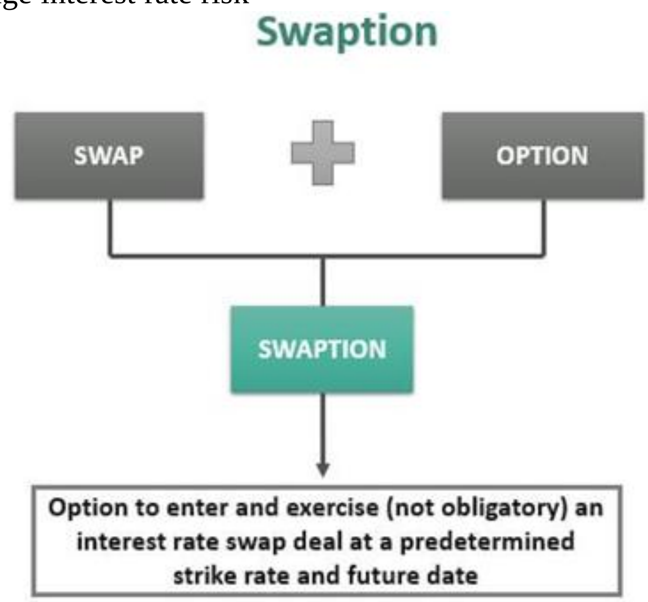
The disadvantages have been stated below.

- **Costs: Direct Costs:** Implementing hedging strategies often involves transaction costs, such as fees and commissions, which can reduce the overall returns on the investment.
- **Indirect Costs:** There may be indirect costs associated with the management and monitoring of hedging positions, including the need for specialized expertise and technology.
- Over-Hedging: **Reduced Profit Potential:** Over-hedging, where the extent of the hedge exceeds the actual risk exposure, can limit potential profits. If the hedging is more than necessary, gains in the underlying asset may be offset by losses in the hedging instrument.
- Complexity: **Complex Instruments:** Some hedging instruments, such as derivatives, can be complex and difficult to understand. This complexity may increase the risk of mismanagement or misunderstanding of the hedge's effectiveness.
- Basis Risk: **Basis Misalignment:** Basis risk occurs when the price movements of the hedged item and the hedging instrument do not perfectly align. This can result in imperfect protection against losses.
- Ineffectiveness: **Market Conditions:** Hedging strategies may not always work as intended, especially during extreme market conditions or unforeseen events. The effectiveness of the hedge depends on the correlation between the hedged item and the hedging instrument.

- Liquidity Risk: **Illiquid Markets:** In certain markets, finding liquid hedging instruments can be challenging. Illiquidity can affect the ability to enter or exit positions at desired prices, leading to potential losses.
- Counterparty Risk: **Credit Risk:** Hedging often involves dealing with counterparties, such as banks or financial institutions. There is a risk that these counterparties may default on their obligations, leading to financial losses.
- Regulatory Changes: **Policy and Regulatory Risks:** Changes in government policies or regulations can impact the effectiveness of hedging strategies. Regulatory changes may limit the use of certain instruments or alter the risk landscape.
- Rigidity: **Inflexibility:** Hedging strategies, once implemented, may be difficult to adjust quickly in response to changing market conditions. This lack of flexibility can be a disadvantage when rapid adjustments are needed.
- Opportunity Cost: **Missed Opportunities:** Hedging may require tying up capital or resources that could otherwise be used for alternative investments. This opportunity cost can be a drawback if the anticipated risks do not materialize.
- Herd Behavior: **Market Movements:** In times of uncertainty, market participants may engage in herd behavior, causing sudden and large movements. Such movements can disrupt hedging strategies and lead to unexpected outcomes.

12.6 SWAPS OPTIONS

A swaption, also known as a swap option, refers to an option to enter into an interest rate swap or some other type of swap. In exchange for an options premium, the buyer gains the right but not the obligation to enter into a specified swap agreement with the issuer on a specified future date.Swaptions are over-the-counter contracts and are not standardized, like equity options or futures contracts. Thus, the buyer and seller need to both agree to the price of the swaption, the time until expiration of the swaption, the notional amount and the fixed/floating rates.Swaptions are generally used to hedge options positions on bonds, to aid in restructuring current positions, to alter a portfolio or to adjust a party's aggregate payoff profile. Due to the nature of swaptions, market participants are typically large financial institutions, banks and/or hedge funds. Large corporations also participate in the swaption market to help manage interest rate risk



A swaption contract gives buyers the right to enter into an interest rate swap in exchange for a premium, but it is not obligatory.It is traded outside the stock exchange at a predetermined strike rate and future date, and the buyer pays a premium upfront to the issuer of the swap agreement.A swap option agreement is non-standardized and provides the buyer with freedom and protection while guaranteeing a maximum fixed interest rate.The interest rate swap is categorized as Payer and Receiver. It can be executed in three ways – European, American, and Bermudan and physically resolved or cash-paid at expiry.

12.6.1Features of swaps options

- A swaption is traded outside the stock exchange or open market.
- It usually occurs in the U.S. dollar, sterling, euro, and Japanese yen.
- The buyer and the seller must predetermine the swap option price (premium) and expiry date.
- The premium allows the trader to execute the swap option at a fixed or floating rate and notional amounts.
- The buyer must pay a premium to the issuer of the swap deal.
- Large corporations, investment and commercial banks , financial institutions , and hedge funds are the main participants in the swap option.
- Investors use the contract as a backup plan if their main operations and financial arrangements are exposed to interest rate risk

12.6.2 Swaption Benefits

A swaption is an interest rate swap contract between a buyer and a seller (issuer). It is one of the best backup strategies for traders who want protection against risks of market interest rate swings that could occur at any moment in the future.

- Non-Standardize
- Guaranteed maximum fixed interest rate
- Provides flexibility and protection from unpredictable interest rate movements
- Cash/swap settlement
- No additional fees

12.6.3 Types of Swaptions

A swaption is an over-the-counter contract that allows but does not obligate the buyer to enter into an interest rate swap deal at a predetermined strike rate and future date. The phrase is a portmanteau of swap and option, enabling traders to reduce interest rate risk by swapping cash flows or liabilities.The two common types of swaption are:

1. **Put or Payer Swaption:** This form of swap option gives purchasers the option of entering into a swap agreement in which they pay a fixed swap or strike rate (non-changeable) while receiving a floating (variable) swap rate. Firms frequently choose this option to protect themselves from interest rate risk if interest rates rise in the future.
2. **Call or Receiver Swaption:**Here, buyers have the opportunity, but not the obligation, to participate in a swap option contract in which they obtain a fixed swap rate while paying the variable swap rate. Mortgage lenders typically choose this option to protect themselves from decreased interest rates, which would result in early mortgage prepayment.

12.7 SUMMARY

Foreign exchange risk can be caused by appreciation/depreciation of the base currency, appreciation/depreciation of the foreign currency, or a combination of the two. It is a major risk to consider for exporters/importers and businesses that trade in international markets.Foreign exchange risk arises when a company engages in financial transactions denominated in a currency other than the currency where that company is based.The parent company faces potential losses when it must translate the subsidiaries' financial statements into its own country's currency.

A parent company owning a subsidiary in another country could face losses when the subsidiary's financial statements, which will be denominated in that country's currency, have to be translated back to the parent company's currency.Options giving the holder a right to buy are called call options and Options giving the holder a right to sell is called put options. It is possible to take advantage of the potential gains through currency options.While hedging can help investors reduce their downside risk, it also involves additional costs, such as premiums for options and other derivatives. It requires careful consideration and analysis to determine the appropriate level of hedging for a particular portfolio and investment strategy. In this lesson detailed discuss reduce foreign exchange risk**,** hedging techniqueswithadvantages and disadvantages of hedging. And also coverfeatures of swaps options, its benefits and types.

12.8 KEY WORDS

- ❖ Foreign exchange risk: Foreign exchange risk, also known as exchange rate risk, is the risk of financial impact due to exchange rate fluctuations. In simpler terms, foreign exchange risk is the risk that a business' financial performance or financial position will be impacted by changes in the exchange rates between currencies.
- ❖ Transaction risk: This is the risk that a company faces when it's buying a product from a company located in another country. The price of the product will be denominated in the selling company's currency. If the selling company's currency were to appreciate versus the buying company's currency then the company doing the buying will have to make a larger payment in its base currency to meet the contracted price. This immediate risk arises from time lags between entering a contract and settling it.
- ❖ Economic risk: Also called forecast risk, refers to when a company's market value is continuously impacted by an unavoidable exposure to currency fluctuations. This long-term risk affects a company's market value.
- ❖ Hedging: Hedging meaning in the stock market is a risk management strategy used by investors to reduce potential losses from adverse price movements. It involves taking an offsetting position in a related asset or security to minimize the impact of market fluctuations. The concept of hedging can be applied to various types of investments, including stocks, bonds, commodities, and currencies. In the stock market, hedging is typically achieved by using derivatives such as options, futures, and swaps.
- ❖ Currency Futures: Currency futures contract involves a standardized contract between two parties to buy/sell an amount of currency at a fixed price on a specified date in the future and are traded on organized exchanges. Futures contracts are more liquid than forward contracts as they are traded in an organized exchange. A depreciation of currency can be hedged by selling futures and currency appreciations can be hedged by buying futures.
- ❖ Netting: It implies offsetting exposures in one currency with exposure in the same or another currency, where exchange rates are expected to move high in such a way that losses or gains on the first exposed position should be offset by gains or losses on the second currency exposure. It is of two types of bilateral netting & multilateral netting.
- ❖ Swaption:A swaption, also known as a swap option, refers to an option to enter into an interest rate swap or some other type of swap. In exchange for an options premium, the buyer gains the right but not the obligation to enter into a specified swap agreement with the issuer on a specified future date.Swaptions are over-the-counter contracts and are not standardized, like equity options or futures contracts.

12.9 SELF-ASSESSMENT QUESTIONS

1. Defineforeignexchangerisk? Whataretypes of foreign exchange risk
2. How to overcome Foreign Exchange Risk? Give with any two examples.
3. What is Hedging? what are the Hedging techniques in foreign exchange risk?
4. What are the advantages and disadvantages of Hedging?
5. Define Swaps Options? Write its features of swaps options andtypes of swaptions?

12.10 FURTHER READINGS

- Foreign Exchange Operations by DeRosa David F., John Wiley & Sons Inc
- Foreign Exchange Option Pricing by Clark Iain J., John Wiley & Sons Inc
- Foreign Exchange: A Practical Guide to the FX Markets by Weithers, Tim, Southaustralianbooks, 2006.

