

PERIYAR UNIVERSITY

(NAAC 'A++' Grade with CGPA 3.61 (Cycle - 3))

State University - NIRF Rank 59 - NIRF Innovation Band of 11-50)

SALEM - 636 011

**CENTRE FOR DISTANCE AND ONLINE EDUCATION
(CDOE)**

**MASTER OF COMMERCE
SEMESTER – III**



**ELECTIVE COURSE: INTERNATIONAL
FINANCIAL MANAGEMENT**
(Candidates admitted from 2024 onwards)

PERIYAR UNIVERSITY

CENTRE FOR DISTANCE AND ONLINE EDUCATION (CDOE)

M.Com 2023 -2024 onwards

Elective - V B

International Financial Management

Prepared by:

Centre for Distance and Online Education
Periyar University
Salem - 636011

Course Code	Title of the Course	Category	L	T	P	O	Credits	Inst. Hours	Marks		
									CIA	External	Total
23UPCO M3E10	INTERNATIONAL FINANCIAL MANAGEMENT		5	-	-	-	3	5	25	75	100
Course Objectives											
1	To understand the importance and nature of international flow of funds										
2	To gain knowledge on the various features and transactions in the foreign exchange market										
3	To analyse the techniques of international investment decisions for building a better portfolio										
4	To understand the flow of funds in the international banks										
5	To become familiar with various international instruments										

SYLLABUS**UNIT I (12 hrs)****International Financial Management**

International Financial Management: An overview – Importance – Nature and Scope – International flow of Funds – Balance of Payments – International Monetary System.

UNIT II(12 hrs)**Foreign Exchange Market**

Foreign Exchange Market: Features – Spot and Forward Market – Exchange Rate Mechanism – Exchange Rate determination in the Spot and Forward Markets – Factors Influencing Exchange Rate – Salient Features of FEMA – Market for Currency Futures and Currency Options – Hedging with Currency Future and Options.

UNIT III**(12 hrs)****International Investment Decision**

Foreign Direct Investment – International Capital Budgeting – International Portfolio Investment: Meaning – Benefit of International Portfolio Investment – Problem of International Investment.

UNIT IV (12 Hrs)**International Financial Decisions**

Overview of the International Financial Market – Channels for International Flow of Funds – Role and Functions of Multilateral Development Banks – International Banking: Functions – Credit Creation – Control of International Banks.

UNIT V**(12 hrs)****International Financial Market Instruments**

Short-term and Medium-term Instruments – Management of Short-term Funds – Management of Receivables and Inventory – Factors behind the Debt Crisis.

Course out comes: Students will be able to

CO No.	CO Statement	Knowledge level

CO 1	Explain the importance and nature of international flow of funds	K2
CO 2	Analyse the fluctuations in exchange rate and impact on exchange markets	K4
CO 3	Analyse the techniques of international investment decisions for building a better portfolio	K4
CO 4	Explain the flow of funds in the international banks	K2
CO 5	Examine various international financial market instruments	K4

Books for study:

1. Vyuptakesh Sharan, (2010), "International Financial Management" 6th Edition, Prentice Hall India Learning Pvt. Ltd, Delhi
2. Seth A K and Malhotra S K, (2000), "International Financial Management" 2nd Edition, Galgotia Publishing Company, Delhi
3. Agarwal O P, (2021), "International Financial Management" 3rd Edition, Himalaya Publishing House Pvt Ltd, Mumbai
4. Apte P G, (2006), "International Financial Management" 4th Edition, MCGraw Hill (India) Pvt. Ltd., Noida, Uttar Pradesh
5. Varshney R L and Bhashyam S (2016), "International Financial Management An Indian Perspective", Sultan Chand & Sons, New Delhi

Books for reference:

1. Jeevanandam C, (2020), "Foreign Exchange Practice Concepts and Control", 17th Edition, Sultan Chand & Sons, New Delhi
2. Kevin S, (2022), "Fundamentals of International Financial Management" 2nd Edition, Prentice Hall India Learning Pvt. Ltd, Delhi
3. Amuthan R, (2021), "International Financial Management" 3rd Edition, Himalaya Publishing House Pvt Ltd, Mumbai
4. Bhalla V K (2014), "International Financial Management (Text and Cases)", Sultan Chand & Sons, New Delhi

Web references:

1. <https://iare.ac.in/sites/default/files/LECTURE%20NOTES-IFM.pdf>
2. <https://www.bauer.uh.edu/rsusmel/4386/ifm%20-%20lecture%20notes.pdf>
3. https://ebooks.lpude.in/management/mba/term_4/DMGT549_INTER_NATIONAL_FINANCIAL_MANAGEMENT.pdf

Note: Latest edition of the books may be used

Mapping of course outcomes with POs and PSOs

	POs						PSOs		
	1	2	3	4	5	6	1	2	3
CO 1	1	2	2	3	2	2	2	1	2
CO 2	1	2	2	3	2	2	2	1	2
CO 3	2	3	2	3	2	2	2	2	2
CO 4	1	2	2	3	2	2	2	1	2
CO 5	2	3	2	3	2	2	2	2	2

High – 3

Medium – 2

Low – 1



PERIYARUNIVERSITY

(Re-accredited with "A++" Grade by NAAC)

SALEM-636 011

**CENTRE FOR DISTANCE AND ONLINE EDUCATION
(CDOE)- ONLINE DEGREE PROGRAMMES
MASTER OF COMMERCE – M.COM
III SEMESTER -INTERNATIONAL FINANCIAL MANAGEMENT**

UNIT 1- International Financial Management

International Financial Management (IFM) is a branch of financial management that deals with the financial decisions and operations of multinational corporations, institutions, and governments operating in a global environment. It involves managing various financial aspects of international business, such as foreign investments, international trade, currency exchange rates, and global capital flows.

Section	Financial Management	PPT	VIDEO
1.1			
1.1.1	Meaning and definition of finance Management		
1.1.2	Nature of Financial Management		
1.1.3	Finance and other related disciplines		
Section 1.2	International Financial Management		
1.2.1	Meaning and definition of International financial management		
1.2.2	Objectives of International Financial Management		
1.2.3	Concept of international financial management:		
1.2.4	Nature of international financial management		

1.2.5	Scope of international financial management		
1.2.6	Importance of international financial management		
1.2.7	Domestic and offshore markets:		
1.2.8	Role of international financial manager		
1.2.9	Changes in global financial markets:		
1.2.10	Challenges in international financial management:		
Section 1.3	Balance of Payments		
1.3.1	Features of balance of payment		
1.3.2	Importance of Balance Of Payments		
1.3.3	Types of Balances		
1.3.4	Disequilibrium In The Balance Of Payments		
1.3.5	Measures To Correct Disequilibrium in the BOP		
1.3.6	Reasons for poor performance of India's export trade		
Section-1.4	International monetary system		
1.4.1	Formation of IMF		
1.4.2	Organizational structure of international monetary fund (IMF)		
1.4.3	Objectives of the IMF		
1.4.4	Functions of the IMF		
1.4.5	India & IMF		
1.4.6	Features and historical developments of the international monetary system:		
1.4.7	Emerging dimensions of international financial markets		

1.5	Unit-Summary		
	Check your progress		
1.6	Glossary		
1.7	Self-Assessment questions		
1.8	Reference		
Unit 2- Foreign Exchange Market			
The foreign exchange market or forex market is the market where currencies are traded. The forex market is the world's largest financial market where trillions are traded daily. It is the most liquid among all the markets in the financial world.			
Section 2.1	Foreign exchange Market	PPT	Video
2.1.1	Meaning and definition of foreign exchange markets		
2.1.2	Features of the foreign exchange market		
2.1.3	Structure of foreign exchanges markets		
2.1.4	Types of exchanges rate		
2.1.5	Exchange rate quotations:		
2.1.6	Nominal and real exchange rate in financial decision:		
Section 2.2	FEMA		
2.2.1	Meaning and definition of FEMA		
2.2.2	Objectives of FEMA		
2.2.3	FEMA Act (Foreign Exchange Management Act) – Classification		
2.2.4	Features of FEMA		
2.2.5	Primary Goal of FEMA		
Section 2.3	Provisions of FEMA Act 1999		
2.3.1	Penalty Under FEMA Act		
2.3.2	Categories of Authorized Persons under FEMA		
2.3.3	Importance of FEMA in India		
2.4	Unit -Summary		
2.5	Check your progress		
2.6	Glossary		
2.7	Self -Assessment questions		
2.8	Reference:		

Unit -3 International investments Decision

It also serve as a means of adding different financial instruments to the list when domestic markets are confined and limited by their variety. International investments aim to assure investors of two probabilities; the counter of domestic market risks and the opportunities in foreign markets.

Section 3.1.	International investments		
3.1.2	Foreign Direct Investment (FDI):		
3.1.3	Meaning and Concept of Foreign Direct Investment		
3.1.4	Forms of FDI		
3.1.5	Foreign Direct Investment brings several benefits to both the host country and the investing entity:		
3.1.6	FDI has a significant impact on host countries:		
3.1.7	How Does Foreign Direct Investment (FDI) Work?		
3.1.8	Types of FDI		
3.1.9	Advantages of Foreign Direct Investments		
3.1.10	Disadvantages of Foreign Direct Investment		
Section 3.2	International Capital Budgeting		
3.2.1	Introduction to International Capital Budgeting		
3.2.2	Importance of International Capital Budgeting		
3.2.3	Factors Affecting International Budgeting		
3.2.4	Influence of Inflation on Capital Budgeting Decisions		
3.2.5	Benefits of International Capital Budgeting		
Section 3.3	International Portfolio		
3.3.1	Understanding the International Portfolio		
3.3.2	About Foreign Portfolio Investments		
3.3.3	Differences between FPI and FDI		
3.3.4	Advantages and Disadvantages of an International Portfolio		
3.4	Unit-summary		
3.5	Check your progress		

3.6	Glossary		
3.7	Self Assessment		
Unit-4 International Financial Decision			
The financing decision depends upon two main criteria: cost and risks assumed by the company. This paper will discuss the solution in this case to compare different international financing opportunities that are expressed in different currencies from the perspective of a debtor (company).			
Section 4.1	Understanding International Finance		
4.1.1	Nature of International Finance		
4.1.2	Principles of International Finance		
4.1.3	Importance of Managing International Finance		
4.1.4	Types of International Financial Markets		
Section 4.2	International Monetary Fund (IMF)		
4.2.1	International flow of funds		
4.2.2	Types of International Capital Movements		
4.2.3	Factors Influencing International Flow of Funds		
4.2.4	Significance of International Flow of Funds		
4.2.5	Importance of International Flow of Funds		
4.3.	What is a Multilateral Development Bank (MDB)?		
4.3.1	Understanding Multilateral Development Banks		
4.3.2	Importance of MDBs		
4.3.3	Multilateral development finance in context		
4.3.4	Funding to the multilateral development system		
4.3.5	Criticisms of Multilateral Development Banks		
Section 4.4	International Banking		
4.4.1	Understanding the International Banking System		
4.4.2	Functions of International Banking		
4.4.3	Types of International Banking Offices		
4.4.4	International Banking Services		
4.4.5	Types of International Banks		
4.5	Credit Creation		
4.5.1	Basic Concepts of Credit Creation`		
4.5.2	Credit Creation		
4.5.3	Understanding Credit Creation in the Financial Sector		

4.5.4	Understanding the Process of Bank Credit Creation		
4.5.5	Credit Creation Theory in Macroeconomics		
4.5.6	Deep Dive into The Process of Credit Creation		
Section 4.6	International Bank		
4.6.1	International Banking Services		
4.6.2	Overview of International Bank Activities		
4.6.3	Internal Control Objectives		
4.7	Check your progress		
4.8	Glossary		
4.9	Self - Assessment		
4.10	Reference		
Unit 5 – International Financial Markets and Instruments			
International financial instruments include bonds, notes, and equity-like instruments used across borders. Some key types discussed are: 1. International bonds such as foreign bonds, Eurobonds, global bonds, straight bonds, convertible bonds, and floating rate notes.			
Section 5.1	Meaning of International Financial Markets		
5.1.1	Segments of International Financial Markets		
5.1.2	Instruments of International Financial Markets...		
5.1.3	Need for GDR issues by Indian Companies		
5.1.4	Parties to GDRs		
5.1.5	Steps in issue of GDRs		
Section 5.2	Varieties of Global Debt Instrument		
5.2.1	Types of Certificates of Deposits		
5.2.2	Euro Credits		
5.2.3	Euro Loan Syndication		
5.2.4	Unique features of syndicated loans		
5.2.5	Concepts of Loan Syndication		
5.2.6	Euro Bonds		
5.2.7	Types of Bonds		
5.2.8	Commercial Papers		
Section 5.3	In International financial markets- short-term and medium-term		
5.3.1	Short term services of International financial transaction		
5.3.2	International Financial System-Short Term		
5.3.3	Sources of Financing		
Section 5.4	International receivables and		

	inventory management		
5.4.1	Meaning and objectives of receivable management		
5.4.2	Objectives of Receivable Management:		
5.4.3	Cost and Benefits of Receivables		
5.4.4	Inventory Management		
5.4.5	Principle of Inventory Management		
5.4.6	Benefits of holding Inventory		
Section 5.5	Credit Policy in Receivable Management		
5.5.1	Concept of credit policy		
5.5.2	Types of credit policy		
5.5.3	Setting a Credit Policy		
5.5.4	Techniques of the Inventory Management		
5.6	Unit-Summary		
5.7	Check your progress		
5.8	Glossary		
5.9	Self-Assessment Questions		

SELF-LEARNING MATERIAL

INTERNATIONAL FINANCIAL MANAGEMENT

In this unit, learners will have a comprehensive understanding of financial management and financial institutions, including their roles, functions, and the impact they have on the economy. Learners will be able to analyse different types of financial institutions, understand the range of financial services they provide, and evaluate the regulatory environment in which these institutions operate.