Dr. Shaik Zakir Hussain

LESSON – 13
OFFSHORE BANKING

OBJECTIVES:

- To understand the offshore banking
- To know thecommercial invoice
- To study letter of credit
- To focus on bills of exchange

STRUCTURE:

13.1 CONCEPT OF OFFSHORE BANKING

In today's globalized world, offshore banking has become increasingly popular. For those looking to diversify their financial portfolio, protect their assets, or enjoy enhanced privacy, offshore banking can offer a range of benefits. Offshore banking refers to the practice of keeping money in a bank located outside one's home country. Offshore banks, often situated in low-tax jurisdictions, provide individuals and corporations with the opportunity to grow their wealth while enjoying various advantages.

The term offshore 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.Offshore refers to any (business) activity that takes place outside an entity's home base.The term may be used to describe foreign banks, corporations, investments, and deposits. A company may legitimately move offshore for the purpose of tax avoidance or to enjoy relaxed regulations.Offshore financial institutions can also be used for illicit purposes such as money laundering and tax evasion.Increased pressure is leading to more reporting of foreign accounts to international tax authorities.

Offshore 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.In the simplest sense, offshore 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 offshore 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 offshore financial centers (OFCs).

Offshore 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 offshore 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 offshore 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 offshore 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. Offshore banking involves depositing funds in a bank located in a foreign country. Offshore banks are typically situated in tax havens, which are jurisdictions offering favorable tax conditions and financial regulations. By placing their funds in offshore accounts, individuals and businesses can potentially benefit from tax advantages, financial privacy, and a more extensive range of investment options.

The practice of offshore banking dates back centuries, with its origins rooted in trade and exploration. During the heyday of colonialism, European powers established offshore banks to facilitate international trade and handle transactions in their colonies. Over time, offshore banking evolved and expanded, attracting investors seeking tax advantages and asset protection. As the world became more interconnected, offshore banking gained popularity beyond colonial powers. In the late 20th century, globalization and advancements in technology further fueled the growth of offshore banking. The ease of transferring funds across borders and the increasing complexity of international financial transactions contributed to the rise of offshore banking as a global phenomenon.

Today, offshore banking has become a global phenomenon, with numerous jurisdictions around the world offering offshore banking services to customers worldwide. However, it is essential to navigate the legal aspects and comply with tax regulations to ensure a smooth and legal offshore banking experience. Understanding the benefits of offshore banking can help to make an informed decision regarding this financial strategy. A large number of countries offer offshore banking. A few of the most well-known countries for offshore banking are tax havens meaning a country or jurisdiction that has low or no taxes for corporations or individuals such as Switzerland, Panama and the Cayman Islands. Other popular places for offshore banking include Hong Kong, Belize, Bermuda, Singapore and Germany.

13.2 OFFSHORE ACCOUNTS

Offshore accounts are a game-changer when dealing with finances across different countries and regions. They allow making hassle-free international payments and transfers in different currencies. For people with strong ties to multiple countries, it can make a lot of sense to keep a financial footprint in these places.Many expats and digital nomads maintain a bank account in their home country and one in their current residence. While offshore accounts provide plenty of flexibility and advantages don't forget that they also come with their own tax liability and regulation.

Offshore accounts, also known as offshore bank accounts or offshore savings accounts, offer individuals a convenient and effective means of managing their finances across multiple countries and regions. They serve as valuable tools, particularly for expatriates and individuals with international financial commitments. Expats commonly maintain bank accounts in both their home country and the country they currently reside in. However, many also opt to open offshore accounts due to various reasons.

These include being already established or working abroad, planning to relocate internationally, or frequently moving countries for work. Additionally, individuals who receive payments in foreign currencies, own assets abroad, or financially support family members living abroad find offshore accounts beneficial. Offshore accounts offer a range of features and benefits tailored to meet the diverse financial needs of account holders. One of the primary advantages is the potential for tax-efficient savings and investments in various currencies, although the extent of tax benefits depends on individual circumstances. These accounts enable users to hold funds, make and receive payments in multiple currencies, and effectively manage foreign exchange transactions. Additionally, they provide access to international expertise and investment advice, allowing account holders to make informed financial decisions across borders.

Another notable benefit is the ability to centralize funds in a secure location, while still being connected to local accounts, offering convenience and peace of mind. Furthermore, offshore accounts offer continuity as individuals relocate allowing them to maintain the same bank account regardless of their geographic location. Alongside these specialized features, offshore accounts typically include standard banking services such as debit cards and online/mobile banking, enhancing accessibility and usability for account holders. Some other reasons to open an offshore account are:

- Planning a nomadic lifestyle
- Retiring in a different country
- Frequent international business trips
- Receiving payment in foreign currencies
- Owning property or other investments abroad
- Financially supporting family members in other countries

13.2.1 The benefits of an offshore bank account

Think of an offshore bank account like a financial Swiss Army knife. While each offshore account has its unique perks, there are some common benefits:

- **Tax efficiency:** Offshore accounts often have the potential to help save on taxes, especially when dealing with different currencies. The extent of these tax benefits depends on specific situation. There can be expat tax advantages to using an offshore bank but whether these apply in case will depend on personal circumstances, such as country of residence. Also, some account holders who bank in jurisdictions like the Isle of Man and Jersey, for example, can choose to receive interest on their savings tax free. The interest is credited gross to their account, which means there is no income tax deduction at source. As an expat, this removes the need to reclaim tax paid, and avoids the hassle of reconciling the tax returns to ensure are not over-paying tax. An offshore bank account can also be useful when it comes to estate planning.
- **Convenience:** It can hold, send, and receive money in multiple currencies. That means no more juggling exchange rates and dealing with multiple accounts.
- **International financial advice:** With an offshore account, can access international expertise and investment advice.
- **Security:** There’s no need to open a new bank account every time to move. Instead, keep money in a safe and central location. The company can use offshore accounts to

avoid the unfavourable circumstances associated with keeping money in a bank in home nation. By using an offshore bank, based in a highly regulated, transparent jurisdiction, such as the Isle of Man for example, it can feel secure that money is safe. Holding offshore bank accounts makes it more difficult for them to be seized by authorities.

- **Privacy and service levels:** One of the attractions of having accounts held outside home country is the privacy get. Bank secrecy in some countries like Switzerland and Singapore is a legal entitlement, and banks cannot disclose details of their account holders or assets, except in extreme circumstances like a criminal investigation. This has led to widespread tax evasion, but many banks and governments have moved forward in recent years to ensure all money upon which tax is due is declared, and new anti-money laundering rules are in place. And as well as complying with these robust standards, expats may still be able to enjoy more privacy from an offshore bank than they can from an onshore one.Around the clock help if something goes wrong, with access to telephone and online banking 24 hours a day, 7 days a week, 365 days of the year - usually come as standard.
- **Convenience and accessibility:** As an international professional, being able to keep the bank account in one place, no matter how many times to move countries, is a major benefit.
- **Investing offshore:** Offshore investing is common for high-net-worth individuals. A good offshore bank will provide with a wide choice of funds and investments that are not usually available either in home country or where are currently living. However, select the bank carefully, some just white label other's solutions and offer poor choice.
- **Preferential foreign exchange services:** For those who work internationally, the ability to save and use funds in a foreign currency for international dealings can be a benefit. With multi-currency accounts usually coming as standard, transferring money between accounts will be fast and free. And, if need to transfer money between currencies, some offshore banks provide a competitive foreign exchange rate, compared to a regular banking service. This is one of the biggest advantages of offshore banking facilities for expats with international financial obligations.
- **Lending, leveraging and credit:** Once new banking arrangements are open, will often be able to apply for a mortgage or lending facilities. The best offshore banks will usually be flexible in their lending arrangements, and will often find competitive mortgage rates available for property, particularly if buying in a mainstream market like the UK.

13.2.2 The different types of offshore accounts

Offshore accounts have the same range of financial goals and requirements as any other bank account. Choosing the right one depends on specific situation and goals. Here are some of the typical categories:

- ❖ Offshore Bank Accounts: This is the most common type regular checking and savings accounts but in a foreign country. They’re good for personal or business purposes and for managing the finances in various currencies.
- ❖ Offshore Investment Accounts: Designed for investment purposes, they allow to invest in international stocks, bonds, funds, and other financial instruments.
- ❖ Offshore Trust Accounts: Trust accounts are legal entities that can hold and protect to assets. They’re commonly used for estate planning, asset protection, and privately passing wealth to beneficiaries.
- ❖ Offshore Business Accounts: If run a business with international operations or transactions, offshore business accounts make finances easier. They’re designed

for particular business needs, including handling cross-border payments and assets.

13.2.3 OFFSHORE BANKING UNIT (OBU)

An offshore banking unit (OBU) is a bank shell branch, located in another international financial center. For instance, an offshore banking unit could be a London-based bank with a branch located in Delhi. Offshore banking units make loans in the Eurocurrency market when they accept deposits from foreign banks and other OBUs. Eurocurrency simply refers to money held in banks located outside of the country which issues the currency.

An offshore bank account, often referred to as an overseas bank account, is a financial account held in a country where the account holder does not reside. These accounts offer individuals the convenience of managing their financial affairs across different countries and regions. They are particularly beneficial for those who need to make regular international payments or transfers, as they can streamline these transactions. Expatriates, in particular, commonly maintain bank accounts in both their home country and the country they currently reside in. However, many also opt to open offshore accounts to facilitate saving, investing, and managing money while living abroad. Offshore accounts provide a versatile solution for individuals navigating the complexities of international financial management, offering flexibility and accessibility across borders.

OBUs have proliferated across the globe since the 1970s. They are found throughout Europe, as well as in the Middle East, Asia, and the Caribbean. U.S. OBUs are concentrated in the Bahamas, the Cayman Islands, Hong Kong, Panama, and Singapore. In some cases, offshore banking units may be branches of resident and/or nonresident banks; while in other cases an OBU may be an independent establishment. In the first case, the OBU is within the direct control of a parent company; in the second, even though an OBU may take the name of the parent company, the entity’s management and accounts are separate. Some investors may, at times, consider moving money into OBUs to avoid taxation and/or retain privacy. More specifically, tax exemptions on withholding tax and other relief packages on activities, such as offshore borrowing, are occasionally available.

There are several steps for a client to get involved in depositing and transacting with an offshore banking unit. Broadly speaking, the offshore banking unit process starts based on an investor's specific needs. Investors choose an offshore jurisdiction based on factors such as its legal framework, tax advantages, political stability, and banking regulations.

After selecting an offshore jurisdiction, investors can open an account with an offshore banking unit, which can be in various forms such as personal, corporate, investment, or trust accounts. They must complete necessary documentation and undergo a due diligence process, including identification documents, proof of address, and the source of funds. Similar to a domestic bank, the investor must decide on the range of services needed as well. Offshore banking units offer a wide range of banking services including deposit accounts, international wire transfers, foreign currency exchange, investment products, loans, credit cards, and wealth management services.

In addition to banking services, offshore banking units can assist investors in optimizing their tax liabilities through legal means, such as favorable tax regimes. They may also offer access to a broader range of investment opportunities, including international stocks, bonds, mutual funds, commodities, and alternative investments. These offshore banking units may also provide legal guidance to ensure compliance with both the offshore jurisdiction's laws and their home country's laws to avoid legal or regulatory issues.

Local monetary authorities and governments do not restrict OBUs' activities; however, they are not allowed to accept domestic deposits or make loans to residents of the country, in which they are physically situated. Overall OBUs can enjoy significantly more flexibility regarding national regulations.

- ❖ Offshore banking units (OBUs) refer to bank branches located outside of its home country, and handling transactions made in foreign currency (known generically as "eurocurrency").
- ❖ OBUs make it easier for individuals and businesses to bank internationally and establish offshore accounts.
- ❖ Individuals may choose to keep their money offshore if there is instability in their own country, and they fear losing their investments.
- ❖ Offshore bank accounts must be declared to the holder's home country for tax reasons; however, some countries allow foreigners to earn capital gains tax-free.

Offshore jurisdictions typically have a dedicated regulatory body or financial authority responsible for overseeing the financial sector. These regulatory bodies include offshore banking units. OBUs must obtain proper licensing and authorization from the regulatory body, meeting specific requirements such as capital adequacy, operational infrastructure, and adherence to anti-money laundering (AML) and know-your-customer (KYC) regulations.

The regulatory framework aims to maintain the integrity of the financial system, protect customers, and prevent illicit activities. Therefore, regulatory authorities supervise OBUs to ensure compliance including ongoing monitoring, periodic audits, and examinations of operations. OBUs are required to submit periodic reports and financial statements to the regulatory authority. Offshore jurisdictions also often engage in international cooperation and information exchange agreements to combat financial crimes and ensure regulatory compliance. This includes sharing information with foreign regulatory bodies, participating in international initiatives against tax evasion, and adhering to global standards like the Common Reporting Standard (CRS) and the Foreign Account Tax Compliance Act (FATCA).

13.3 ADVANTAGES AND DISADVANTAGES OF OFFSHORE BANKING

The potential benefits of offshore banking include tax advantages, a higher level of privacy, and the ability to make investments in different currencies.

Advantages of offshore banking

- ❖ **Tax benefits**: Depending on the country where live and the country where the bank is located, offshore account could be tax-free or at least taxed at a low rate.
- ❖ **Asset protection**: An offshore account can be used to protect assets in case are sued or the business fails.
- ❖ **Convenience**: it will have easy access to account.
- ❖ **Privacy**: Many offshore banks offer higher levels of privacy than banks in the U.S.
- ❖ **Currency diversification**: Offshore banks allow holding money and making investments in different currencies.
- ❖ **Investment opportunities**: An offshore bank may open up access to investment opportunities wouldn't have in home country.

Disadvantages of offshore banking

Before opening offshore accounts, it's important to consider the potential downsides to offshore banking.

- ❖ **High costs**: The costs of setting up and maintaining an account can be high. May need to make a sizable minimum deposit and maintain a hefty minimum balance. Also may have to pay additional fees for maintaining the account and using the bank's services.

- **Safety**: If the offshore bank defaults due to financial difficulties, might not receive protection from the government. Unlike banks in the U.S., offshore banks may not be insured.
- **Increased regulatory scrutiny**: Because offshore banking is often associated with tax evasion, money laundering and organized crime, it's under scrutiny and rules imposed by tax agencies and other authorities. If an international regulator determines to violate tax laws or anti-money laundering rules, it can be subjected to financial penalties or even criminal charges. Many wealthy individuals, who might have benefited from the tax advantages of offshore banking, find it's not worthwhile to open bank accounts abroad.
- **Negative stigma:** Offshore banking often carries a negative stigma due to those who use it for crimes such as tax evasion and money laundering.

13.4 COMMERCIAL INVOICE

A commercial invoice is a document that a seller provides to a buyer to request payment for goods or services. Under Indian Law, a commercial invoice must be raised during the shipment or delivery of the goods or services.According to Indian Law, a commercial invoice must contain specific information such as the name and address of the buyer and seller, a description of the services or goods sold the price, and any taxes or duties. A commercial invoice details the transaction between a seller and a buyer. It includes information about the goods being sold, such as their type, quantity, value, and payment terms. The document is used for customs clearance purposes and serves as proof of the transaction between the parties. A commercial invoice is a critical document for international trade, as it helps ensure smooth shipment, legal protection, and financial record-keeping. It is typically prepared by the seller and provided to the buyer to facilitate the import or export of goods across international borders.

In simple words, a commercial invoice is an export document that serves as legal evidence of a sale transaction between the buyer and the seller. It is mainly used for clearance purposes with regard to customs and helps in the determination and assessment of duties and taxes payable. It contains the full description of goods sold, their quantities, and value as previously agreed upon by the parties.

A commercial invoice contains the following information-

- **Information regarding the buyer and seller**
  - Name, address, tax information, and contact details of the buyer
  - Name, address, tax information, and contact details of the seller
- **Information regarding the transaction**
  - Date of the invoice
  - Invoice number
  - Order number
  - Description of the goods
  - Quantity and value of the goods
  - Mode of payment and related instructions
  - IEC Code and GSTIN
  - Country of origin
- **Shipping related information**
  - Freight charges
  - Export route
  - Date of shipment
  - Gross weight

- Number of packages
- Insurance charges

13.4.1 The importance of a commercial invoice

Commercial invoices help customs official's clear shipment as it provides all the information they need. It protects business interests and keeps finance team happy.A commercial invoice is like a passport for goods. Just as wouldn't be allowed into a foreign country without a passport, goods won't be allowed across international borders without a commercial invoice.It's a crucial document for customs clearance.

The importance of a commercial invoice can be seen in the following manner-

- ❖ **Helps in maintaining records**: Commercial invoices are a mandatory document in the import and export procedures and constitute an important part of the paper trail for transactions relating to exports and imports.
- ❖ **Proof of sale**: Since a commercial invoice contains all the transaction details, including the details of the buyer, seller, and description and value of goods, it constitutes an essential part of the evidence that the sale transaction has taken place.
- ❖ **Guarantees payment**: A commercial invoice is a legal document evidencing a sale transaction and therefore plays a vital role in ensuring payment for the same.
- ❖ **Assistance in verification**: The description of goods in terms of quality, quantity and price enables the importer to cross-check and verify the contents of the shipment to see if they correspond to the contents mentioned in the commercial invoice.
- ❖ **Can serve as a notice for payment due**: The commercial invoice contains all the details of a regular invoice and can be used as a reminder for payments due. It is an efficient tool to maintain customer relationships.
- ❖ **Ensures no one gets fleeced**: Since the commercial invoice is relatively detailed and can be used as proof, there is no way the buyer can escape payment of the same.

13.4.2 Elements in commercial invoice

A commercial invoice contains several elements that may require explanation. Here is a glossary of some common terms:

- ❖ **Invoice Date** – The date, on which the seller issues the commercial invoice to the buyer, indicating the start of the payment period.
- ❖ **Buyer** – The party that purchases goods or services from the seller and is responsible for paying for them.
- ❖ **Seller** – The party that sells goods or services to the buyer and is responsible for providing the products and issuing the invoice.
- ❖ **Description of Goods** – A detailed and accurate description of the goods being shipped, including their quantity, weight, value, and any relevant specifications.
- ❖ **Unit Price** – The price of one unit of the product or service being sold, usually expressed in the currency of the invoice.
- ❖ **Total Price** – The total amount due for the goods or services being sold, calculated by multiplying the unit price by the number of goods.
- ❖ **Payment Terms** – The conditions under which the buyer is required to pay for the goods or services, including the payment method, due date, and any applicable penalties for late payment.
- ❖ **Incoterms** – A set of standardized trade terms used to define the rights and obligations of buyers and sellers in international trade, including responsibility for shipping, insurance, and customs clearance.
- ❖ **Harmonized System (HS) Code** – A standardized classification system used to identify and classify goods for customs purposes based on their nature, composition, and intended use.

- **Country of Origin** – The country in which the goods were produced or manufactured, which is often required for customs clearance and tariff calculations.

13.5 LETTER OF CREDIT

Letter of Credit (LC) is a credit limit that is used majorly by businesses engaged in international trade. It acts as a payment guarantee offered by Bank/NBFCs to exporters. Letter of Credit is a payment instrument in which Banks/NBFCs offer monetary guarantee to enterprises that are engaged in the import and export businesses, in case of payment delays or any default.Letter of Credit is issued by the Bank to the Buyer in order to secure the timely payment by the buyer to the seller. It acts as a guarantee on behalf of the buyer that he/she pays the full amount to the seller, as per the defined timeline or on time. If in case the buyer is unable to repay the amount to the seller on time, then the bank will pay on the buyer's behalf to the seller.