INTRODUCTION:

Finance is called “The science of money”. It studies the principles and the methods of obtaining control of money from those who have saved it, and of administering it by those into whose control it passes. Finance was a branch of Economics till 1890. Economics is defined as study of the efficient use of scarce

resources. The decisions made by business firm in production, marketing, finance and personnel matters form the subject matters of economics

Finance is the process of conversion of accumulated funds to productive use. It is so intermingled with other economic forces that there is difficulty in appreciating the role it plays.

MEANING AND DEFINITION OF FINANCE:

Howard and Uptron in his book Introduction to Business Finance defined, “as that administrative area or set of administrative function in an organization which relate with the arrangement of cash and credit so that the organization may have the means to carry out its objectives as satisfactorily as possible”.

In simple terms finance is defined as the activity concerned with the planning, raising, controlling and administering of the funds used in the business. Thus, finance is the activity concerned with the raising and administering of funds used in business.

1.1.1 MEANING AND DEFINITION OF FINANCIAL MANAGEMENT:

Financial management is managerial activity which is concerned with the planning and controlling of the firm’s financial resources.

Definitions:

Howard and Uptron define financial management “as an application of general managerial principles to the area of financial decision-making”.

Weston and Brigham define financial management “as an area of financial decision making, harmonizing individual motives and enterprise goal”

“Financial management is concerned with the efficient use of an important economic resource, namely capital funds” - **Solomon Ezra & J. John Pringle.**

“Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient business operations”- **J.L. Massie.**

“Financial Management is concerned with managerial decisions that result in the acquisition and financing of long-term and short-term credits of the firm. As such it deals with the situations that require selection of specific assets (or combination of assets), the selection of specific liability (or combination of liabilities) as well as the problem of size and growth of an enterprise. The analysis of these decisions is based on the expected inflows and outflows of funds and their effects upon managerial objectives”. - **Phillippatus.**

1.1.2 Nature of Financial Management

The nature of financial management refers to its relationship with related disciplines like economics and accounting and other subject matters.

The area of financial management has undergone tremendous changes over time as regards its scope and functions. The finance function assumes a lot of significance in the modern days in view of the increased size of business operations and the growing complexities associated thereto.

1.1.3 FINANCE AND OTHER RELATED DISCIPLINES

Financial management, is an integral part of the over all management, on other disciplines and fields of study like economics, accounting, production, marketing, personnel and quantitative methods. The relationship of financial management with other fields of study is explained as under:

- Economics
- Corporate Finance
- Responsibility
- Cost Accounting
- Financial Accounting
- Business Finance
- Transactional Accounting
- Management Accounting
- Human Resource Accounting

Finance and Economics

Finance is a branch of economics. Economics deals with supply and demand, costs and profits, production and consumption and so on. The relevance of economics to financial management can be described in two broad areas of economics i.e., micro economics and macroeconomics.

Micro economics deals with the economic decisions of individuals and firms. It concerns itself with the determination of optimal operating strategies of a business firm. These strategies include profit maximization strategies, product pricing strategies, strategies for valuation of firm and assets etc. The basic principle of micro economics that applies in financial management is marginal analysis. Most of the financial decisions should be made taken into account the marginal revenue and marginal cost. So, every financial manager must be familiar with the basic concepts of micro economics.

Macro economics deals with the aggregates of the economy in which the firm operates. Macro economics is concerned with the institutional structure of the banking system, money and capital markets, monetary, credit and fiscal policies etc. So, the financial manager must be aware of the broad economic environment and their impact on the decision-making areas of the business firm.

Finance and Accounting:

Accounting and finance are closely related. Accounting is an important input in financial decision-making process. Accounting is concerned with recording of business transactions. It generates information relating to business transactions and reporting them to the concerned parties.

The end product of accounting is financial statements namely profit and loss account, balance sheet and the statements of changes in financial position. The information contained in these statements assists the financial managers in evaluating the past performance and future direction of the firm (decisions) in meeting certain obligations like payment of taxes and so on. Thus, accounting and finance are closely related

Finance and Production:

Finance and production are also functionally related. Any changes in production process may necessitate additional funds which the financial managers must evaluate

and finance. Thus, the production processes, capacity of the firm are closely related to finance

Finance and Marketing:

Marketing and finance are functionally related. New product development, sales promotion plans, new channels of distribution, advertising campaign etc. in the area of marketing will require additional funds and have an impact on the expected cash flows of the business firm. Thus, the financial manager must be familiar with the basic concept of ideas of marketing.

Finance and Quantitative Methods:

Financial management and Quantitative methods are closely related such as linear programming, probability, discounting techniques, present value techniques etc. are useful in analyzing complex financial management problems. Thus, the financial manager should be familiar with the tools of quantitative methods. In other way, the quantitative methods are indirectly related to the day-to-day decision making by financial managers

Finance and Costing:

Cost efficiency is a major strategic advantage to a firm, and will greatly contribute towards its competitiveness, sustainability and profitability. A finance manager has to understand, plan and manage cost, through appropriate tools and techniques including Budgeting and Activity Based Costing.

Finance and Law:

A sound knowledge of legal environment, corporate laws, business laws, Import Export guidelines, international laws, trade and patent laws, commercial contracts, etc. are again important for a finance executive in a globalized business scenario. For example, the guidelines of Securities and Exchange Board of India [SEBI] for raising money from the capital markets.

Similarly, now many Indian corporate are sourcing from international capital markets and get their shares listed in the international exchanges. This calls for sound

knowledge of Securities Exchange Commission guidelines, dealing in the listing requirements of various international stock exchanges operating in different countries.

Finance and Taxation:

A sound knowledge in taxation, both direct and indirect, is expected of a finance manager, as all financial decisions are likely to have tax implications. Tax planning is an important function of a finance manager. Some of the major business decisions are based on the economics of taxation. A finance manager should be able to assess the tax benefits before committing funds. Present value of the tax shield is the yardstick always applied by a finance manager in investment decision.

Finance and Treasury Management:

Treasury has become an important function and discipline, not only in banks, but in every organization. Every finance manager should be well grounded in treasury operations, which is considered as a profit center. It deals with optimal management of cash flows, judiciously investing surplus cash in the most appropriate investment avenues, anticipating and meeting emerging cash requirements and maximizing the overall returns, it helps in judicial asset liability management. It also includes, wherever necessary, managing the price and exchange rate risk through derivative instruments. In banks, it includes design of new financial products from existing products.

Finance and Banking:

Banking has completely undergone a change in today's context. The type of financial assistance provided to corporate has become very customized and innovative. During the early and late 80's, commercial banks mainly used to provide working capital loans based on certain norms and development financial institutions like ICICI, IDBI, and IFCI used to provide long term loans for project finance. But, in today's context, these distinctions no longer exist. Moreover, the concept of development financial institutions also does not exist any longer.

The same bank provides both long term and short term finance, besides a number of innovative corporate and retail banking products, which enable corporate to choose between them and reduce their cost of borrowings. It is imperative for every finance manager to be up-to date on the changes in services & products offered by banking

sector including several foreign players in the field. Thanks to Government's liberalized investment norms in this sector.

Finance and Insurance:

Evaluating and determining the commercial insurance requirements, choice of products and insurers, analyzing their applicability to the needs and cost effectiveness, techniques, ensuring appropriate and optimum coverage, claims handling, etc. fall within the ambit of a finance manager's scope of work & responsibilities.

International Finance:

Capital markets have become globally integrated. Indian companies raise equity and debt funds from international markets, in the form of Global Depository Receipts (GDRs), American Depository Receipts (ADRs) or External Commercial Borrowings (ECBs) and a number of hybrid instruments like the convertible bonds, participatory notes etc., Access to international markets, both debt and equity, has enabled Indian companies to lower the cost of capital. For example, Tata Motors raised debt as less than 1% from the international capital markets recently by issuing convertible bonds.

Finance managers are expected to have a thorough knowledge on international sources of finance, merger implications with foreign companies, Leveraged Buy Outs (LBOs), acquisitions abroad and international transfer pricing. The implications of exchange rate movements on new project viability have to be factored in the project cost and projected profitability and cash flow estimates. This is an essential aspect of finance manager's expertise. Similarly, protecting the value of foreign exchange earned, through instruments like derivatives, is vital for a finance manager as the volatility in exchange rate movements can erode in no time, all the profits earned over a period of time.

Finance and Information Technology:

Information technology is the order of the day and is now driving all businesses. It is all pervading. A finance manager needs to know how to integrate finance and costing with operations through software packages including ERP. The finance manager takes an active part in assessment of various available options, identifying the right one and in the implementation of such packages to suit the requirement.

1.2.1 Meaning of International financial management

International financial management, also known as [international finance](#), is the management of finance in an international business^[1] environment; that is, trading and making money through the exchange of foreign currency. The international financial activities help the organizations to connect with international dealings with overseas business partners- customers, [suppliers](#), lenders etc. It is also used by government organization and non-profit institutions.

History and background

During the post-war years, the [GATT](#) was established to improve trade. It removed the trade barriers notably over the years, as a result of which international trade grew manifold. The financial participation of the trader's exporters and importers and the international transactions flowed significantly. It started when different countries started "liberalizing" i.e. when countries agreed to open doors for each other and traded. The advancement of technology and liberalization resulted in the idea of financial management both domestically and globally.

Definition of International Financial Management:

International Financial Management refers to the planning, organizing, and controlling of finances in the context of multinational corporations (MNCs) . It involves making investment and financing decisions in the international business environment.

Domestic vs international financial management (IFM)

Financial Systems may be classified as domestic or overseas, closed or open. A 'domestic' is one inside a country. Thus, financial system in the United States, is an international financial system from the India's view. The mean and objective of both domestic and international financial management remains the same but the dimensions and dynamics broaden drastically.

Foreign currency, market imperfections, enhanced opportunity sets and political risks are four broader heads under which IFM can be differentiated from financial management (FM). The goal of IFM is not only limited to maximization of [shareholders](#) but also [stakeholders](#).

1.2.2 OBJECTIVES OF INTERNATIONAL FINANCIAL MANAGEMENT

The primary objectives of international financial management are to maximize shareholder wealth, minimize financial risks, and optimize the allocation of financial resources across different countries and currencies. Some key areas within international financial management include:

1.Foreign Exchange Management:

This involves dealing with the exchange of currencies to facilitate international trade and investment. It includes managing foreign exchange risk and exposure due to fluctuating exchange rates.

2.International Investment Decisions:

Companies often invest in foreign markets to expand their operations and diversify their risks. International financial managers assess the feasibility and profitability of such investments and determine the appropriate financing methods.

3.Financing Decisions:

International financial managers have to decide how to raise capital for global operations, whether through local borrowing, international debt issuance, or equity financing.

4.International Trade and Payment Mechanisms:

Companies engaged in global trade must handle various payment methods, such as letters of credit, trade finance, and international payment systems.

5.Political and Country Risk Management:

Operating in different countries exposes businesses to various political, economic, and regulatory risks. International financial managers evaluate and mitigate these risks to safeguard the company's interests.

6.Multinational Treasury Management:

This involves managing cash and liquidity across different countries to optimize working capital and minimize transaction costs.

7.International Taxation:

Companies with global operations need to navigate complex international tax laws to ensure compliance and efficiency in tax planning.

8.Financial Reporting and Compliance:

International financial managers must comply with accounting standards and reporting requirements in different jurisdictions while also addressing currency translation and consolidation issues.