'Letters of Credit' also known as 'Documentary Credits' is the most commonly accepted instrument of settling international trade payments. A Letter of Credit is an arrangement whereby Bank acting at the request of a customer (Importer / Buyer), undertakes to pay for the goods / services, to a third party (Exporter / Beneficiary) by a given date, on documents being presented in compliance with the conditions laid down.Below stated are the documents required to apply for a Letter of Credit:

- Duly filled application form with passport-sized photographs
- KYC of the applicant, co-applicants, partners, directors (Passport, Voter ID card, Aadhar Card, Driving License, etc.)
- Bill of Exchange
- Commercial Invoice
- Certificate of Origin
- Health and Insurance certificates – Original
- Buyer's Financial Documents
- Packing, Shipping, and Transport Documents
- Landing airway bills, cargo receipts, etc.
- Related Commercial documents – Certificate of Inception
- Official Documents required by the buyer's/seller's country
- Any other document required by the lender

13.5.1 Features of LC

- LC is issued against Collateral/Security that may include buyer's Fixed Deposits and Bank Deposit, etc.
- Certain fees is charged by the Bank depending on the type of Letter of Credit
- Guidelines are issued by the International Chambers of Commerce (ICC) for any form of Letter of Credit
- Correctness of Letter of Credit: Only documents are exchanged and no goods and services are involved in this process. Therefore, mentioned details in the letter should be correct that including the name of the seller, date, amount, product name and quantity, etc.
- Banks will deny the payment, if they find any slightest mistake in the buyer's name, product name, shipping date, etc.
- As all parties deal in documents only and not goods and services, so the payment will not depend on the defects in goods and services, if any

13.5.2 Parties in Letter Of Credit (LC)

A letter of credit transaction normally involves the following parties :

- ❖ Applicant / Opener: The buyer of the goods / services (Importer) on whose behalf the credit is issued
- ❖ Issuing Bank: The Bank which issues the credit and undertakes to make the payment on behalf of the applicant as per terms of the L/C.
- ❖ Beneficiary: The seller of the goods / services (exporter) in whose favour the credit is issued and who obtains payment on presentation of documents complying with the terms and conditions of the LC.
- ❖ Advising Bank: Banks which advises the LC, certifying its authenticity to beneficiary and is generally a bank operating in the country of the beneficiary.
- ❖ Confirming Bank: A bank which adds its guarantee to the LC opened by another Bank and thereby undertakes responsibility for payment/acceptance/negotiation/incurring deferred payment under the credit in addition to that of the Issuing Bank. It is normally a bank operating in the country of the beneficiary and hence it's guarantee adds to the acceptability of the LC for the beneficiary. This is being done at the request / authorization of the Issuing Bank.
- ❖ Nominated Bank: A Bank in exporter's country which is specifically authorized by the Issuing Bank to receive, negotiates, etc., the documents and pays the amount to the exporter under the LC.
- ❖ Reimbursing Bank: Bank authorised to honour the reimbursement claim made by the paying, accepting or negotiating bank. It is normally the bank with which Issuing Bank has Nostro Account from which the payment is made to the nominated bank.
- ❖ Transferring Bank: In a transferable LC, the 1st Beneficiary may request the nominated bank to transfer the LC in favour of one or more second beneficiaries. Such a bank is called Transferring Bank. In the case of a freely negotiable credit, the bank specifically authorised in the LC as a Transferring Bank, can transfer the LC.

13.5.3 Process of Letter of Credit

The exporter and their bank must be satisfied with the creditworthiness of the importer's bank. Once the Sales Agreement is completed, the importer applies to their bank to open a Letter of Credit in favor of the exporter. The Importer's bank drafts the Letter of Credit using the Sales Agreement terms and conditions and transmits it to the exporter's bank. The exporter's bank reviews and approves the Letter of Credit and sends it to the exporter. The exporter ships the goods in the manner provided for in the letter of credit and submits the required documents to their bank. A freight forwarder may be used to assist in this process.

The Exporter's bank checks the documents for compliance with the Letter of Credit terms and conditions. Any document errors and discrepancies must be amended and resubmitted. After approval, the exporter's bank submits the complying documents to the importer's bank. The importer's bank releases payment to the exporter's bank. The importer's account is and their bank releases the documents to the importer to claim the goods and clear customs. The following are the Process of Letter of Credit:

- ❖ **Step 1:** The applicant or the buyer approaches the desired bank for the issuance of a letter of credit. This bank is known as an opening or issuing bank.
- ❖ **Step 2:** There will be an advising bank (mostly an international bank) for the beneficiary or seller that will receive the Letter of Credit issued by the issuing bank of the buyer. Further, the advising bank will check the authenticity of the letter of credit by checking the name, product details, etc.

- **Step 3:** Advising bank will share the letter of credit with the seller by keeping him/her rest assured that the money shall be received, as banks are now involved in this process.
- **Step 4:** Post seller assurance, the goods will be shipped as per the details mentioned by the buyer or applicant. The seller will now receive the bill of lading as the seller has already exported the goods.
- **Step 5:** The buyer shall now present the Bill of Lading to the Nominated or the Negotiating bank (International bank) where the bank will check all the shipping documents, and whether all goods were shipped as per the instructions. Finally, the nominating bank will do the payment to the seller or exporter.
- **Step 6:** Further the nominating bank will share the shipping documents with the issuing bank and will demand payment.
- **Step 7:** Issuing bank will further share the documents with the buyer, seeking approval on whether all documents the correct, as per the buyer's information, and if all the products are shipped or not.
- **Step 8:** The buyer now does the payment to the issuing bank and further the issuing bank sends the payment to the nominated or negotiating bank.

13.5.3 Types of Letters of Credit

- The different types of Letters of Credit offered by banks in India are as follows: **Documentary**: A documentary LC is an obligation by the issuing bank to pay the agreed amount to the beneficiary (usually the seller) on behalf of the applicant (buyer) upon receipt of specified documents.
- **Sight LC or Usance Credit**: A sight LC guarantees the payment once the beneficiary (the party which is about to receive the payment) presents the sight LC to the bank along with any other required documents.
- **Standby LC**: A Standby LC (SBLC) is a type of guarantee issued by the buyer's bank in favour of the seller. If the buyer fails to pay for the goods and services provided by the seller, the seller will demand the buyer's bank to step in and make the payment. An SBLC essentially acts as a backup.
- **Revocable and Irrevocable Credit**: With a Revocable LC, the terms and conditions can be changed or cancelled by the bank that has issued the LC. Banks do not need to give any prior notice to beneficiaries before doing so. On the other hand, an irrevocable LC is one wherein the terms and conditions cannot be changed or cancelled; the Issuing Bank is bound by the commitments given in the LC.
- **Back-to-Back Credit**: With this LC, the beneficiary (i.e., the seller) can request their bank to issue an LC on behalf of their supplier on the basis of the export LC received.
- **Transferable Credit**: This is an LC with an added provision permitting the bank to transfer the sum specified by the LC to another party at the request of the original beneficiary.
- **Revolving LC**: A Revolving LC is a single LC that can cover multiple shipments, so the credit can be renewed either as to the amount or as to the time it is available. These are often used where regular shipments are made from the same seller over a period of time.
- **Confirmed LCs**: Confirmation is usually requested if the seller is concerned about the creditworthiness of the issuing bank and/or the buyer's country risk. The advising bank adds its confirmation to the LC at the issuing bank's request The advising bank then becomes the confirming bank and undertakes to pay the seller (this is a separate undertaking from the one given by the issuing bank and so offers extra security to the seller).

13.6BILLS OF EXCHANGE

A bill of exchange is a written order used primarily in international trade that binds one party to pay a fixed sum of money to another party on demand or at a predetermined date. Bills of exchange are similar to checks and promissory notes they can be drawn by individuals or banks and are generally transferable by endorsements.A bill of exchange is a written order from a drawer instructing a drawee to pay a specified amount of money at a specific date. Simply put, a bill of exchange is a note that tells someone to pay a certain amount of money at a later date.

According to the Negotiable Instruments Act 1881, a bill of exchange is defined as “an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument”. A bill of exchange is a written order binding one party to pay a fixed sum of money to another party on demand or at some point in the future. A bill of exchange often includes three parties the drawee is the party that pays the sum, the payee receives that sum, and the drawer is the one that obliges the drawee to pay the payee. A bill of exchange is used in international trade to help importers and exporters fulfill transactions. While a bill of exchange is not a contract itself, the involved parties can use it to specify the terms of a transaction, such as the credit terms and the rate of accrued interest. There are three parties to a bill of exchange

- ❖ Drawee: Drawee is the person upon whom the bill of exchange is drawn. Drawee is the purchaser or debtor of the goods upon whom the bill of exchange is drawn. The party required to pay the money
- ❖ Drawer: A seller/creditor that is entitled to receive money from the debtor can draw a bill of exchange upon the buyer/debtor. The drawer after writing the bill of exchange has to sign it as maker of the bill of exchange. The maker of the bill of exchange
- ❖ Payee: Payee is the person to whom the payment is to be made. The drawer of the bill himself will be the payee if he keeps the bill with him till the date of its payment. The party that receives the money. The payee may change when in case the drawer has got the bill discounted, the person who has discounted the bill will become the payee; or in case the bill is endorsed in favour of a creditor of the drawer, the creditor will become the payee.

13.6.1 Features of a bill of exchange

The following features of a bill of exchange:

- ❖ A bill of exchange must be in writing.
- ❖ It is an order to make payment.
- ❖ The order to make payment is unconditional.
- ❖ The maker of the bill of exchange must sign it.
- ❖ The payment to be made must be certain.
- ❖ The date on which payment is made must also be certain.
- ❖ The bill of exchange must be payable to a certain person
- ❖ The amount mentioned in the bill of exchange is payable either on demand or on the expiry of a fixed period of time.
- ❖ It must be stamped as per the requirement of law

13.6.2 Essentials Elements of a Bills of Exchange

The essential elements of Bills of Exchange are:

- ❖ Bills of Exchange should always be a written document.
- ❖ Bills of Exchange must be dated and stamped.
- ❖ Bills of Exchange must be signed by the maker or drawer.
- ❖ The Bills of Exchange must clearly mention the name of the drawer.
- ❖ The order for the Bills of Exchange must be an unconditional one.

- Bills of Exchange must have an order to pay money and not goods.
- The sum payable for the Bills of Exchange must be specified.
- The money for the Bills of Exchange must be payable to a definite person or to his order or to the bearer.
- The amount for the Bills of Exchange should be paid within a stipulated time.
- Bills of Exchange must have adequate stamp duty at the prescribed rate.

13.6.3 Issuing and Negotiating Bills of Exchange

When it comes to issuing and using bills of exchange, there are a few important steps and people involved. Let's break it down in easy-to-understand language:

- Creation: The person who owes money (called the "drawer") creates a document called a bill of exchange. They write down who should receive the money (the "payee"), how much needs to be paid, and when it's due.
- Presentation: The bill is given to the person who needs to pay the money (called the "drawee"). The drawee can either agree to pay the amount on the due date (this is called "acceptance") or refuse to accept the bill.
- Endorsement: The person who should receive the money (the "payee") can endorse the bill, which means they can make it payable to someone else. They can either leave it blank so anyone can receive the money (this is called "bearer form"), or they can specify a particular person who should get the money (this is called "order form").
- Discounting: The payee has the option to get money before the bill's due date by selling it to a bank or financial institution at a discounted value. This is called "discounting," and it allows the payee to receive funds right away.
- Payment: When the due date arrives, the drawee is legally obliged to pay the money to the payee or anyone else who holds the bill at that time.

13.7 SUMMARY

Offshore banking refers to the practice of keeping money in a bank located outside one's home country. Offshore banks, often situated in low-tax jurisdictions, provide individuals and corporations with the opportunity to grow their wealth while enjoying various advantages. Offshore 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.