Overall, international financial management is essential for companies and organizations with international operations to navigate the complexities of the global financial landscape and make sound financial decisions that promote sustainable growth and profitability

1.2.3 Concept of international financial management

The concept of international financial management revolves around managing financial resources and making financial decisions in a global business environment. It involves dealing with various complexities and challenges that arise when businesses operate across national borders and engage in international trade, investments, and financial transactions. Here are some key concepts related to international financial management:

1.Foreign Exchange and Exchange Rate Risk:

One of the fundamental aspects of international financial management is dealing with foreign exchange rates. Companies engaged in international trade and investment are exposed to exchange rate fluctuations, which can impact their profitability and cash flows. International financial managers must assess and manage this exchange rate risk to protect the company from adverse currency movements.

2.Cross-Border Investment:

International financial management encompasses the decision-making process for investing in foreign assets or starting operations in other countries. Evaluating the risks and returns associated with cross-border investments is crucial for maximizing shareholder value.

3. International Capital Budgeting:

When evaluating investment projects in different countries, international financial managers need to consider various factors, including differences in inflation rates, tax laws, regulatory environments, and repatriation restrictions.

4. Global Financing Options:

International financial managers need to decide on the optimal mix of financing sources, considering factors such as availability, costs, and risks associated with domestic and international debt and equity markets.

5. International Trade Finance:

International financial management involves handling the financial aspects of international trade transactions, such as letters of credit, trade financing, and export-import financing.

6. Political and Country Risk Management:

Operating in multiple countries exposes businesses to political, economic, and country-specific risks. International financial managers must analyze and mitigate these risks to protect the company's interests and investments.

7. Global Liquidity and Cash Management:

Managing cash flows and liquidity across different countries can be complex. International financial managers must efficiently allocate funds to meet financial obligations and investment opportunities worldwide.

8. Transfer Pricing and Taxation:

For multinational corporations, transfer pricing becomes crucial to determine prices for goods and services exchanged between related entities in different countries.

International financial managers must also navigate international tax laws and treaties to optimize tax efficiency.

9. Financial Reporting and Accounting Standards:

Companies with international operations must comply with various accounting standards and reporting requirements in different jurisdictions. International financial managers deal with the challenges of consolidating financial statements, handling currency translation, and complying with international financial reporting standards.

10. International Regulatory Compliance:

Operating across borders often involves adhering to different regulatory frameworks, such as foreign investment regulations, trade policies, and anti-money laundering laws. International financial managers must ensure compliance with these regulations.

In summary, international financial management is a multidimensional field that requires an understanding of global financial markets, risk management techniques, and an ability to navigate through diverse regulatory environments. It aims to enable businesses to optimize their financial decisions, minimize risks, and create value in an increasingly interconnected and dynamic global economy.

1.2.4 Nature of international financial management

The nature of international financial management is dynamic and multifaceted, characterized by various features and challenges that arise from operating in a global business environment. Some key aspects that define the nature of international financial management include

❖ Global Operations:

International financial management deals with the financial decisions and operations of companies that have a presence in multiple countries. These companies engage in cross-border trade, investments, and financing, which requires a comprehensive understanding of international financial markets and regulations.

❖ Foreign Exchange Exposure:

Operating in different countries exposes businesses to foreign exchange rate fluctuations. International financial managers must assess and manage exchange rate risk to mitigate the impact of currency movements on financial performance.

❖ **Multinational Capital Budgeting:**

International financial management involves evaluating investment projects in various countries, considering factors like different inflation rates, tax laws, and political stability. Decisions on resource allocation need to consider diverse economic and financial conditions.

❖ **Political and Country Risks:**

Companies operating internationally face geopolitical, regulatory, and economic risks specific to each country. International financial managers must analyze and manage these risks to protect the organization's interests and assets.

❖ **Global Financial Markets:**

International financial management requires a deep understanding of global financial markets, including equity markets, debt markets, and foreign exchange markets. It involves raising capital from diverse sources and managing investments in a global context.

❖ **International Trade Finance:**

Managing trade transactions involving different currencies requires expertise in trade finance instruments, such as letters of credit, bills of exchange, and trade insurance.

❖ **Diverse Regulatory Environments:**

Companies operating across borders must comply with various financial regulations, tax laws, and reporting standards in different jurisdictions. International financial managers must navigate these complexities while ensuring compliance.

❖ **Transfer Pricing:**

Multinational corporations often engage in transfer pricing, determining prices for goods and services exchanged between related entities in different countries. International financial managers must ensure that transfer pricing practices are consistent with regulations and arm's length principles.

❖ **Hedging and Risk Management:**

Given the inherent uncertainties in global markets, international financial management involves using hedging strategies and risk management techniques to protect against adverse events and stabilize cash flows.

❖ **Ethical and Social Responsibility:**

International financial managers face ethical dilemmas concerning social responsibility, sustainability, and fair business practices, especially when dealing with countries with different ethical standards and environmental regulations.

❖ **Currency Translation and Consolidation:**

Companies with foreign subsidiaries must consolidate financial statements, considering currency translation effects. International financial managers deal with the complexities of converting financial results into a common reporting currency.

Overall, the nature of international financial management is complex and requires a broad skill set, including financial acumen, knowledge of international markets and regulations, risk management expertise, and a keen awareness of global economic and political dynamics. International financial managers play a crucial role in guiding businesses to make sound financial decisions in an increasingly interconnected world.

1.2.5 Scope of international financial management

The scope of international financial management is broad and continues to expand as global business activities grow in complexity and scale. It encompasses various aspects related to managing financial resources and making financial decisions

in a global business environment. Some key areas within the scope of international financial management include:

1.Global Financial Markets:

Engaging with global financial markets, including foreign equity and debt markets, and accessing international capital.

2.Financial Reporting and Accounting Standards:

Complying with various accounting standards and reporting requirements in different jurisdictions, handling currency translation, and consolidating financial statements.

3.Foreign Direct Investment (FDI):

Analyzing opportunities and challenges related to foreign direct investments and making decisions on establishing subsidiaries or acquiring foreign firms.

4.Currency Risk Management:

Implementing hedging strategies to mitigate risks associated with currency fluctuations, such as forward contracts and currency swaps.

5 International Payment Systems:

Understanding and managing the intricacies of international payment systems and methods, including cross-border fund transfers.

6.International Financial Institutions:

Engaging with international financial institutions like the World Bank, International Monetary Fund (IMF), and regional development banks for financing and risk management.

7.Ethical and Social Responsibility Considerations:

Addressing ethical and social responsibility concerns when conducting business in different countries with varying cultural, ethical, and environmental norms.

The scope of international financial management is not limited to these areas and continues to evolve as global economic and financial landscapes change. International

financial managers must stay abreast of emerging trends, geopolitical developments, technological advancements, and regulatory changes that impact global financial operations. The ability to adapt to dynamic global markets and make informed decisions is essential for success in this field

1.2.6 Importance of international financial management

International financial management holds significant importance for businesses, governments, and financial institutions operating in a globalized world. Some key reasons why international financial management is crucial are:

1.Global Business Expansion:

In today's interconnected world, companies seek to expand their operations internationally to access new markets, resources, and growth opportunities. International financial management helps businesses assess the feasibility and profitability of global expansion while managing financial risks associated with foreign operations.

2.Currency Risk Management:

Operating across different countries exposes businesses to foreign exchange rate fluctuations. International financial management helps companies hedge against currency risk, protecting them from adverse movements that can impact profitability and cash flow. **3.Capital Allocation Optimization:**

International financial management enables efficient allocation of financial resources across various countries and projects. Companies can identify and invest in regions with higher returns and lower risks, maximizing shareholder value.

4. Access to Global Capital:

Multinational corporations often need to raise funds from global financial markets. Effective international financial management facilitates access to diverse sources of capital, including international debt and equity markets.

5.International Trade Facilitation:

For businesses engaged in international trade, financial management helps in navigating trade financing, letters of credit, and payment mechanisms, ensuring smooth cross-border transactions.

6. Risk Diversification:

International financial management allows companies to diversify their risks by operating in different countries and markets. This reduces dependence on a single economy and enhances overall resilience to economic fluctuations.

7. Optimal Tax Planning:

Managing international tax regulations is critical for companies with global operations. International financial management helps businesses structure their operations to optimize tax efficiency and reduce tax liabilities legally.

8. Economic Stability and Development:

For countries, effective international financial management helps attract foreign direct investments (FDIs) and foster economic development. It enables governments to manage international reserves, exchange rates, and foreign debts more prudently.

9. Global Financial Stability:

Given the interconnectedness of financial markets, the effective management of cross-border capital flows and international financial institutions contributes to global financial stability.

10. Global Economic Integration:

International financial management plays a vital role in promoting economic integration and trade relationships between countries, leading to increased prosperity and economic growth.

11. Regulatory Compliance:

Operating in multiple countries requires adherence to diverse financial regulations and reporting standards. International financial management ensures compliance with legal requirements in various jurisdictions.

12.Sustainable Growth:

By managing financial resources efficiently, international financial management contributes to sustainable growth and long-term success for businesses operating on a global scale.

In summary, international financial management is essential for companies and governments to navigate the complexities of the global financial landscape, optimize financial decisions, and achieve their strategic objectives in an increasingly interconnected and dynamic world.

1.2.7 Domestic and offshore markets:

Domestic and offshore markets are two distinct market segments that refer to different geographical locations where financial instruments, assets, and services are traded and offered. Let's explore the differences between these two markets:

Domestic Market:

- The domestic market refers to the financial market within a specific country, where residents and local entities conduct buying and selling of financial assets and securities.
- It operates under the regulatory framework and laws of that particular country and is subject to the jurisdiction of its financial regulatory authorities.
- Domestic markets primarily deal with the local currency and are more accessible to residents and businesses within the country.
- Examples of domestic markets include stock exchanges, bond markets, and money markets operating within a specific country, such as the New York Stock

Exchange (NYSE) in the United States or the London Stock Exchange (LSE) in the United Kingdom.

Offshore Market:

- The offshore market refers to financial activities conducted in a jurisdiction outside the home country of the investor or entity.
- It involves financial transactions, investments, and services that take place in countries with favorable regulations, tax benefits, or privacy laws.
- Offshore markets are often used for international financial operations, including foreign investments, currency trading, and asset protection.
- These markets are typically more accessible to foreign investors and institutions than domestic markets, and they offer unique advantages, such as reduced taxes or less stringent regulations.
- Examples of offshore financial centers include places like the Cayman Islands, Switzerland, Singapore, and Luxembourg, where investors and corporations use offshore accounts and entities for various financial purposes.

Key Differences:

1.Location:

Domestic markets operate within a specific country, while offshore markets exist in a different country or jurisdiction than the investor's home country.

2.Regulatory Framework:

Domestic markets are subject to the regulations and oversight of the home country's financial authorities, while offshore markets may have more lenient regulations and tax benefits.

3.Currency:

Domestic markets primarily deal with the local currency of the country, while offshore markets often facilitate transactions in multiple currencies.

4.Accessibility:

Domestic markets are generally more accessible to local residents and businesses, while offshore markets cater to a broader international clientele.

5. Financial Services:

Offshore markets may offer specialized financial services like offshore banking, tax planning, and asset protection, which are not available in domestic markets.

It's important to note that while offshore markets offer certain advantages, they can also carry higher risks due to potential regulatory differences and reduced transparency. Investors and entities considering offshore financial activities should carefully assess the associated risks and compliance requirements. Additionally, international financial management professionals play a crucial role in navigating the opportunities and challenges presented by both domestic and offshore markets.

1.2.8 Role of International Financial Manager

International financial managers play a crucial role in guiding and overseeing financial decisions and operations of companies, institutions, and governments operating in a global business environment. Their responsibilities encompass various aspects of international finance and require a comprehensive understanding of global markets, regulations, and risks. Some key roles of international financial managers include:

1. Global Investment and Capital Budgeting:

International financial managers assess investment opportunities in different countries, considering factors like risk, return, cashflow, and economic conditions. They evaluate the feasibility of projects and make capital budgeting decisions to allocate resources optimally across various countries and business units.

2. Foreign Exchange Risk Management:

Given the exposure to fluctuating exchange rates, international financial managers employ hedging strategies to manage foreign exchange risk. They implement tools such as forward contracts, currency swaps, and options to mitigate the impact of currency movements on financial performance.

3. International Trade Finance:

International financial managers handle financial aspects of international trade, including trade financing, letters of credit, and managing trade-related risks. They ensure smooth cross-border transactions and compliance with trade regulations.

4.Capital Structure and Financing Decisions:

International financial managers determine the appropriate mix of debt and equity financing for global operations. They assess the costs and risks associated with various financing sources in different countries.

5.Political and Country Risk Assessment:

International financial managers analyze and manage political and country risks associated with operating in different jurisdictions. They stay updated on geopolitical developments and regulatory changes that can impact business operations.

6.Global Treasury Management:

Managing cash flows and liquidity across multiple countries is vital for international businesses. International financial managers optimize working capital, assess funding needs, and ensure efficient cash management across borders.

7.International Tax Planning:

International financial managers navigate complex international tax laws and treaties to optimize tax efficiency. They structure operations to minimize tax liabilities legally while ensuring compliance with relevant regulations.

8.Financial Reporting and Consolidation:

Companies with global operations require financial reporting and consolidation of results from different subsidiaries. International financial managers handle currency translation, compliance with international accounting standards, and consolidation issues.

9.Relationships with International Financial Institutions:

International financial managers interact with international financial institutions like the World Bank, IMF, and regional development banks for financing, risk management, and regulatory compliance.

10.Ethical and Social Responsibility Considerations:

International financial managers address ethical dilemmas related to social responsibility, sustainability, and fair business practices when operating in diverse cultural and regulatory environments.

11.Risk Management and Compliance:

International financial managers implement risk management practices to identify, assess, and mitigate financial risks related to global operations. They ensure compliance with financial regulations in various jurisdictions.

12.Monitoring Economic and Financial Trends:

International financial managers continuously monitor global economic and financial trends, political developments, and technological advancements to adapt financial strategies accordingly.

Overall, international financial managers play a vital role in guiding businesses and institutions through the complexities of international finance. They must possess a comprehensive understanding of global financial markets, risk management techniques, international regulations, and the ability to make informed financial decisions that promote sustainable growth and profitability in a constantly evolving global landscape.

1.2.9 Changes in global financial markets

As of my last update in September 2021, global financial markets were continuously evolving due to various factors and events. However, it's important to note that the financial landscape is highly dynamic, and significant changes might have occurred since then. Some of the key changes that were observed or anticipated in global financial markets as of September 2021 include.

1.Pandemic Impact:

The COVID-19 pandemic had a profound impact on global financial markets. Governments and central banks implemented massive stimulus packages and accommodative monetary policies to support economies, leading to record-low interest rates and increased liquidity.

2.Digital Transformation:

Financial markets were witnessing a significant digital transformation. Fintech innovations, blockchain technology, and digital currencies (e.g., cryptocurrencies like Bitcoin) were gaining momentum, reshaping the way financial transactions and investments are conducted.

3.Sustainability and ESG Investing:

Environmental, Social, and Governance (ESG) investing was becoming more prominent, with investors focusing on companies' environmental and social responsibility practices. Sustainable finance and green bonds were gaining popularity as investors sought to align their investments with sustainability goals.

4.Rise of Retail Investors:

The rise of retail investors, fuelled by online trading platforms and social media, was impacting market dynamics. Retail investors' collective actions and social media-driven stock movements influenced stock prices and market sentiment.

5.Geopolitical Risks:

Geopolitical tensions and trade disputes between major economies, such as the US-China trade war, were affecting market sentiment and causing uncertainties in global financial markets.

6.Cryptocurrency Regulation:

Regulators around the world were grappling with the regulation of cryptocurrencies and digital assets. Some countries were exploring the possibility of launching central bank digital currencies (CBDCs).

7.Inflation Concerns:

Rising inflation in various economies was a concern for financial markets. Investors closely monitored central banks' responses to inflationary pressures and potential changes in monetary policies.

8.Remote Work and Digital Finance Services:

Remote work trends and digital financial services gained prominence during the pandemic, leading to an increased focus on cybersecurity and digital infrastructure.

9.Global Trade and Supply Chain Disruptions:

Supply chain disruptions due to the pandemic and other factors impacted global trade patterns and commodity prices, affecting specific industries and regions.

10.Interest Rate Expectations:

Market participants closely watched central banks' forward guidance on interest rates, amid concerns about potential tapering of stimulus measures.

These changes highlighted the importance of adaptability, risk management, and staying informed in the global financial markets. Financial institutions, investors, and policymakers needed to carefully navigate these evolving dynamics to make informed decisions and mitigate risks.

1.2.10 Challenges in International Financial Management

International financial management presents several challenges due to the complexities and risks associated with operating in a global business environment. Some of the key challenges include:

1.Foreign Exchange Rate Risk:

Operating in different countries exposes businesses to fluctuations in exchange rates. Volatile currency movements can impact profitability, cash flows, and the valuation of assets and liabilities denominated in foreign currencies.

2.Political and Country Risk:

Businesses must navigate political instability, regulatory changes, and economic uncertainties in foreign markets. Geopolitical tensions, trade disputes, and changes in government policies can create risks and uncertainties for international operations.

3.Diverse Regulatory Environments:

Complying with various financial regulations, tax laws, and reporting standards in different jurisdictions can be complex and time-consuming. Conflicting regulations and compliance challenges may arise when conducting cross-border transactions.

4.Cultural and Language Differences:

Conducting business in diverse cultural settings may require understanding and adapting to local customs, practices, and languages. Effective communication and negotiation skills are crucial for international financial managers.

5.International Tax Complexity:

Managing tax obligations in multiple countries involves dealing with complex international tax laws, transfer pricing, and tax treaties. Optimizing tax efficiency while ensuring compliance can be challenging.

6.Global Economic Uncertainties:

Economic fluctuations and market uncertainties in various countries can impact investment decisions and cash flow projections. International financial managers need to stay abreast of economic trends and adapt strategies accordingly.

7.Liquidity Management:

Managing cash and liquidity across different countries can be challenging due to varying banking systems, currency restrictions, and transaction costs. Efficient cash flow management is crucial for multinational companies.

8.Trade Barriers and Tariffs:

Trade barriers, tariffs, and trade disputes between countries can disrupt supply chains, increase costs, and affect international trade volumes.

9.Foreign Market Knowledge:

Gathering accurate and timely market information in different countries is essential for making informed investment and financing decisions. Lack of reliable data and local market knowledge can pose challenges.

10. Cross-Cultural Business Ethics:

Different countries may have diverse ethical standards and business practices. Ensuring adherence to ethical principles and maintaining a positive reputation in international markets is crucial.

11. Risk of Capital Flight:

Rapid capital outflows from a country due to market sentiment changes or economic instability can create financial and currency crises, impacting multinational businesses.

12. Managing Global Supply Chains:

Multinational companies with complex supply chains across multiple countries need to manage supply chain disruptions, logistics, and inventory levels effectively.

13. Exchange Controls and Restrictions:

Some countries impose exchange controls and restrictions on cross-border transactions, which can hinder capital movement and create challenges for businesses operating globally.

14. Currency Translation and Reporting:

Currency translation for financial reporting and consolidation can lead to earnings volatility due to exchange rate fluctuations.

Overcoming these challenges requires a combination of financial expertise, risk management strategies, cultural sensitivity, and adaptability to navigate the intricacies of international financial management successfully. Businesses need skilled international financial managers who can develop robust financial strategies and make informed decisions to thrive in a dynamic global marketplace.

1.3 Balance of Payments

Balance of Payments According to Kindle Berger, "The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time".

It is a double entry system of record of all economic transactions between the residents of the country and the rest of the world carried out in a specific period of time

when we say "a country's balance of payments" we are referring to the transactions of its citizens and government.

Balance Of Payment :

Definition The balance of payments of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world. It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents and payments made by them on account of goods imported and services received from the capital transferred to non-residents or foreigners.

- Reserve Bank of India

1.3.1 Features of balance of payment:

- ❖ It is a systematic record of all economic transactions between one country and the rest of the world.
- ❖ It includes all transactions, visible as well as invisible.
- ❖ It relates to a period of time. Generally, it is an annual statement.
- ❖ It adopts a double-entry book-keeping system. It has two sides: credit side and debit side. Receipts are recorded on the credit side and payments on the debit side
- ❖ Balance of Trade The difference between a country's imports and its exports.
- ❖ Balance of trade is the largest component of a country's balance of payments.
- ❖ Debit items include imports, foreign aid, domestic spending abroad and domestic investments abroad.
- ❖ Credit items include exports, foreign spending in the domestic economy and foreign investments in the domestic economy.

- ❖ When exports are greater than imports then the BOT is favourable and if imports are greater than exports then it is unfavourable.

Balance of Trade V/s Balance of Payment

S.NO	BOP	BOT
1	It is a broad term	It is a narrow term.
2	It includes all transactions related to visible, invisible and capital transfers.	It includes only visible items.
3	It is always balances itself	It can be favourable or unfavourable.
4	BOP = Current Account + Capital Account + or - Balancing item (Errors and omissions)	BOT = Net Earning on Export - Net payment for imports.
5.	Following are main factors which affect BOP a) Conditions of foreign lenders. b) Economic policy of Govt. c) all the factors of BOT	Following are main factors which affect BOT a) cost of production b) availability of raw materials c) Exchange rate d) Prices of goods manufactured at home

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Balance of Payments

- ✓ BOP records all the transactions that create demand for and supply of currency.
- ✓ Judge economic and financial status of a country in the short-term
- ✓ BOP may confirm trend in economy's international trade and exchange rate of the currency. This may also indicate change or reversal in the trend.
- ✓ This may indicate policy shift of the monetary authority (RBI) of the country.
- ✓ BOP may confirm trend in economy's international trade and exchange rate of the currency. This may also indicate change or reversal in the

trend.

The General Rule in BOP Accounting

- a) If a transaction earns foreign currency for the nation, it is a credit and is recorded as a plus item.
- b) If a transaction involves spending of foreign currency, it is a debit and is recorded as a negative item.

The various components of a BOP statement

1. Current Account
2. Capital Account
3. Reserve Account
4. Errors & Omissions

❖ Current Account Balance

- ✓ BOP on current account is a statement of actual receipts and payments in short period.
- ✓ It includes the value of export and imports of both visible and invisible goods. There can be either surplus or deficit in current account.
- ✓ The current account includes: - export & import of services, interests, profits, dividends and unilateral receipts/payments from/to abroad.
- ✓ BOP on current account refers to the inclusion of three balances of namely – Merchandise balance, Services balance and Unilateral Transfer balance

1.3.3 Types of Balances

Trade Balance:

- Merchandise: exports - imports of goods
- Services: exports - imports of services

Income Balance:

- Net investment income: net income receipts from assets
- Net international compensation to employees: net compensation of Employees

Net Unilateral Transfers

- Gifts from foreign countries minus gifts to foreign countries

❖ Capital Account Balance:

- ✓ The capital account records all international transactions that involve a resident of the country concerned changing either his assets with or his liabilities to a resident of another country. Transactions in the capital account reflect a change in a stock – either assets or liabilities.
- ✓ It is difference between the receipts and payments on account of capital account. It refers to all financial transactions.
- ✓ The capital account involves inflows and outflows relating to investments, short term borrowings/lending, and medium term to long term borrowing/lending.

❖ Capital Account Balance:

- ✓ There can be surplus or deficit in capital account.
- ✓ It includes: - private foreign loan flow, movement in banking capital, official capital transactions, reserves, gold movement etc.
- ✓ These are classifying into two categories
 1. Direct foreign investments
 2. Portfolio investments
 3. Other capital

❖ The Reserve Account :

- ✓ Three accounts: IMF, SDR, & Reserve and Monetary Gold are collectively called as The Reserve Account.
- ✓ The IMF account contains purchases (credits) and repurchase (debits) from International Monetary Fund.
- ✓ Special Drawing Rights (SDRs) are a reserve asset created by IMF and allocated from time to time to member countries. It can be used to settle international payments between monetary authorities of two different countries.

❖ Errors & Omissions:

- ✓ The entries under this head relate mainly to leads and lags in reporting of transactions
- ✓ It is of a balancing entry and is needed to offset the overstated or understated components.