The practice of offshore banking dates back centuries, with its origins rooted in trade and exploration. During the heyday of colonialism, European powers established offshore banks to facilitate international trade and handle transactions in their colonies. Over time, offshore banking evolved and expanded, attracting investors seeking tax advantages and asset protection. Offshore accounts are a game-changer when dealing with finances across different countries and regions. They allow to make hassle-free international payments and transfers in different currencies.

An offshore bank account, often referred to as an overseas bank account, is a financial account held in a country where the account holder does not reside. These accounts offer individuals the convenience of managing their financial affairs across different countries and regions. They are particularly beneficial for those who need to make regular international payments or transfers, as they can streamline these transactions.

A commercial invoice is a document that a seller provides to a buyer to request payment for goods or services. Under Indian Law, a commercial invoice must be raised during the shipment or delivery of the goods or services. ‘Letters of Credit’ also known as ‘Documentary Credits’ is the most commonly accepted instrument of settling international trade payments. A Letter of Credit is an arrangement whereby Bank acting at the request of a customer (Importer / Buyer), undertakes to pay for the goods / services, to a third party (Exporter / Beneficiary) by a given date, on documents being presented in compliance with the conditions laid down.

A bill of exchange is a written order from a drawer instructing a drawee to pay a specified amount of money at a specific date. Simply put, a bill of exchange is a note that tells someone to pay a certain amount of money at a later date. A bill of exchange often includes three parties the drawee is the party that pays the sum, the payee receives that sum, and the drawer is the one that obliges the drawee to pay the payee. A bill of exchange is used in international trade to help importers and exporters fulfill transactions. While a bill of exchange is not a contract itself, the involved parties can use it to specify the terms of a transaction, such as the credit terms and the rate of accrued interest. Finally, in this lesson covers importance of a commercial invoice, elements in commercial invoice, Parties in Letter of Credit (LC) and Process of Letter of Credit.And discuss **e**ssentials elements of a Bills of ExchangeandIssuing and Negotiating Bills of Exchange.

13.8 KEY WORDS

- **Offshore:** The term offshore 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.Offshore refers to any (business) activity that takes place outside an entity's home base.The term may be used to describe foreign banks, corporations, investments, and deposits.
- **Offshore banking**: It involves securing assets in financial institutions in foreign countries, which may be limited by the laws of the customer's home nation—much like offshore 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 offshore accounts to avoid the unfavorable circumstances associated with keeping money in a bank in their home nation.
- **Offshore Accounts:** Offshore accounts, also known as offshore bank accounts or offshore savings accounts, offer individuals a convenient and effective means of managing their finances across multiple countries and regions. They serve as valuable tools, particularly for expatriates and individuals with international financial commitments. Expats commonly maintain bank accounts in both their home country and the country they currently reside in. However, many also opt to open offshore accounts due to various reasons.
- Offshore Trust Accounts: **Trust accounts are legal entities that can hold and protect assets. They're commonly used for estate planning, asset protection, and privately passing wealth to beneficiaries.**
- **Offshore Banking Unit (OBU):** Offshore Banking Unit is a bank shell branch, located in another international financial center. For instance, an offshore banking unit could be a London-based bank with a branch located in Delhi. Offshore banking units make loans in the Eurocurrency market when they accept deposits from foreign banks and other OBUs. Eurocurrency simply refers to money held in banks located outside of the country which issues the currency.
- **Commercial Invoice:** A commercial invoice is a document that a seller provides to a buyer to request payment for goods or services. Under Indian Law, a commercial invoice must be raised during the shipment or delivery of the goods or services.According to Indian Law, a commercial invoice must contain specific

information such as the name and address of the buyer and seller, a description of the services or goods sold the price, and any taxes or duties.

- **Letter of Credit (LC):** Letter of Credit (LC) is a credit limit that is used majorly by businesses engaged in international trade. It acts as a payment guarantee offered by Bank/NBFCs to exporters. Letter of Credit is a payment instrument in which Banks/NBFCs offer monetary guarantee to enterprises that are engaged in the import and export businesses, in case of payment delays or any default.Letter of Credit is issued by the Bank to the Buyer in order to secure the timely payment by the buyer to the seller. It acts as a guarantee on behalf of the buyer that he/she pays the full amount to the seller, as per the defined timeline or on time. If in case the buyer is unable to repay the amount to the seller on time, then the bank will pay on the buyer's behalf to the seller. 'Letters of Credit' also known as 'Documentary Credits' is the most commonly accepted instrument of settling international trade payments.
- Issuing Bank: **The Bank which issues the credit and undertakes to make the payment on behalf of the applicant as per terms of the L/C.**
- **Revocable and Irrevocable Credit**: With a Revocable LC, the terms and conditions can be changed or cancelled by the bank that has issued the LC. Banks do not need to give any prior notice to beneficiaries before doing so. On the other hand, an irrevocable LC is one wherein the terms and conditions cannot be changed or cancelled; the Issuing Bank is bound by the commitments given in the LC.
- **Bill Of Exchange:** According to the Negotiable Instruments Act 1881, a bill of exchange is defined as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument". A bill of exchange is a written order binding one party to pay a fixed sum of money to another party on demand or at some point in the future. A bill of exchange often includes three parties the drawee is the party that pays the sum, the payee receives that sum, and the drawer is the one that obliges the drawee to pay the payee

13.9 SELF-ASSESSMENT QUESTIONS

1. What is offshore banking? Explain the concept of offshore banking in trade?
2. Define offshore accounts? What are the benefits of an offshore bank account?
3. What is meant by Commercial Invoice? What are elements in commercial invoice?
4. What is letter of credit? Explain the **process of letter of credit?**
5. Define bills of exchange? Explain its features and essentials elements of a bills of exchange?

13.10 FURTHER READINGS

- Elements of Foreign Exchange: A Foreign Exchange Primer by Franklin Escher, Alpha Editions, 2021
- Exchange Rate Management and Risk by Mr. Kishor Bhatt, JBS Academy Pvt. Ltd.,2016
- International Business Environment and Foreign Exchange by Singh P. V. New Age International Pvt Ltd.

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LESSON – 14
DOCUMENTS AND FINANCING TECHNIQUES

OBJECTIVES:

- To understand documentation in trade.
- To know the importance and benefits of commercial invoice and certificate of origin
- To focus on various financing techniques in foreign trade

STRUCTURE:

14.1 INTRODUCTION TO DOCUMENTATION

Trade finance is a crucial aspect of international business that facilitates the exchange of goods and services across borders. It encompasses various financial instruments and processes designed to mitigate the risks associated with international trade, such as currency fluctuations, non-payment, and political instability. A fundamental component of trade finance is the meticulous management of documentation, which ensures that transactions are carried out legally, efficiently, and to the satisfaction of all parties involved.

Crucial trade finance documents include the commercial invoice, bill of lading, and insurance certificates, among others. These documents serve as a record of the transaction, proof of shipment, and assurance of risk coverage, respectively. Equally important are letters of credit, which are financial guarantees from a bank that payment will be made to the exporter, provided the terms specified in the letter are fulfilled. Properly managing these documents can help reduce transactional risks and facilitate smoother trade operations. Proper documentation is vital for the legal and efficient execution of international trade. Letters of credit provide a secure payment mechanism for international transactions. Thorough risk management is essential to safeguard trade operations. Understanding the assortment of trade documents is crucial for businesses engaged in international trade.

These documents serve as evidence of transactions, ensure compliance with international laws, and facilitate smooth customs clearance. Common trade documents such as the **commercial invoice, bill of lading,** and **certificate of origin** are the cornerstones of trade finance documentation. The commercial invoice contains details about the goods or services provided, including quantity and price. It's a fundamental document for customs and payment processing. The bill of lading, serving as a **receipt** for shipped goods, provides details about the cargo and terms of delivery. It also acts as a document of title that can be required by banks if letters of credit are used. The certificate of origin verifies the country in which the goods were manufactured, and is vital for customs to assess duties and enforce trade agreements or embargoes.

Exporters must prepare comprehensive documentation to meet the requirements of banks, buyers, and customs authorities. Insurance certificates are important to reassure the buyer that goods are covered against loss or damage during transport. A packing list details the contents of each shipment, helping in the verification of cargo and in the event of inspections. Additionally, exporters often interact with export credit agencies and employ digital signatures to certify and secure documents. Export factoring is another financial tool used to ensure cash flow, providing an advance against accounts receivable.

For importers, obtaining the right documentation is essential for proving ownership and clearing goods through customs. The **insurance certificate** must accompany the relevant risks covered and terms that match the sales contract. The **bill of lading** needs to be presented in its original form to take possession of the cargo. Importers rely heavily on trade finance documentation for payment assurance and often seek guarantees from banks or trade finance institutions. Compliance with **customs authorities** is non-negotiable, making the accuracy and completeness of trade documents like the **certificate of origin** and **commercial invoice** critical.

14.2 BILL OF LADING

A bill of lading (BL or BoL) is a legal document issued by a carrier (transportation company) to a shipper that details the type, quantity, and destination of the goods being carried.1 A bill of lading also serves as a shipment receipt when the carrier delivers the goods at a predetermined destination. This document must accompany the shipped products, no matter the form of transportation, and must be signed by an authorized representative from the carrier, shipper, and receiver.

A bill of lading is a legal document issued by a carrier to a shipper that details the type, quantity, and destination of the goods being carried. A bill of lading is a document of title, a receipt for shipped goods, and a contract between a carrier and a shipper.This document must accompany the shipped goods and must be signed by an authorized representative from the carrier, shipper, and receiver. If managed and reviewed properly, a bill of lading can help prevent asset theft. There are different types of bills of lading, so it's important to choose the right one. The bill of lading is a legally binding document that provides the carrier and the shipper with all of the necessary details to accurately process a shipment.

The importance of a bill of lading lies in the fact that it's a legally binding document that provides the carrier and the shipper with all of the necessary details to accurately process a shipment. This implies that it can be used in litigation if the need should arise and that all parties involved will take great pains to ensure the accuracy of the document. Essentially, a bill of lading works as undisputed proof of shipment. Furthermore, a bill of lading allows for the segregation of duties that is a vital part of a firm's internal control structure to prevent theft.

14.2.1 BILL OF LADING-FUNCTIONS

It has three main functions:

1. **Receipt –** It acts as a document of the receipt of the goods by the issuing body.
2. **Contract –** It outlines the shipping method that will be used for the cargo and acts as evidence of the contract of carriage with the carrier.
3. **Title of goods –** For a named consignee to take the delivery of the goods on the discharge port or on the final destination (depending on what has agreed on), they must surrender the original copy of a B/L.