1.3.4 Disequilibrium In The Balance Of Payments

- ✓ A disequilibrium in the balance of payment means its condition of Surplus Or deficit
- ✓ A Surplus in the BOP occurs when Total Receipts exceeds Total Payments. Thus, $BOP = CREDIT > DEBIT$
- ✓ A Deficit in the BOP occurs when Total Payments exceeds Total Receipts. Thus, $BOP = CREDIT < DEBIT$

Causes of Disequilibrium in The BOP

- ❖ Cyclical fluctuations
- ❖ Short fall in the exports
- ❖ Economic Development
- ❖ Rapid increase in population
- ❖ Structural Changes
- ❖ Natural Calamities
- ❖ International Capital Movements

1.3.5 Measures to Correct Disequilibrium in the BOP

1. Monetary Measures: -

a) Monetary Policy

The monetary policy is concerned with money supply and credit in the economy. The Central Bank may expand or contract the money supply in the economy through appropriate measures which will affect the prices.

b) Fiscal Policy

Fiscal policy is government's policy on income and expenditure. Government incurs development and non - development expenditure, It gets income through taxation and non - tax sources. Depending upon the situation governments expenditure may be increased or decreased.

c) Exchange Rate Depreciation

By reducing the value of the domestic currency, government can correct the disequilibrium in the Bop in the economy. Exchange rate depreciation reduces the value of home currency in relation to foreign currency. As a result, import becomes costlier and export become cheaper. It also leads to inflationary trends in the country,

d) Devaluation

Devaluation is lowering the exchange value of the official currency. When a country devalues its currency, exports becomes cheaper and imports become expensive which causes a reduction in the BOP deficit.

e) Deflation

Deflation is the reduction in the quantity of money to reduce prices and incomes. In the domestic market, when the currency is deflated, there is a decrease in the income of the people. This puts curb on consumption and government can increase exports and earn more foreign exchange.

f) Exchange Control

All exporters are directed by the monetary authority to surrender their foreign exchange earnings, and the total available foreign exchange is rationed among the licensed importers. The license-holder can import any good but amount is fixed by monetary authority

II. Non-monetary measures: -

a) Export Promotion

- ❖ To control export promotions the country may adopt measures to stimulate exports like:
- ❖ export duties may be reduced to boost exports
- ❖ cash assistance, subsidies can be given to exporters to increase exports
- ❖ goods meant for exports can be exempted from all types of taxes.

b) Import Substitutes

Steps may be taken to encourage the production of import substitutes. This will save foreign exchange in the short run by replacing the use of imports by these import substitutes.

c) Import Control

Import may be kept in check through the adoption of a wide variety of measures like quotas and tariffs. Under the quota system, the government fixes the maximum quantity of goods and services that can be imported during a particular time period.

1. Quotas –

Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system, the deficit is reduced and the balance of payments position is improved.

2. Tariffs –

Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduce the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes

INDIA'S BALANCE OF PAYMENT

- ✓ A country, like India, which is on the path of development generally, experiences a deficit balance of payments situation.
- ✓ This is because such a country requires imported machines, technology and capital equipment's in order to successfully launch and carry out the programme of industrialization
- ✓ India's current account deficit (CAD) narrowed to US\$ 6.2 billion (1.2 per cent of GDP) in Q1 of 2015-16 from US\$ 7.8 billion (1.6 per cent of GDP) a year ago.
- ✓ This improvement was mainly on account of the merchandise trade deficit (US\$ 34.2 billion during Q1 of 2015-16) which contracted on a year-on-year (y-o-y) basis due to a larger absolute decline in merchandise imports relative to merchandise exports.
- ✓ The reduction in the CAD was also enabled by higher net earnings through services and lower outflow on account of primary income (profit, dividend and interest).
- ✓ Private transfer receipts, mainly representing remittances by Indians employed overseas, amounted to US\$ 16.2 billion, a marginal decline from their level a year ago
- ✓ In the financial account, net inflows of foreign direct investment were higher on a y-o-y basis, however, portfolio investment declined sharply.
- ✓ Non-resident Indian (NRI) deposits received by commercial banks during the quarter at US\$ 5.9 billion were more than double the net inflow into these accounts in Q1 of last year.
- ✓ Net loans availed by banks witnessed an inflow of US\$ 5.4 billion, mainly on account of a fall in foreign currency assets held abroad by banks.
- ✓ In April-June 2015 there was net accretion of US\$ 11.4 billion to India's foreign exchange reserves on a BoP basis; which was marginally higher than the accretion in the corresponding quarter of last year .

1.3.6 Reasons For Poor Performance Of India's Export Trade

There are Several reasons for India's Poor performance. Some off them are:

I. Export - Related Problems: -

1.High Prices: -

As compared to other Asian Countries the price of Indian goods is high. Prices are high due to documentation formalities, high transaction costs & also to make higher profits.

2. Poor - Quality: -

Many Indian exporters do not give much importance to quality control, so their products are of poor quality. Due to low quality many times Indian goods are rejected & sent back to India by foreign buyers.

3.Poor Negotiation Skills: -

Indian exporters lack Negotiation Skills due to poor training in Marketing. They fail to Convince & induce the foreign buyers to place orders.

4.Inadequate Promotion: -

For Export Marketing, Promotion is important. Many Indian Exporters do not give much importance to promotion. A good no. of Indian exporters are not professional in advertising & Sales promotion. They do not take part in trade fairs & exhibitions.

5.Poor follow-up of sales: -

Indian exporters are ineffective in providing after sale-service. They do not bother to find out the reactions of buyers after sale. This results in poor performance of India's export trade.

II. General Causes

1.Good Domestic Market

Sellers find a ready market for their goods within the country, so they do not take parts to get orders from overseas markets.

2. Number of formalities

There are number of documentation & other formalities due to which the some marketers do not enter the export field. So there is a need to simplify formalities.

3. Problem of Trading Blocs

Trading blocs reduce trade barriers on member nations, but they impose trade barrier son non-members. As India is not a member of some powerful trading blocs, it has to face some problems.

4. Negative Attitude

Some of the overseas buyers have a negative attitude towards Indian goods. They feel that Indian goods are inferior goods. Thus there is a need to correct this attitude.

5. Poor Infrastructure

Indian infrastructure is poor. Indian exporters find it difficult to get orders & also to deliver them at time.

1.4 International monetary system

The formation of the IMF was initiated in 1944 at the Bretton Woods Conference. IMF came into operation on 27th December 1945 and is today an international organization that consists of 189 member countries. Headquartered in Washington, D.C., IMF focuses on fostering global monetary cooperation, securing financial stability, facilitating and promoting international trade, employment, and economic growth around the world. The IMF is a specialized agency of the [United Nations](#).

1.4.1 Formation of IMF

The breakdown of international monetary cooperation during the Great Depression led to the development of the IMF, which aimed at improving economic growth and reducing poverty around the world. The International Monetary Fund (IMF) was initially formed at the Bretton Woods Conference in 1944. 45 government

representatives were present at the Conference to discuss a framework for postwar international economic cooperation.

The IMF became operational on 27th December 1945 with 29 member countries that agreed to bound to this treaty. It began its financial operations on 1st March 1947. Currently, the IMF consists of 189 member countries.

The IMF is regarded as a key organisation in the international economic system which focuses on rebuilding the international capital along with maximizing the national economic sovereignty and human welfare.

1.4.2 Organizational Structure of International Monetary Fund (IMF)

The [United Nations](#) is the parent organization that handles the proper functioning and administration of the IMF. The IMF is headed by a Managing Director who is elected by the Executive Board for a 5-year term of office. The International Monetary Fund (IMF) consists of the Board of Governors, Ministerial Committees, and the Executive Board.

To know more about the organizational structure of IMF, refer to the table below:

Structure of the International Monetary Fund (IMF)	
Governing Bodies of IMF	Roles and Responsibilities
Board of Governors	<ul style="list-style-type: none"> • Each governor of the Board of Governors is appointed by his/her respective member country. • Elects or appoints executive directors to the Executive Board. • Board of Governors is advised by the International Monetary and Financial Committee (IMFC) and the Development Committee. • An annual meet up between the Board of Governors and the World Bank Group is conducted during the IMF–World Bank Annual Meetings to discuss the work of their respective

	institutions.
Ministerial Committees 1. International Monetary and Financial Committee (IMFC) 2. Development Committee	<ul style="list-style-type: none"> • It manages the international monetary and financial system. • Amendment of the Articles of Agreement. • To solve the issues in the developing countries that are related to economic development.
Executive Board	<ul style="list-style-type: none"> • It is a 24-member board that discusses all the aspects of the Funds. • The Board normally makes decisions based on consensus, but sometimes formal votes are taken.

1.4.3 Objectives of the IMF

IMF was developed as an initiative to promote international monetary cooperation, enable international trade, achieve financial stability, stimulate high employment, diminish poverty in the world, and sustain economic growth. Initially, there were 29 countries with a goal of redoing the global payment system. Today, the organization has 189 members. The main objectives of the International Monetary Fund (IMF) are mentioned below:

1. To improve and promote global monetary cooperation of the world.
2. To secure financial stability by eliminating or minimizing the exchange rate stability.
3. To facilitate a balanced international trade.
4. To promote high employment through economic assistance and sustainable economic growth.
5. To reduce poverty around the world.

1.4.4 Functions of the IMF

IMF mainly focuses on supervising the international monetary system along with providing credits to the member countries. The functions of the International Monetary Fund can be categorized into three types:

Regulatory Functions:

IMF functions as a regulatory body and as per the rules of the Articles of Agreement, it also focuses on administering a code of conduct for exchange rate policies and restrictions on payments for current account transactions.

Financial functions:

IMF provides financial support and resources to the member countries to meet short term and medium-term Balance of Payments (BOP) disequilibrium.

Consultative functions:

IMF is a centre for international cooperation for the member countries. It also acts as a source of counsel and technical assistance.

1.4.5 India & IMF

India is a founder member of the IMF. India's Union Finance Minister is the Ex Officio Governor on the IMF's Board of Governors. Each member country also has an alternate governor. The alternate governor for India is the Governor of the RBI. There is also an Executive Director for India who represents the country at the IMF.

- India's quota in the IMF is SDR 13,114.4 million that gives India a shareholding of 2.76%. Read about the [Special Drawing Rights – Created in 1969 by International Monetary Fund \(IMF\)](#) at the linked article.
- This makes India the eight largest quota holding country at the organization.
- In 2000, India completed the repayment of all the loans it had taken from the IMF.
- Now, India is a contributor to the IMF.
- The emerging economies have gained more influence in the governance architecture of the International Monetary Fund (IMF).

- The reforms were agreed upon by the then 188 members of the IMF in 2010, in the aftermath of the global financial meltdown.
- More than six percent of the quota shares will shift to emerging and developing countries from the U.S. and European countries.

Which countries gained?

- India's voting rights increased to 2.63 percent from the current 2.3 percent, and China's to 6.08 percent from 3.8. Russia and Brazil are the other two countries that gain from the reforms.

Why delay the reforms?

- Among the reasons for the delay has been the time it took the U.S Congress to approve the changes.
- Though the country holds veto power, Republicans have been agitated over "declining U.S power."

Advantages

- For the first time, the Executive Board will consist entirely of elected executive directors, ending the category of appointed executive directors. Currently, the members with the five largest quotas appoint an executive director, a position that will cease to exist.
- The significant resource enhancement will fortify the IMF's ability to respond to crises more effectively.
- These reforms will reinforce the credibility, effectiveness, and legitimacy of the IMF.

1.4.6 Features and historical developments of the international monetary system:

1. Gold Standard (19th and early 20th centuries):

The gold standard was one of the earliest international monetary systems. Under this system, currencies were directly pegged to a fixed amount of gold. Countries

maintained a fixed exchange rate with gold, which provided stability and credibility to their currencies. However, the gold standard had limitations, and countries faced difficulties in adjusting to economic changes.

2. **Bretton Woods System (1944-1971):**

Established after World War II, the Bretton Woods system created a new international monetary order. Countries pegged their currencies to the U.S. dollar, which, in turn, was convertible to gold at a fixed rate. The International Monetary Fund (IMF) and the World Bank were also established during this period to provide financial assistance and promote economic cooperation among member countries. However, the system faced challenges, including imbalances and the gradual loss of gold reserves by the U.S., leading to its eventual collapse.

3. **Floating Exchange Rates (1971-present):**

In 1971, the Bretton Woods system collapsed, and major economies adopted floating exchange rates, where exchange rates are determined by market forces of supply and demand. Central banks intervene in the foreign exchange markets to influence exchange rates, but they are not fixed to a specific value. This system provides more flexibility, allowing countries to adjust their exchange rates according to economic conditions. However, it can also lead to exchange rate volatility and speculative movements.

4. **Managed Float (Current System):**

Most countries today operate under a managed float system, where central banks intervene to influence exchange rates and prevent extreme fluctuations. They use various monetary and fiscal policies to stabilize their currencies, ensure price stability, and promote economic growth.

5. **Regional Monetary Arrangements:**

Some regions have adopted specific monetary arrangements, such as the European Monetary Union (Eurozone), where participating countries share a common currency (Euro). Other examples include currency boards and currency pegs within specific regions.

6. **Special Drawing Rights (SDRs):**

The IMF issues SDRs, which are international reserve assets, to member countries. SDRs are used as a supplement to member countries' official reserves and serve as a unit of account in IMF transactions.

7. The international monetary system

It continues to evolve, driven by changes in global economic conditions, technological advancements, and geopolitical developments. Countries and international institutions work together to address challenges and ensure the stability and efficiency of the international monetary system. However, achieving a fully stable and equitable global monetary system remains an ongoing challenge.

1.4.7 Emerging dimensions of international financial markets :

The international financial markets were continuously evolving, with several emerging dimensions shaping their landscape.

1. Digital Transformation:

The adoption of digital technologies was revolutionizing international financial markets. Fintech innovations, blockchain technology, and digital currencies (e.g., cryptocurrencies) were gaining traction, transforming payment systems, cross-border transactions, and financial services.

2. Sustainable Finance and ESG Investing:

Environmental, Social, and Governance (ESG) considerations were becoming increasingly important for investors and financial institutions. There was a growing focus on sustainable finance, green bonds, and impact investing, as stakeholders sought to align their investments with environmental and social goals.

3. Decentralized Finance (DeFi):

Decentralized Finance, or DeFi, was gaining momentum, leveraging blockchain technology to offer financial services and products without traditional intermediaries. DeFi platforms enabled activities such as lending, borrowing, and trading using smart contracts.

4. Central Bank Digital Currencies (CBDCs):

Several central banks were exploring the possibility of launching their own digital currencies. CBDCs were seen as a potential evolution of the payment system and could have implications for cross-border transactions and monetary policy.

5.Remote Work and Digital Services:

The COVID-19 pandemic accelerated the adoption of remote work and digital financial services, leading to increased online trading, virtual meetings, and digital customer interactions.

6.Rise of Retail Investors and Social Media Influence:

Retail investors, empowered by online trading platforms and social media, were exerting influence on stock movements and market sentiment, leading to unprecedented volatility and challenges for market regulators.

7.Regulatory and Compliance Changes:

Regulators were responding to the evolving financial landscape by updating regulations and addressing challenges posed by digital assets, cryptocurrencies, and cross-border transactions.

8.Alternative Investments and Private Markets:

Investors were exploring alternative investments, including private equity, venture capital, and real estate, seeking higher returns and diversification beyond traditional asset classes.

9.Geopolitical Risks and Trade Tensions:

Geopolitical tensions and trade disputes between major economies were impacting financial markets, causing uncertainties and volatility.

10.Financial Inclusion and Emerging Markets:

Efforts were being made to promote financial inclusion in emerging markets through digital financial services and innovative financial products.

11.Cybersecurity Concerns:

The increasing reliance on digital technologies raised cybersecurity concerns, with financial institutions facing threats from cyberattacks and data breaches.

12. Alternative Lending and Crowdfunding:

The rise of alternative lending platforms and crowdfunding allowed small businesses and startups to access capital from a broader investor base.

These emerging dimensions reflected the ongoing transformation of international financial markets, driven by technological advancements, changing investor preferences, and the impact of global events. It's important to note that the financial landscape is continually evolving, and new dimensions may have emerged since my last update. For the most current developments in international financial markets, it's essential to refer to the latest sources and analyses.

1.5 Unit-Summary:

International finance management plays an important role in managing the finance of various countries. International finance promotes and encourages the integration of economics, providing an easy flow of monetary. It results in equity for countries which are part of the global finance system. International finance is a practice and theory of international business management. It is connected with activities with the movement of resources. It is not easy for the financial manager to handle and coordinate all the international finance activities and to record them. To reduce the cost of finance, it ensures sufficient availability of funds, deals with the planning, organizing, and controlling of financial activities like the procurement and utilization of funds.

International financial management is an emerging field, and it's expected to grow even more in the coming years. The demand for professionals will only increase as businesses continue expanding into new global markets, capitalising on the global flow of funds and using different international payment methods.

The balance of payments is very important for a country to try and keep equal. To low and you have a deficit to where you borrow money and to high and you're in a surplus which if taken lightly can actually lead to a deficit. For the U.S., wanting to keep our dollar strong will help with the economy and help with trading. The U.S. is working towards bringing the deficit down and this will help keep us competitive in the global market aside from just our services. Imports and exports keep a country running, and keeping the balance keeps a country competitive in the global market.

The international monetary system as it exists today is sufficiently strong to allow of a calm and dispassionate consideration of the possibilities of amending and improving it. Even if there is no need for immediate action to create additional reserves, it is nonetheless important to consider well in advance the many problems of principle and technique that would present themselves if the necessity for such action should arise. The work that has been carried out in the Fund and, with the collaboration of the Fund's staff, elsewhere has prepared the way for further advance toward an international consensus regarding both the major objectives of liquidity policy and the broad nature of the techniques to achieve these objectives. The Executive Directors have not, at this stage, attempted to reach a common view on the merits of the various possibilities indicated above. They intend, however, to devote further attention to these matters in the coming year

Check your progress

Q1. Investment can be defined as

- A) Person's dedication to purchasing a house or flat
- B) Use of capital on assets to receive returns
- C) Usage of money on a production process of products and services
- D) Net additions made to the nation's capital stocks

Q2. The concept of Financial management is

- A) Profit maximization
- B) All features of obtaining and using financial resources for company operations
- C) Organization of funds
- D) Effective Management of every company

Q3. What is the primary goal of financial management?

- A) To minimise the risk
- B) To maximise the owner's wealth
- C) To maximise the return

D) To raise profit

Q4. GST is a consumption of goods and service tax based on.

A) Development

B) Dividend

C) Duration

D) Destination

Q5. The finance manager is accountable for.

A) Earning capital assets of the company

B) Effective management of a fund

C) Arrangement of financial resources

D) Proper utilisation of funds

Q6. Trade between two countries can be useful if cost ratios of goods are:

A. Undetermined

B. Decreasing

C. Equal

D. Different

Q7. 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

Q8. 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

Q9. 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

Q10. International trade and domestic trade differ because of:

A. Different government policies

B. Immobility of factors

C. Trade restrictions

D. All of the above

Q11. Which of the following statement is not true about the International Monetary Fund?

(a) IMF was established along with the world bank

(b) IMF is the result of the Bretton Woods conference

(c) Christine Lagarde is the current Chief Executive Officer of the IMF

(d) Currently 193 countries are the members of the IMF

Q12. When was IMF established?

(a) Dec. 27, 1945

(b) Jan. 30, 1947

(c) Jan. 1, 1946

(d) Sept. 24, 1947

Q13. Which of the following statement is NOT correct regarding the membership of the IMF?

(a) Currently its membership is 189

(b) All "member countries" of the IMF are members of the United Nations

(c) All member countries of the IMF are not sovereign states

(d) Nauru is the latest member of the IMF

Q14. The value of Special Drawing Right (SDR) is determined by the basket ofcurrencies.

(a) 4

(b) 5

(c) 6

(d) 7

Q15. Which of the following currency has largest weightage in the determination of the value of the SDR?

(a) Japanese Yen

(b) Euro

(c) US Dollar

(d) British Pound

Q16. 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

Q17. 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

Q18. Govt. policy about exports and imports is called:

A. Commercial policy

B. Fiscal policy

C. Monetary policy

D. Finance policy

Q19. Which of the following is international trade?

A. Trade between countries

B. Trade between regions

C. Trade between provinces

D. Both (b) and (c)

Q20. Market in which currencies buy and sell and their prices settle on is called the

A. International bond market

B. International capital market

C. Foreign exchange market

D. Eurocurrency market

1.6 Glossary

Balance of Trade	The net of imports and exports of goods and services reported in the balance of payments.
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Balance of Payments	A financial statement prepared for a given country summarizing the flows of goods, services, and funds between the residents of that country and the residents of the rest of the world during a certain period of time. The balance of payments is prepared using the concept of double-entry bookkeeping, where the total of debits equals the total of credits.
International Monetary Market	A centralized auction market in Chicago where currency and financial futures contracts are traded. Part of the Chicago Mercantile Exchange.
Economic and Monetary Union	A common European currency, central bank and monetary policy which melds the separate European economies into a single unit (like the USA) that can "enable Europe to negotiate with the US and Japan as an equal, to compete more effectively and to guarantee monetary stability."
Adjusted Rate of Charge	Rate applied to charge members on their outstanding credit to the IMF.
Average SDR Interest Rate	Average of the weekly rates calculated at the end of each financial quarter for that quarter.

1.7 Self -Assessment questions

1. What is international finance?
2. Why is it important to study International financial Management?
3. What do you mean by deficit in Balance of trade?
4. What is Trade Balance?
5. What do you mean by surplus in Balance of trade?

ii) Answer the Essay question

1. Explain the objectives of financial management.
2. Give a brief note on sources of business finance.
3. What were the main objectives of the Bretton Woods system?
4. Explain how the special drawing right (SDR) is constructed.
5. Discuss the circumstances under which the SDR was created.

- 6.Explain international monetary system
7. What is the Index of Industrial Production?
8. Explain the international capital structure.
9. Explain any three financial institutions.
- 10.Explain the emerging dimensions of international financial markets

1.8 Reference:

1.Financial management & International finance

2.india's overall balance of payment 4 Years summary Source: RBI

3.International Monetary Fund (IMF) - Organizational Structure, Objectives (UPSC Notes)

UNIT-II

FOREIGN EXCHANGE MARKET

2.1 INTRODUCTION:

The Foreign Exchange Market

The foreign exchange market is the global market for exchanging currencies of different countries. It is decentralized in a sense that no one single authority, such as an international agency or government, controls it. The major players in the market are governments (usually through their central banks) and commercial banks. Firms such as manufacturers, exporters and importers, and individuals such as international travellers also participate in the market.

There are a few key concepts we need to understand the market. Foreign exchange is the action of converting one currency into another. The rate that is agreed upon by the two parties in the exchange is called exchange rate, which may fluctuate widely, creating the foreign exchange risk. As will be seen in the case of Japan Airlines (JAL) below, the risk can be high.

There are two types of exchange rates that are commonly used in the foreign exchange market. The spot exchange rate is the exchange rate used on a direct exchange between two currencies “on the spot,” with the shortest time frame such as on a particular day. For example, a traveller exchanges some Japanese yen using US dollars upon arriving at the Tokyo airport.

The forward exchange rate is a rate agreed by two parties to exchange currencies for a future date, such as 6 months or 1 year from now. A main purpose of using the forward exchange rate is to manage the foreign exchange risk, as shown in the case below.

The main functions of the market are to

- (1) Facilitate currency conversion
- (2) Provide instruments to manage foreign exchange risk (such as forward exchange)
- (3) Allow investors to speculate in the market for profit.



2.1.1 Meaning and definition of Foreign exchange markets

The foreign exchange (forex or FX) market refers to the global decentralized market where currencies are bought, sold, exchanged, and speculated upon. It is the largest and most liquid financial market in the world, where participants, such as banks, financial institutions, corporations, governments, and individual traders, conduct currency trading.

The foreign exchange market is over a counter (OTC) global marketplace that determines the exchange rate for currencies around the world. This foreign exchange market is also known as Forex, FX, or even the currency market. The participants engaged in this market are able to buy, sell, exchange, and speculate on the currencies.

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, we will widen our discussion on the 'Foreign Exchange Market'.

2.1.2 Features of the Foreign Exchange Market

1.Decentralized Market:

The forex market operates as an over-the-counter (OTC) market, meaning that there is no central exchange or physical location where currency trading takes place. Instead, trading occurs electronically through a network of banks and financial institutions around the world.

2.24-Hour Market:

The forex market operates 24 hours a day, five days a week, due to its global nature and the different time zones of major financial centers. As a result, trading can take place at any time during the week.

3.Liquidity:

The forex market is highly liquid, with a daily trading volume surpassing several trillion dollars. This liquidity ensures that traders can buy or sell currencies quickly without significantly affecting exchange rates.

4.Currency Pairs:

Forex trading involves the simultaneous buying and selling of currencies in pairs. For example, in the EUR/USD currency pair, a trader buys euros and sells an equivalent number of US dollars.

5.Speculation and Hedging:

Participants in the forex market engage in various activities, including speculation to profit from currency price movements and hedging to protect against currency risk in international trade and investments.

6.Influence of Fundamental and Technical Analysis:

Traders use both fundamental and technical analysis to make trading decisions. Fundamental analysis involves assessing economic indicators and geopolitical events, while technical analysis involves analyzing historical price charts and patterns.

7.Leverage:

Forex trading often involves the use of leverage, allowing traders to control larger positions with a smaller initial capital investment. While leverage can amplify gains, it also increases the risk of significant losses.

8. Central Banks' Role:

Central banks play a crucial role in the forex market, as they intervene to stabilize their currencies, manage inflation, and influence interest rates.

9. Interbank Market and Retail Market:

The forex market consists of both the interbank market, where large financial institutions trade with each other, and the retail market, where individual traders participate through brokers.

The foreign exchange market facilitates international trade and investment by providing a mechanism for converting one currency into another. It is essential for global businesses, financial institutions, and investors to manage currency risk, conduct cross-border transactions, and participate in the global economy. The forex market's continuous operation and vast trading volume make it a vital component of the international financial system.