142.2 Types of Bill of Lading

Based on history, the Bill of Lading was initially used for sea shipments as it is the common mode of transport during the pre-modern times. However, the Bill of Lading is now being used by other methods of shipments such as rail and inland freight.

- **Straight Bill of Lading**: This is a standard B/L, used if the shipment is going to a customer who has already paid a shipment. The shipment can only be received by the consignee and the bill and cannot be transferred.
- **Order Bill of Lading**: This is the type of shipment that is usually used for consignments. The consignee on the record is considered the owner of the cargo unless the consignee has transferred the title of the cargo ownership to another entity by endorsing the Bill of Lading.
- **Charter Party Bill of Lading**: This type of Bill of Lading is used when a shipper, or group of shippers, charter or rent a whole vessel to carry the cargo.
- **Switch Party Bill of Lading**: This Bill of Lading is considered a duplicate. The consignee can request the carrier to switch the Bill of Lading when the consignee does not want to divulge the carrier information to the new consignee or buyer.
- **Air Waybill**: This is a non-negotiable document that is only used for cargo that is transferred via air freight. Unlike an ocean's Bill of Lading, an Air Waybill does not act as a title of goods.
- **Ocean Bill of Lading**: This type allows the carrier to ship the goods domestically or internationally. The carrier's responsibility starts from the port of origin and typically ends at the port of discharge, stated in the document. This is also known as a port-to-port Bill of Lading.
- **Inland Bill of Lading**: This document shows the information of the carrier transporting the cargo domestically either by road or rail.
- **Direct Bill of Lading**: This is used if the carrier will be the same carrier who will handle the shipment to the final destination. The responsibility of the carrier in this case is from the receipt of the goods until it gets delivered to the final destination.
- **Multimodal or Combined Transport Bill of Lading**: This B/L covers at least two modes of transport. An example is a combination of sea, rail, and road. The carrier can subcontract the other mode of shipment to other carriers.
- **Through Bill of Lading**: This type of bill is very similar to combined transport or multimodal, where there are different legs of shipments. The only difference is that there is no change in the shipping mode (an ocean shipment will remain on the waters) on this Bill of Lading.
- **Transshipment Bill of Lading**: If a carrier doesn't have a direct service between two ports, a carrier can transship the cargo to another port at the carrier's expense.

The types of Bill of Ladings could be overwhelming; however, as a buyer, looking to ship cargo, it is not necessary to know all of the types of Bill of Ladings. However, it is best for the buyer to know the Bill of Lading that is applicable to their business.

14.2.3THE CONTENTS OF A BILL OF LADING

Bills of lading typically include the following contents:

- Name and address of the shipper
- Name and address of the consignee
- Date of delivery
- City/port of delivery
- Type of transport
- Type and quantity of goods being shipped
- Type of packaging
- Shipping date and estimated date of arrival
- Shipping route (including stops/transfers)
- Item description
- Terms and conditions of the transportation (including special handling instructions)

14.3 COMMERCIAL INVOICE

One of the most important documents in international trade, the Commercial Invoice is a contract and proof of sale issued by the seller to the buyer. This document describes the goods being sold and details the price, value, and quantity of the goods. The Commercial Invoice does not indicate ownership or carry a title to the goods that is in the Bill of Lading. However, the commercial invoice is required for Customs clearance.

A commercial invoice is a document that a seller provides to a buyer to request payment for goods or services. Under Indian Law, a commercial invoice must be raised during the shipment or delivery of the goods or services. In addition to facilitating customs clearance, a commercial invoice serves as proof of the transaction. So, in case of any disputes or discrepancies, it has a legal record of the agreement. It's also an essential document for accounting and tax purposes, as it helps to keep track of to sales revenue. Commercial invoices are critical documents for organizations engaged in international trade. It's an essential tool for customs clearance, legal protection, and financial record-keeping.

A commercial invoice details the transaction between a seller and a buyer. It includes information about the goods being sold, such as their type, quantity, value, and payment terms. The document is used for customs clearance purposes and serves as proof of the transaction between the parties. A commercial invoice is a critical document for international trade, as it helps ensure smooth shipment, legal protection, and financial record-keeping. It is typically prepared by the seller and provided to the buyer to facilitate the import or export of goods across international borders.

14.3.1 IMPORTANCE OF COMMERCIAL INVOICE

Commercial invoices help customs officials clear the shipment as it provides all the information they need. It protects the business interests and keeps finance team happy.

A commercial invoice document is necessary for international trade and may be required in various scenarios. For instance, if exporting goods to another country, it must provide a commercial invoice to the buyer. Similarly, if imported goods, the supplier must prepare a commercial invoice.

Customs officials also require a commercial invoice to clear goods through their system, and it's important to ensure it includes accurate and complete information to avoid delays or rejections. In addition, a commercial invoice is essential for legal and financial record-keeping purposes, as it serves as proof of the transaction between the buyer and the seller.

Therefore, if engaged in international trade, it's important to understand when a commercial invoice is required and to ensure that prepare accurate and complete invoices for all the transactions.

Importance of commercial invoice

- A commercial invoice is like a passport for the goods. Just as it wouldn't be allowed into a foreign country without a passport, the goods won't be allowed across international borders without a commercial invoice.
- It's a crucial document for customs clearance. It wants the shipment held up at the border for days, weeks, or months because forgot to include a commercial invoice. Customs officials use this document to determine the appropriate duties taxes to be paid and to verify that the shipment meets all import requirements.
- A commercial invoice serves as proof of the transaction. It's like a receipt for the business deal, showing that both parties agreed on the terms of the sale and that payment was made or is due.
- It's essential for financial record-keeping. It should get audited and be unable to account for the international sales revenue. A commercial invoice provides a clear and concise transaction record that it can use for accounting and tax purposes.
- Without a commercial invoice, it would might as well be playing international trade "Guess who?" with customs officials. They won't know what's in the shipment, how much it's worth, or how it was paid for, and it can bet they won't take kindly to that.

14.3.2Components of commercial invoice

Here are the main components of a commercial invoice.

- Details regarding goods being shipped, including quantity, weight, and value
- All details such as name and address of both the buyer and seller
- Terms of payment and delivery
- Country of origin of the goods
- Mode of transport
- Destination country
- A tax identification number and exporter's registration number
- Any other required information for legal and regulatory compliance

14.4CERTIFICATE OF ORIGIN

In international trade, where goods traverse borders and navigate across diverse regulations, the certificate of origin (CO) is a vital document. It not only establishes a product's nationality. Certificate of Origin s verify that traders are following customs and tariff requirements, help determine eligibility for preferential treatment under trade agreements, and verify that goods aren't from a country subject to trade sanctions or restrictions or produce goods under unethical or exploitive conditions. A certificate of origin (CO) records the country of origin that an imported good has come from. The CO is often mandated by importing countries and included in trade agreements, as it is used to levy the appropriate import tax, if any.Preferred COs are truncated versions that verify they qualify under a free-trade agreement.

The main requirement for a Certificate of Origin is for clearing customs. If the goods, exported/imported do not come with a Certificate of Origin, the Customs officer tasked with checking the goods will not allow the goods to leave the warehouse. The Certificate of Origin is used by the Customs officer to determine the duties that have to be paid and to check whether the goods being exported/imported are illegal.

Certificate of Origin is issued by both the Indian Chamber of Commerce as well as Trade Promotion Council of India. This certificate issued by these two bodies is essential for exporters in India to prove that the commodities being exported are of Indian origin. It also proves that the commodity exported is wholly obtained, manufactured or produced in India. Millions of Certificates of Origins are issued around the world to facilitate trade and commerce worldwide. A Certificate of Origin must be signed by the exporter with a permanent indemnity bond on a non-judicial stamp paper of Rs 10, duly notarized (format for Indemnity Bond is available with the Certificate of Origin Dept). The certificate must also be signed and stamped by the Chamber of Commerce or any other authority with such qualification. It is the most commonly used document to prove the origin of goods. The Certificate of Origin is issued by the exporter of the goods. After preparing the necessary information about the product, its origin, and relevant tariff codes, the exporter submits the CO to a chamber of commerce or customs authority for approval.

14.4.1 TYPES OF CERTIFICATE OF ORIGIN

There are two kinds of Certificate of Origin that Chambers of Commerce may issue:

- **Non preferential certificate of origin:** This type of Certificate of Origin states that the goods being exported/imported are not given any preferential tariff treatment and the due duties must be levied upon the goods that are being moved.
- **Preferential certificate of origin:** This type of Certificate of Origin is given towards goods that are subject to preferential tariff treatment in the payment of duties. These duties may be a reduction of the normal tariff, or it also may be a complete exemption of the tariffs. Such a situation arises when two or more nations reach a trade agreement entailing such exemptions when goods are exported or imported between these nations.

These are the following schemes under which India receives tariff preferences:

- **Generalized system of preference (GSP):** This system is implemented to support developing countries by giving them preference in trade tariffs from industrialised and developed countries. It is a non-contractual instrument that is unilateral and is based on a non-reciprocity extension of tariff concessions.
- **Global system of trade preference (GSTP):** This system extends tariff concessions between developing countries who are parties to an agreement. Export Inspection Council (EIC) has the sole authority to issue Certificate of Origin under GSTP.
- **SAARC preference Trading Agreement (SAPTA):** Tariff concession extends only to countries in SAARC.
- **Asia-Pacific Trade Agreement (APTA):** Presently, India, China, South Korea, Sri Lanka and Bangladesh exchange tariff concession under APTA. APTA offers liberalisation of tariff and non-tariff barriers in order to expand trade in goods in the Economic and Social Commission for Asia and Pacific (ESCAP) region.
- **India-Sri Lanka Free Trade Agreement (ISLFTA):** This agreement is a free trade agreement between India and Sri Lanka. Under this agreement, EIC has the sole authority to issue Certificate of Origin.
- **Indo-Thailand Free Trade Agreement:** This agreement between India and Thailand is to implement the Early Harvest Scheme where products under this protocol are given tariff preference. Early Harvest Scheme under India-Thailand Free Trade Agreement offers tariff preferences for imports on items, which satisfy Rules of Origin criteria notified by the Department of Revenue, Ministry of Finance vide notification no. 101/2004-Customs dated 31.08.2004. Export Inspection Council is the sole agency to issue Certificate of Origin under this protocol.
- **India-Malaysia Comprehensive Economic Cooperation Agreement (IMCECA):** This is an agreement between India and Malaysia and the EIC has the sole authority to issue Certificate of Origin.
- **India-Korea Comprehensive Economic Partnership Agreement (CEPA):** India and South Korea (Republic of Korea) signed the Comprehensive Economic Partnership Agreement (CEPA) to expand the business and commercial opportunities

between these two countries. EIC has the sole authority to issue Certificate of Origin under this agreement.