2.1.3 Structure of foreign exchanges markets

The structure of foreign exchange (forex or FX) markets is multi-tiered and consists of various participants, each with distinct roles and functions. The forex market operates as an over-the-counter (OTC) market, meaning that there is no centralized exchange or physical location where trading takes place. Instead, trading occurs electronically through a global network of banks, financial institutions, brokers, and individual traders. Here are the main components of the structure of foreign exchange markets:

1. Interbank Market:

The interbank market is the primary and most significant segment of the forex market. It comprises the largest financial institutions, such as banks, central banks, hedge funds, and large corporations.

Interbank trading involves direct transactions between these institutions, without the need for intermediaries. The interbank market accounts for a significant portion of daily forex trading volume and is the driving force behind currency price movements.

2. Electronic Trading Platforms:

The vast majority of forex trading occurs on electronic trading platforms, which connect various participants to the market. These platforms facilitate real-time trading, price quotes, and order execution. Some of the most commonly used electronic platforms include EBS (Electronic Broking Service) and Reuters Dealing, among others.

3. Commercial and Investment Banks:

Commercial banks play a central role in the forex market, as they facilitate currency trading for their clients and manage foreign exchange transactions. They act as market makers, offering bid and ask prices for currency pairs and profiting from the spread between these prices.

4. Central Banks:

Central banks, such as the Federal Reserve (US), European Central Bank (ECB), and Bank of Japan (BOJ), participate in the forex market to implement monetary policies and stabilize their currencies. They may intervene in the foreign exchange market to influence exchange rates and manage inflation.

5. Retail Market:

The retail market consists of individual traders and small investors who participate in forex trading through online retail brokers. Retail brokers act as intermediaries between individual traders and the larger interbank market. The retail market has grown significantly in recent years, thanks to the availability of online trading platforms and leverage offered by brokers.

6. Brokers and Market Makers:

Forex brokers play a vital role in connecting retail traders to the forex market. They offer trading platforms, execute orders, and provide leverage to retail clients. Some brokers also act as market makers, providing liquidity by offering bid and ask prices to traders.

7.Hedgers and Speculators:

Participants in the forex market include hedgers, such as international businesses and investors, who use forex instruments to hedge against currency risk in their international trade and investments. Speculators, on the other hand, seek to profit from currency price movements by taking positions in the market.

8.Electronic Communication Networks (ECNs):

ECNs are electronic trading platforms that allow direct access to the interbank market for large institutional clients and professional traders. ECNs enable participants to see real-time price quotes from multiple liquidity providers and trade at the best available prices.

Overall, the forex market's structure is dynamic and constantly evolving, driven by advancements in technology and changes in market participants' preferences and behaviour. The OTC nature of the market, with its diverse participants and electronic trading platforms, ensures continuous liquidity and 24-hour trading operations.

2.1.4 Types of exchanges rate

Exchange rates refer to the value of one currency expressed in terms of another currency. There are different types of exchange rates, each serving different purposes and applications. Here are the main types of exchange rates

1.Spot Exchange Rate:

The spot exchange rate is the current market rate at which currencies can be exchanged for immediate delivery (usually within two business days). It represents the rate at which two parties agree to exchange currencies at the present moment.

2. Forward Exchange Rate:

The forward exchange rate is a rate agreed upon today for the exchange of currencies at a specified future date. Forward rates are used for hedging purposes to protect against future currency fluctuations in international trade and investments.

3.Fixed Exchange Rate:

In a fixed exchange rate system, the value of a currency is pegged or fixed to the value of another currency, a basket of currencies, or a commodity like gold. Governments or central banks intervene in the foreign exchange market to maintain the fixed exchange rate.

4.Floating Exchange Rate (Flexible Exchange Rate):

In a floating exchange rate system, the value of a currency is determined by market forces of supply and demand. The exchange rate fluctuates freely based on changes in economic conditions, capital flows, and other market factors.

5.Managed Exchange Rate:

A managed exchange rate system is a hybrid of fixed and floating exchange rates. In this system, the government or central bank intervenes in the foreign exchange market to influence the exchange rate without fully pegging it.

6.Nominal Exchange Rate:

The nominal exchange rate is the rate at which one currency is exchanged for another, without adjusting for inflation or other price level changes. It reflects the relative value of two currencies.

7.Real Exchange Rate:

The real exchange rate adjusts the nominal exchange rate for differences in price levels (inflation) between two countries. It measures the relative purchasing power of two currencies.

8. Cross Exchange Rate:

The cross-exchange rate is the rate between two currencies, neither of which is the official currency of the country where the quote is provided. It is derived from their respective exchange rates with a third currency.

9. Effective Exchange Rate (Trade-Weighted Exchange Rate):

The effective exchange rate is a weighted average of a country's exchange rates against a basket of currencies of its major trading partners. It provides a broader measure of the currency's value in international trade.

10. Bilateral Exchange Rate:

The bilateral exchange rate is the rate between two specific currencies, representing the value of one currency in terms of the other.

These various types of exchange rates play important roles in international trade, investments, financial markets, and economic policies. Governments and central banks often manage exchange rates to achieve their economic objectives and promote stability in the foreign exchange market.

2.1.5 Exchange rate quotations:

Exchange rate quotations represent the price at which one currency can be exchanged for another currency. They provide information on the value of one currency relative to another and are essential for conducting international trade, investments, and financial transactions. Exchange rate quotations are typically displayed in currency pairs, where one currency is the base currency, and the other currency is the quote currency.

There are two common methods of expressing exchange rate quotations:

1. Direct Quotation:

In a direct quotation, the domestic currency is the base currency, and it is expressed in terms of a certain amount of foreign currency. For example, if you see a direct quotation for the USD/EUR currency pair as 1.2000, it means that one U.S. dollar (USD) is equivalent to 1.2000 euros (EUR).

2. Indirect Quotation:

In an indirect quotation, the foreign currency is the base currency, and it is expressed in terms of a certain amount of the domestic currency. For example, if you see

an indirect quotation for the EUR/USD currency pair as 0.8333, it means that one euro (EUR) is equivalent to 0.8333 U.S. dollars (USD).

The choice between direct and indirect quotation depends on the currency standards and practices of a particular country. For example, the United States and many other countries typically use direct quotations, while some European countries may use indirect quotations.

It's important to note that exchange rate quotations can be either spot rates or forward rates:

1.Spot Rate:

The spot rate represents the current market rate at which currencies can be exchanged for immediate delivery (usually within two business days). Spot rates are used for immediate transactions and are the most commonly quoted rates in the forex market.

2. Forward Rate:

The forward rate is a rate agreed upon today for the exchange of currencies at a specified future date. Forward rates are used for hedging purposes to protect against future currency fluctuations in international trade and investments.

Exchange rate quotations are available through various financial sources, such as financial news websites, forex trading platforms, and financial institutions. As exchange rates fluctuate continuously due to various factors, it's essential to check for the most current and accurate quotations when conducting foreign exchange transactions.

Buying and selling rates:

In foreign exchange markets, buying and selling rates, also known as bid and ask rates, are the prices at which market participants can buy or sell a particular currency. These rates are quoted for currency pairs and represent the two sides of a trade. The buying rate refers to the price at which a market participant can buy a currency, while the selling rate indicates the price at which the same participant can sell that currency.

1.Buying Rate (Bid Rate):

The buying rate is the price at which a market maker or a financial institution is willing to buy the base currency (first currency in the currency pair) from a customer. In other words, it is the rate at which a trader can sell the quote currency (second currency in the currency pair) and receive the base currency in return.

2. Selling Rate (Ask Rate):

The selling rate is the price at which a market maker or a financial institution is willing to sell the base currency to a customer. It is the rate at which a trader can buy the quote currency by paying with the base currency.

When you see exchange rate quotations, you will typically come across two prices: the bid price and the ask price. The bid price is the buying rate, and the ask price is the selling rate. The difference between the bid and ask prices is known as the "spread," and it represents the profit for the market maker or financial institution facilitating the currency exchange.

For example, if you see an exchange rate quotation for the USD/EUR currency pair as 1.2000/1.2010, it means that the market maker is willing to buy 1 US dollar (USD) from you at the rate of 1.2000 euros (EUR) and sell 1 US dollar (USD) to you at the rate of 1.2010 euros (EUR).

The bid-ask spread can vary depending on the currency pair and market conditions. Major currency pairs, such as EUR/USD, USD/JPY, and GBP/USD, typically have narrower spreads due to their high liquidity and trading volume. In contrast, less commonly traded currency pairs may have wider spreads.

When conducting currency transactions, individuals and businesses will pay the higher ask price to buy a currency and receive the lower bid price when selling a currency. The difference between the two rates represents the cost of the transaction or the profit for the financial institution involved.

Forward market quotations :

Forward market quotations, also known as forward exchange rates or forward rates, are the prices at which currencies can be exchanged for future delivery. Unlike spot

exchange rates, which refer to immediate currency transactions, forward rates are agreed upon today but apply to a specified future date.

Forward rates are essential in the foreign exchange market for hedging purposes. They allow businesses, investors, and financial institutions to lock in an exchange rate today for a future transaction to protect against potential currency fluctuations.

Forward rates are typically quoted in currency pairs, and they can be either at a premium or at a discount compared to the spot rate. The relationship between the forward rate and the spot rate is influenced by the interest rate differential between the two currencies involved.

➤ **Forward Premium:**

If the forward rate is higher than the current spot rate, it is said to be at a premium. This means that the foreign currency is more expensive in the forward market compared to the spot market. A forward premium indicates that the market expects the foreign currency to appreciate against the domestic currency by the future delivery date.

➤ **Forward Discount:**

If the forward rate is lower than the current spot rate, it is considered to be at a discount. This means that the foreign currency is cheaper in the forward market compared to the spot market. A forward discount suggests that the market expects the foreign currency to depreciate against the domestic currency by the future delivery date.

➤ **Forward market quotations:**

It is expressed in the same currency pairs as spot exchange rates, and they include the same two prices: the bid price and the ask price. The difference between the bid and ask forward rates is known as the "forward spread."

For example, a forward market quotation for the USD/EUR currency pair might be as follows:

✓ **Forward Rate (1-Year): 1.2100/1.2120**

This means that the financial institution is willing to enter into a forward contract to buy 1 US dollar (USD) in exchange for 1.2100 euros (EUR) one year from now (at the bid price). Alternatively, it is also willing to sell 1 US dollar (USD) in exchange for 1.2120 euros (EUR) one year from now (at the ask price).

The forward market enables businesses and investors to manage currency risk and plan their international transactions with greater certainty by fixing the exchange rate in advance. It plays a crucial role in global trade and investment by providing a mechanism to mitigate the impact of currency fluctuations on financial transactions.

2.1.6 Nominal and real exchange rate in financial decision:

Nominal and real exchange rates are important factors in financial decision-making, especially for businesses engaged in international trade, investments, and multinational operations. Understanding the difference between these two exchange rates helps companies and investors make informed decisions and manage currency-related risks effectively.

1. Nominal Exchange Rate:

The nominal exchange rate is the rate at which one currency can be exchanged for another, without considering changes in price levels due to inflation. It represents the relative value of two currencies in the foreign exchange market. For example, if the nominal exchange rate between the US dollar (USD) and the euro (EUR) is 1.20, it means that 1 USD can be exchanged for 1.20 EUR.

2. Real Exchange Rate:

The real exchange rate, on the other hand, takes into account the effect of inflation on the relative prices of goods and services in two countries. It reflects the purchasing power of one currency relative to another, considering changes in price levels. The real exchange rate is calculated as the nominal exchange rate multiplied by the ratio of the domestic price level to the foreign price level.

Real Exchange Rate = (Nominal Exchange Rate * Domestic Price Level) / Foreign Price Level

A real exchange rate value greater than 1 indicates that the domestic currency is overvalued compared to the foreign currency, meaning that domestic goods are relatively more expensive than foreign goods. Conversely, a real exchange rate value less than 1 suggests an undervalued domestic currency, making domestic goods relatively cheaper for foreign buyers.

Financial Decision Implications:

1.Pricing Strategies:

Understanding the real exchange rate helps businesses determine competitive pricing strategies in international markets. An overvalued domestic currency may lead to higher export prices, while an undervalued currency may offer a competitive advantage in export markets.

2.Currency Risk Management:

Businesses engaged in international trade or investments need to consider both nominal and real exchange rates to manage currency risk. Changes in nominal exchange rates can impact the profitability of foreign transactions, while changes in real exchange rates affect the competitiveness of goods and services in foreign markets.

3. Inflation Hedging:

Businesses operating in countries with high inflation rates need to consider the impact of inflation differentials on the real exchange rate. Hedging against inflation can help protect against currency depreciation and maintain competitiveness in global markets.

4.Investment Decision:

Investors evaluating foreign investment opportunities should assess real exchange rates to understand the potential purchasing power of investment returns in different countries.