- **India-Japan Comprehensive Economic Partnership Agreement (IJCEPA):** This agreement is between India and Japan to improve and protect investments made between the two countries. Under this agreement, the EIC has the sole authority to issue Certificate of Origin.
- **ASEAN-India Free Trade Agreement:** This agreement is between India and Japan to improve and protect investments made between the two countries. Under this agreement, the EIC has the sole authority to issue Certificate of Origin.

14.4.2 BENEFITS OF CERTIFICATE OF ORIGIN

The Certificate of Origin offers several advantages:

- **Tariff Preferences**: One of the significant advantages of a Certificate of Origin is its role in obtaining tariff preferences and reducing import duties. Many countries offer preferential tariffs on products from specific countries or under certain trade agreements. With a valid CO, exporters can take advantage of these tariff concessions, making their products more competitive globally.
- **Trade Agreements**: Certificates of Origin are essential for products to qualify for trade agreements and free trade agreements (FTAs) between countries. Under these agreements, products from member countries can enjoy lower or zero tariffs, enhancing the competitiveness of exporters within the agreement.
- **Customs Clearance**: The CO streamlines the customs clearance process by providing clear information about the product's origin. Customs authorities use the CO to assess the eligibility of products for preferential treatment and to ensure compliance with trade regulations.
- **Market Access**: Having a Certificate of Origin can open up new markets for exporters. Some countries may have stringent import regulations or quotas for products from specific origins. A valid CO allows products to gain access to these markets without unnecessary barriers.
- **Credibility and Trust**: The CO adds credibility to the product and the exporting company. Importers often prefer to deal with exporters who provide proper documentation, including the CO, as it instills trust and confidence in the quality and origin of the goods.
- **Export Incentives**: In some cases, governments offer export incentives or financial assistance to exporters. A valid CO may be a prerequisite for such incentives and benefits.
- **Compliance with Regulations**: Exporters need to comply with various international trade regulations. The Certificate of Origin ensures that the exported goods meet the specific requirements of the importing country and relevant trade agreements.

14.4.3 INFORMATION CONTAIN IN A CERTIFICATE OF ORIGIN

The certificate must be issued on the official government form and contain the following information:

- Name and address of the exporting company
- Name and address of the importer
- A description of the good(s), including the appropriate product codes
- Quantity of merchandise
- Price per unit
- Port of loading
- Place of delivery
- A waybill or bill of lading number
- A dated commercial invoice of payment

14.5 INSURANCE CERTIFICATE

Certificate of Insurance is a document that provides evidence of the insurance. It typically outlines the key covers provided, policy numbers, insurance company, amount of cover offered, and is provided either by the insurance broker or insurer. A certificate of insurance might be requested in various situations, such as when entering into a contract or agreement. For example, contractors or service providers may be required to provide a certificate of insurance to demonstrate that they have the necessary business insurance to protect against potential risks or liabilities associated with their work. A certificate of insurance (COI) is a document issued by an insurance company or broker. The COI verifies the existence of an insurance policy and summarizes the key aspects and conditions of the policy.A certificate of insurance (COI) is issued by an insurance company or broker and verifies the existence of an insurance policy.Small business owners and contractors typically require a COI that grants protection against liability for workplace accidents or injuries to conduct business.If receive a COI from a business, check the policy coverage dates and the limits of the policy.

14.5.1 THE IMPORTANCE OF A CERTIFICATE OF INSURANCE

A Certificate of Insurance is a document issued by an insurance provider to the policyholder as evidence of an existing insurance policy. It contains crucial information about the insurance coverage, including policy limits, effective dates, and the types of coverage in place. The COI is often requested by third parties, such as clients, vendors, landlords, or government agencies, to verify that a business or professional has the necessary insurance protection.

- **Proof of Coverage:** A COI serves as clear and tangible evidence that a business or professional is adequately insured. This is critical for building trust with clients, partners, and regulatory bodies. It assures them that the entity has the financial backing to address potential risks and liabilities.
- **Compliance:** Many contracts, agreements, and lease agreements require the parties involved to carry specific insurance coverage. These contractual obligations often mandate the provision of a COI as proof of compliance. Failing to meet these requirements can result in breaches and legal consequences.
- **Risk Mitigation:** For businesses, a COI is a valuable tool for managing risk. It helps ensure that third parties are aware of the insurance coverage in place and that they will be protected in case of accidents, injuries, property damage, or other unforeseen events.

14.5.2 CERTIFICATE OF INSURANCE-BENEFITS

Certificates of Insurance are not often top-of mind. It may not even know where it is or how to get one. However, this document benefits the business more than it may know. It’s not just a piece of paper; it is evidence of the insurance company has in place. Our number one customer service need is making sure our clients have their certificate of insurance promptly. We make sure that they have access to the certificate when they need it. Here are the benefits of having a certificate of insurance they we have found along the way.

- Proof of Coverage: A certificate of insurance serves as tangible proof of the insurance coverage. When potential clients or business partners request a certificate of insurance they want assurance that it has the necessary insurance in place. By providing a certificate of insurance, instill confidence and demonstrate that a reliable and responsible professional.
- Contract Compliance:Many contracts have insurance requirements that must be met. Failure to comply with these requirements can result in breached contracts, legal disputes, and financial liabilities. A certificate of insurance is the proof that it has insurance coverage,, allowing it to proceed with confidence.

- Enhanced Professional Reputation:Having a certificate of insurance demonstrates commitment to meeting contractual obligations and enhances professional reputation. It shows that prioritize risk management and take proactive measures to protect the business and clients. This can be a differentiating factor when potential clients are choosing between multiple service providers.
- Streamlined Business Processes:By keeping certificate of insurance up to date and readily available, it can streamline the business processes. Instead of scrambling to gather the necessary documentation when requested, it can promptly provide the certificate of insurance, saving time and effort. This efficiency can enhance the credibility and make a preferred partner for collaboration.
- Peace of Mind:Running a business involves inherent risks, and having the right insurance coverage can provide with peace of mind. A certificate of insurance acts as a tangible reminder that it has taken proactive steps to protect the business and assets. It allows focusing on the core operations, knowing that it has coverage in case of unforeseen events or accidents.

15 Risk Mitigation:Insurance coverage is designed to mitigate potential risks and financial losses. A certificate of insurance (COI) serves as evidence that it has taken steps to mitigate risks associated with the operations. It demonstrates the commitment to responsible business practices and can be a valuable asset when seeking new clients or contracts.

16 Building Trust and Relationships:Trust is the foundation of successful business relationships. Providing a certificate of insurance when requested shows transparency and fosters trust between the business and the clients or business partners. It assures them that it has taken the necessary precautions to protect their interests and investments, building strong and long-lasting relationships.

A certificate of insurance is much more than just a document. It offers tangible benefits for the business, including proof of coverage, contract compliance, enhanced reputation, streamlined processes, peace of mind, and fosters the ability to build trust and relationships. By the prioritizing insurance and readily providing a certificate of insurance, the business position as a reliable and responsible professional in the industry. So, don't overlook the importance of a certificate of insurance embrace it as a valuable tool in safeguarding the business and fostering success.

16.4 FINANCING TECHNIQUES

Trade finance is pivotal for maintaining the flow of trade by minimizing the risks associated with global transactions. This section delves into three pivotal financing techniques that offer solutions for exporters and importers to optimize their working capital and secure their trade activities. Financing is the process of providing funds for business activities, making purchases, or investing. Financial institutions, such as banks, are in the business of providing capital to businesses, consumers, and investors to help them achieve their goals. The use of financing is vital in any economic system, as it allows companies to purchase products out of their immediate reach. Trade finance is the term used to describe the tools, techniques, and instruments that facilitate trade and protect both buyers and sellers from trade-related risks. The purpose of trade finance is to make it easier for businesses to transact with each other. It also helps to reduce the risks involved in global trade, for both buyers and sellers.

14.6.1 BANKERS' ACCEPTANCES (B/A)

Bankers' acceptance is an important method of assisting international trade in which a banker accepts 'the time draft' drawn on it by the exporter. By accepting the draft, the bank makes an unconditional promise to pay the holder of the draft a stated amount on a specified date. In this way, by accepting the draft, it creates a negotiable instrument which is freely traded in the money market. Important steps which are taken in creating the banker's acceptance have been discussed here in brief:

- ❖ Firstly, an importer of merchandise seeks credit to finance its purchase until the goods can be resold. For this purpose, he requests the banker (home country) to issue a letter of credit on its behalf, authorising the foreign exporter to draw a 'time draft' on the bank in payment for the goods.
- ❖ Secondly, after getting the authorisation from the importers' bank then the exporter ships the goods on an order bill of lading (B/L) made out to itself and presents a time draft and the endorsed documents to its banker (exporter country bank).
- ❖ Thirdly, the exporter's bank, after that sends all these documents to the importer's bank.
- ❖ **Documents include the time draft, shipping documents, etc. The importer's bank then accepts the draft, and thus, creates a banker's acceptance and sends back to the exporter's banker**
- ❖ Fourthly, the exporter discounts the draft with the accepting bank, and receives payment for the 'shipment.
- ❖ Fifthly, the shipping documents are delivered to the importer and the importer may now claim the shipment.
- ❖ Sixthly, the accepting bank may now either buy (discount) the banker's acceptance (B/ A) and hold it in its own portfolio investment or sell (rediscount) the B/ A in the money market.

The maturities of bankers' acceptances vary and normally range from 30 days to 180 days with the average being 90 days. Maturities should cover the entire period needed to ship and dispose of the goods financed. On the maturity date, the accepting bank will pay the current holder the stated amount on the draft. The holder of B/A can recover his full amount from the last endorser in case the importer is not willing to pay at maturity. Authenticity of B/ A is separated from the underlying transaction and that B / A is not dishonoured for reason of a dispute between the exporter and the importer. As a result, this factor enhances marketability of B/ A and reduce its riskiness.

14.6.2 DISCOUNTING

As we have seen that the trade draft has been accepted by the importer's bank, then draft takes the shape of Banker's acceptance. Even if a trade draft is not accepted by a bank, the exporter can still convert the trade draft into cash by means of 'discounting'. Hence, discounting is another technique of getting funds other than from the importer's bank like financial institutions, or other banks. The exporter gets the amounts of the draft less interest and commission on the same. Normally the shipping documents and other papers are duly insured from an insurance agency against both commercial and political risks. In case of losses, insures will reimburse the exporter or any other financial institution to which the exportee transfers the draft. Discounting is the process of determining the present value of a payment or a stream of payments that is to be received in the future. Given the time value of money, a dollar is worth more today than it would be worth tomorrow. Discounting is the primary factor used in pricing a stream of tomorrow's cash flows.

The discount rate on these papers is normally lower to interest rate on over-draft facilities, bank loans and other funding techniques. This is partly due to government's policy to promote exporters. The discounting can be of two types like with-recourse and without recourse. In case of with recourse, the discounting bank 'can collect from the exporter if the importer fails to pay on the maturity whereas in non-recourse, the bank bears the collection risk of the draft. The types of discount rates commonly used in corporate finance include:

- ❖ **Weighted Average Cost of Capital (WACC)**: Normally used to compute a company's enterprise value.

- **Cost of equity**: Can be used to calculate a company's equity value.
- **Cost of debt**: Used for bond and fixed-income security valuation.
- **A pre-defined hurdle rate**: Generally used in evaluating corporate projects that are internal and to account for the time value of money
- **Risk-free rate**: Used in calculating the cost of equity (as calculated using the CAPM)

14.6.3 FACTORING

Factoring is another important technique of financing foreign trade. In this technique, the firm or exporters sell their accounts receivables to the 'Factor' at a discount to enhance the liquidity. By issuing a factor, a firm can ensure that its terms are in accord with the local practice and are competitive. Usually, under the factoring services customers can be offered payment on open account rather than being asked for a letter of credit or stiffer credit requirements.

Factoring is a type of finance in which a business would sell its accounts receivable (invoices) to a third party to meet its short-term liquidity needs. Under the transaction between both parties, the factor would pay the amount due on the invoices minus its commission or fees. Factoring can be with recourse and non-recourse. In with recourse factoring, the exporter assumes the risks if the debtors do not make payment to the factor whereas in non-recourse factoring, the factor assumes all the credit and political risks except for those involving dispute between the transaction parties. Most factoring in practice is done on the basis of non-recourse. Factor charges a fee for his service rendered to the exporter. Suppose, a business (X) sells goods worth Rs.10,000 to its customers. It sells these invoices to a factor (Y) because it needs quick money for its transactions. Y will purchase the invoices and deduct 5% of this amount towards its commission. This rate is decided between both parties and is usually between 3 to 5%. So, Y earns Rs.500 commission from this transaction. On the remaining amount of Rs.9500, Y may agree to pay 80% immediately and the remaining 20% after X has received its money from its customers as per the payment cycle. In this case, Y pays X 80% of Rs.9,500, which is Rs.7600 immediately.

Factoring provides a quick boost to cashflow. This may be very valuable for businesses that are short of working capital. Advantages are:

- **There are many factoring companies, so prices are usually competitive.**
- **It can be a cost-effective way of outsourcing the sales ledger while freeing up the time to manage the business.**
- **It assists smoother cashflow and financial planning.**
- **Some customers may respect factors and pay more quickly.**
- **Factors may give the useful information about the credit standing of the customers and they can help to negotiate better terms with suppliers.**
- **Factors can prove an excellent strategic - as well as financial - resource when planning business growth.**
- **It will be protected from bad debts if choose non-recourse factoring.**
- **Cash is released as soon as orders are invoiced and is available for capital investment and funding of the next orders.**
- **Factors will credit check the customers and can help the business trade with better quality customers.**

14.6.4 FORFAITING

Forfaiting is another specialised factoring technique used in the case of extreme credit risk. In the field of export financing when the accounts receivable of an exporter are factored whereby the exporter gives up the right to receive payment in favour of forfaiter the transaction is known as forfaiting. In other words, forfaiting is normally without recourse which is discounting of medium term export receivable denominated in fully convertible currencies like US dollar, Swiss, Franc, Pound, deutsche mark etc. This technique is used normally in capital goods exports with a five year maturity and repayments in semi-annual installments.

Forfaiting is a method of trade finance that allows exporters to obtain cash by selling their medium and long-term foreign accounts receivable at a discount to a forfaiter, a specialized finance firm or a department in a bank. Forfaiting can help exporters improve cash flow, particularly when pursuing sales to foreign buyers who depend on longer financing terms which can stretch for months or years. Factoring involves the sale of trade receivables to a factor, typically a bank, in exchange for immediate cash payment. On the other hand, forfaiting is a form of export financing where the exporter sells the rights to trade receivables to a forfaiter and receives instant cash. Forfaiting is a relatively straightforward process, typically involving the following steps:

- The exporter and importer agree on the terms of the sale, including the payment terms.
- The exporter applies to a forfaiter for financing.
- The forfaiter evaluates the creditworthiness of the importer and the transaction.
- If the forfaiter approves the financing, the exporter and forfaiter enter into a forfaiting agreement.
- The exporter transports the merchandise to the importer.
- The importer signs and delivers to the forfaiter a series of bills of exchange or promissory notes, representing the amount of the receivables.
- The forfaiter disburses the cash proceeds of the forfaiting transaction to the exporter.
- The importer pays the forfaiter at maturity of the bills of exchange or promissory notes.

14.7 SUMMARY

A fundamental component of trade finance is the meticulous management of documentation, which ensures that transactions are carried out legally, efficiently, and to the satisfaction of all parties involved Exporters, must prepare comprehensive documentation to meet the requirements of banks, buyers, and customs authorities. Insurance certificates are important to reassure the buyer that goods are covered against loss or damage during transport. For importers, obtaining the right documentation is essential for proving ownership and clearing goods through customs. The **insurance certificate** must accompany the relevant risks covered and terms that match the sales contract.

A bill of lading is a legal document issued by a carrier to a shipper that details the type, quantity, and destination of the goods being carried. A bill of lading is a document of title, a receipt for shipped goods, and a contract between a carrier and a shipper.This document must accompany the shipped goods and must be signed by an authorized representative from the carrier, shipper, and receiver. A commercial invoice is a document that a seller provides to a buyer to request payment for goods or services. Under Indian Law, a commercial invoice must be raised during the shipment or delivery of the goods or services. In addition to facilitating customs clearance, a commercial invoice serves as proof of the transaction. So, in case of any disputes or discrepancies, it has a legal record of the agreement. The main requirement for a Certificate of Origin is for clearing customs. If the goods, exported/imported do not come with a Certificate of Origin, the Customs officer tasked with checking the goods will not allow the goods to leave the warehouse. The Certificate of Origin is used by the Customs officer to determine the duties that have to be paid and to check whether the goods being exported/imported are illegal.

A certificate of insurance (COI) is a document issued by an insurance company or broker. The COI verifies the existence of an insurance policy and summarizes the key aspects and conditions of the policy.A certificate of insurance (COI) is issued by an insurance company or broker and verifies the existence of an insurance policy. Trade finance is the term used to describe the tools, techniques, and instruments that facilitate trade and protect both buyers and sellers from trade-related risks. The purpose of trade finance is to make it easier for businesses to transact with each other. It also helps to reduce the risks involved in global trade, for both buyers and sellers. And also in this lesson discussed very detailed the financial techniques like banker's acceptance, discounting, advantages of factoring and various steps of Forfaiting.

14.8 KEY WORDS

- Documentary: Documentary means that documents form the basis for concluding some agreed upon action or requirement between the parties to a transaction.
- Bill of Lading: A bill of lading is a legal document issued by a carrier to a shipper that details the type, quantity, and destination of the goods being carried. A bill of lading is a document of title, a receipt for shipped goods, and a contract between a carrier and a shipper.This document must accompany the shipped goods and must be signed by an authorized representative from the carrier, shipper, and receiver. If managed and reviewed properly, a bill of lading can help prevent asset theft. There are different types of bills of lading, so it's important to choose the right one.
- Commercial Invoice: A commercial invoice is a document that a seller provides to a buyer to request payment for goods or services. Under Indian Law, a commercial invoice must be raised during the shipment or delivery of the goods or services. In addition to facilitating customs clearance, a commercial invoice serves as proof of the transaction.
- Certificate of origin (CO): A certificate of origin (CO) records the country of origin that an imported good has come from. The CO is often mandated by importing countries and included in trade agreements, as it is used to levy the appropriate import tax, if any.Preferred COs are truncated versions that verify they qualify under a free-trade agreement.
- Tariff Preferences: One of the significant advantages of a Certificate of Origin is its role in obtaining tariff preferences and reducing import duties. Many countries offer preferential tariffs on products from specific countries or under certain trade agreements. With a valid CO, exporters can take advantage of these tariff concessions, making their products more competitive globally.
- Certificate of insurance: A certificate of insurance might be requested in various situations, such as when entering into a contract or agreement. For example, contractors or service providers may be required to provide a certificate of insurance to demonstrate that they have the necessary business insurance to protect against potential risks or liabilities associated with their work. A certificate of insurance (COI) is a document issued by an insurance company or broker.
- Risk Mitigation: For businesses, a COI is a valuable tool for managing risk. It helps ensure that third parties are aware of the insurance coverage in place and that they will be protected in case of accidents, injuries, property damage, or other unforeseen events.
- Bankers' acceptance: It is an important method of assisting international trade in which a banker accepts 'the time draft' drawn on it by the exporter. By accepting the draft, the bank makes an unconditional promise to pay the holder of the draft a stated amount on a specified date.
- Factoring: It is another important technique of financing foreign trade. In this technique, the firm or exporters sell their accounts receivables to the 'Factor' at a discount to enhance the liquidity. By issuing a factor, a firm can ensure that its terms are in accord with the local practice and are competitive.

- Forfaiting: Forfaiting is a method of trade finance that allows exporters to obtain cash by selling their medium and long-term foreign accounts receivable at a discount to a forfaiter, a specialized finance firm or a department in a bank.

14.9 SELF-ASSESSMENT QUESTIONS

1. Definedocumentationintrade? Whatarethemaindocumentsinforeigntrade?
2. Whatisbilloflading? Whatarethetypesofbilloflading?
3. Whatdounderstandaboutcommercialinvoice? Listthecomponentsofcommercialinvoiceinbusiness?
4. Define**certificate of origin?** What are benefits of certificate of origin?
5. What is insurance certificate? Whatisthe importance of a certificate of insurance?
6. Explain the various financing techniques in foreign trade?

14.10 FURTHER READINGS

- Foreign Exchange in Practice, The New Environment
- Exchange Rates and International Finance by Laurence S. Copeland , Pearson.
- Foreign Exchange by Weithers Tim, John Wiley & Sons Inc

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