5.Currency Diversification:

Understanding both nominal and real exchange rates can guide currency diversification strategies to reduce risk and maximize returns in a global investment portfolio.

Incorporating both nominal and real exchange rates into financial decision-making enables businesses and investors to make more informed choices, mitigate currency-related risks, and optimize international trade and investment outcomes.

2.2 FEMA

FEMA stands for Foreign Exchange Management Act. The Foreign Exchange Management Act (FEMA) is a significant legislation in India that replaced the earlier Foreign Exchange Regulation Act (FERA) in the year 2000. FEMA is a comprehensive regulatory framework that governs foreign exchange transactions, external trade, payments, and foreign investments in the country. Its primary purpose is to facilitate external trade and payments, promote orderly development and maintenance of the foreign exchange market, and ensure proper utilization of foreign exchange resources.

2.2.1 Meaning and definition of 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.

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.

2.2.2 Objectives of FEMA

The Foreign Exchange Management Act (FEMA) in India has several key objectives that guide its implementation and regulatory framework. These objectives are

aimed at facilitating foreign exchange transactions, promoting international trade and investment, maintaining the stability of the Indian rupee, and preventing illegal activities such as money laundering and unauthorized foreign exchange dealings. Some of the main objectives of FEMA include:

1.Facilitating External Trade and Payments:

FEMA aims to simplify and streamline foreign exchange transactions to facilitate smooth external trade and payments. It provides a legal framework that allows individuals and businesses to engage in cross-border transactions, including imports, exports, and remittances.

2.Promoting Foreign Investment:

FEMA encourages foreign investment in India by providing a regulatory framework for non-residents to invest in various sectors. It defines the rules for foreign direct investment (FDI) and foreign portfolio investment (FPI) in the country.

3.Maintaining Stability of the Indian Rupee:

The act seeks to maintain the stability of the Indian rupee by regulating the flow of foreign exchange in and out of the country. It aims to prevent excessive fluctuations in the exchange rate, which can impact the economy's stability.

4.Monitoring and Control of Capital Movements:

FEMA empowers the Reserve Bank of India (RBI) to regulate and control capital movements, ensuring that foreign exchange resources are used efficiently and in line with the country's economic goals.

5.Preventing Money Laundering and Illegal Activities:

One of the important objectives of FEMA is to prevent money laundering and illegal activities related to foreign exchange transactions. The act includes provisions to detect and deter financial crimes and unauthorized dealings in foreign exchange.

6.Promoting Financial Stability:

FEMA contributes to the overall financial stability of the country by ensuring a well-regulated foreign exchange market. It helps maintain confidence in the financial system and prevents undue disruptions.

7. Harmonizing with International Standards:

FEMA aims to align India's foreign exchange management practices with global standards. This is important for fostering international trade, investment, and cooperation.

8. Facilitating Cross-Border Transactions:

The act provides a legal framework for various types of cross-border transactions, including remittances, acquisitions of foreign assets, and borrowing from foreign sources. This helps individuals and businesses engage in international financial activities.

9. Promoting Economic Growth:

By promoting international trade and investment, FEMA contributes to overall economic growth and development. It encourages businesses to expand their operations globally and attract foreign investment into the country.

10. Adapting to Economic Changes:

FEMA is designed to be flexible and adaptable to changing economic circumstances. It provides the regulatory framework needed to respond to evolving global economic trends and challenges.

2.2.3 FEMA Act (Foreign Exchange Management Act) – Classification

The Foreign Exchange Management Act (FEMA Act 1999) is a pivotal legislation introduced by the Indian government to effectively regulate and oversee all foreign exchange transactions within the country. This comprehensive law encompasses a wide range of activities, including investments, remittances, and payments involving foreign exchange. Notably, the FEMA Act categorizes these transactions into two distinct categories:

Current Account Transactions:

These pertain to activities such as trade in goods and services, remittances, and various payments. These transactions are crucial for day-to-day economic activities and international trade relationships.

Capital Account Transactions: This category encompasses more substantial financial activities, such as investments in securities and immovable property. These transactions have a significant impact on capital flows and investments in the country.

Structure of the Foreign Exchange Management Act

The central administration of the Foreign Exchange Management Act (FEMA), often referred to as the Enforcement Directorate, is based in New Delhi and is under the leadership of the Director. This core office is responsible for overseeing the enforcement and implementation of FEMA regulations across the country.

Assisting the central office, five zonal offices are situated in key locations, namely Delhi, Chennai, Mumbai, Jalandhar, and Kolkata. Each of these zonal offices is headed by a Deputy Director who oversees and coordinates enforcement activities within their respective zones.

Each of the five zonal offices is divided into seven sub-zonal offices. These sub-zonal offices play a crucial role in carrying out enforcement and regulatory functions at a more localized level. The sub-zonal offices are managed by Assistant Directors, who work closely with the Deputy Directors to ensure compliance with FEMA provisions within their designated areas.

This hierarchical structure allows for effective enforcement, coordination, and implementation of FEMA regulations across different regions of the country. It ensures that foreign exchange transactions and activities adhere to the stipulated legal framework, fostering transparency and maintaining the integrity of India's financial system.

2.2.4 Features of FEMA

The Foreign Exchange Management Act (FEMA) in India is a comprehensive legislation that governs foreign exchange transactions, cross-border trade, investments, and other related activities. It encompasses several important features that shape its

regulatory framework and impact various aspects of India's foreign exchange management. Here are some of the key features of FEMA:

1.Liberalization and Simplification:

FEMA adopts a more liberal and simplified approach compared to its predecessor, FERA. It aligns with India's economic liberalization policies by allowing greater flexibility in foreign exchange transactions, trade, and investments.

2.Unified Regulation:

FEMA consolidates various laws and regulations related to foreign exchange management into a single framework. This unified approach simplifies compliance and reduces complexities.

3.Current Account Transactions:

FEMA allows liberalization of current account transactions, which include routine activities like trade in goods and services, remittances, travel expenses, and more. This promotes ease of doing business and personal remittances.

4.Capital Account Transactions:

The act regulates capital account transactions, including foreign investments such as foreign direct investment (FDI) and foreign portfolio investment (FPI), loans and borrowings, and acquisition of foreign assets.

5.Authorized Persons:

FEMA designates certain entities as "authorized persons" who are authorized to deal in foreign exchange transactions. Authorized dealers (banks), money changers, and other intermediaries facilitate these transactions.

6.Prohibition and Restrictions:

FEMA includes provisions to prohibit or restrict certain transactions to prevent money laundering, illegal activities, and threats to national security. These restrictions align with international standards.

7.Enforcement and Penalties:

The act establishes enforcement mechanisms for violations of its provisions. Penalties for non-compliance include fines, confiscation of assets, and imprisonment in certain cases.

8.Adjudication and Appeals:

FEMA provides a process for adjudication of cases related to violations. It outlines the procedure for appeals against adjudication orders.

9.Foreign Exchange Market Regulation:

The act ensures orderly conduct of foreign exchange transactions by regulating the foreign exchange market, promoting transparency and efficiency.

10.Export and Import of Currency:

FEMA regulates the export and import of Indian and foreign currency. It defines permissible limits for carrying currency during international travel.

11.Realization and Repatriation of Foreign Exchange:

The act governs the realization and repatriation of foreign exchange earnings, ensuring timely repatriation of earnings from trade and services.

12.Compliance and Reporting:

FEMA mandates reporting requirements for certain transactions to track foreign exchange movements and ensure transparency.

13.Cross-Border Transactions:

The act provides a legal framework for cross-border transactions, including remittances, acquisitions of foreign assets, borrowing from foreign sources, and more.

14.Prevention of Money Laundering:

FEMA includes provisions to prevent money laundering and other financial crimes associated with foreign exchange transactions.

2.2.5 Primary Goal of FEMA

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. To fulfil this overarching objective, FEMA is designed to:

1.Promote Economic Growth:

FEMA seeks to regulate foreign exchange transactions in a manner that contributes to the overall economic growth and development of India. By facilitating trade, investments, and international financial activities, the act aims to bolster the country's economic prosperity.

2.Ensure Orderly Foreign Exchange Market:

The act aims to ensure the orderly development and maintenance of the foreign exchange market within India. This involves creating a structured and regulated environment for foreign exchange transactions to take place smoothly.

3.Ensure Transparency and Efficiency:

FEMA emphasizes conducting all foreign exchange transactions transparently and efficiently. This not only fosters trust in the system but also facilitates smooth cross-border transactions.

4.Conserve and Optimize Foreign Exchange Reserves:

FEMA is designed to ensure the conservation of foreign exchange reserves and their optimal utilization. This involves managing the inflow and outflow of foreign

exchange resources to maintain stability and safeguard the country's foreign exchange reserves.

5.Establish Legal Framework for Monitoring and Enforcement:

The act provides a legal framework for monitoring, investigating, and enforcing foreign exchange transactions. This is aimed at preventing violations and ensuring compliance with regulatory requirements.

6.Catalyze Orderly Forex Market Growth:

FEMA was introduced to catalyze the growth and operation of India's forex market in an organized manner. It aims to create an environment conducive to the efficient functioning of the forex market.

7.De-regulation and Liberalization of the Economy:

One of the key objectives of FEMA is to de-regularize and liberalize the Indian economy. It aligns with the broader economic reforms and openness to international trade and investments.

8.Payment Balance Management:

FEMA recognizes the importance of maintaining a balanced payment structure in transactions among citizens of different countries involving goods, services, and assets. It contributes to managing the overall balance of payments.

2.3 Provisions of FEMA Act 1999

The Foreign Exchange Management Act (FEMA) 1999 in India encompasses a wide range of provisions that govern foreign exchange transactions, cross-border trade, investments, and various financial activities involving non-residents and residents. These provisions are designed to regulate and manage foreign exchange resources, promote economic growth, and ensure compliance with regulatory requirements. Here are some key provisions of the FEMA Act 1999:

1.Current Account Transactions (Sections 5 to 8):

These sections govern transactions related to trade in goods and services, remittances, and other routine activities. FEMA allows for liberalization of current account transactions to facilitate ease of doing business and personal remittances.

2.Capital Account Transactions (Sections 9 to 15):

These sections regulate capital account transactions, including foreign investments such as foreign direct investment (FDI) and foreign portfolio investment (FPI), loans and borrowings, acquisition of foreign securities, etc.

3.Authorized Persons (Sections 10, 11, and 28):

FEMA designates certain entities and individuals as “authorized persons” who are permitted to deal in foreign exchange transactions. These authorized persons include authorized dealers (banks), money changers, and other intermediaries.

4.Prohibited Transactions (Sections 3 and 4):

These sections define transactions that are prohibited or restricted to prevent money laundering, illegal activities, and threats to national security. These restrictions are aligned with international standards.

5.Enforcement Mechanisms and Penalties (Sections 13, 14, and 15):

FEMA establishes enforcement mechanisms for violations of its provisions. Penalties for non-compliance include fines, confiscation of assets, and imprisonment in certain cases.

6.Adjudication and Appeals (Sections 17 to 20):

These sections outline the process for adjudication of cases related to violations and contraventions of FEMA provisions. The act also includes provisions for appeals against adjudication orders.

7.Authorized Dealer’s Role (Sections 10 and 10A):

The role and responsibilities of authorized dealers (banks) in facilitating foreign exchange transactions are defined under these sections.

8.Regulation of Foreign Exchange Market (Sections 17 and 18):

FEMA ensures the orderly conduct of foreign exchange transactions by regulating the foreign exchange market, promoting transparency, and efficiency.

9.Export and Import of Currency (Sections 8 and 9):

These sections govern the export and import of Indian and foreign currency, including the permissible limits for carrying currency during international travel.

10.Realization and Repatriation of Foreign Exchange Earnings Sections 4 and 6):

The act outlines the rules for the realization and repatriation of foreign exchange earnings, ensuring that earnings from trade and services are repatriated to India within the stipulated time.

2.3.1 Penalty Under FEMA Act

The Foreign Exchange Management Act (FEMA) 1999 in India includes provisions for penalties in case of violations or contraventions of its provisions. Penalties are imposed to ensure compliance with the law and to deter individuals and entities from engaging in unauthorized or illegal foreign exchange transactions. The penalties under FEMA can vary depending on the nature and severity of the violation. Here are some key points related to penalties under the FEMA Act:

1.Monetary Penalties:

FEMA provides for the imposition of monetary penalties for violations. The penalties are often calculated as a percentage of the amount involved in the transaction or a fixed sum, as determined by the adjudicating authority.

2.Compounding of Contraventions:

FEMA allows for the compounding of contraventions, which means that individuals or entities can voluntarily admit their violations, pay a prescribed compounding fee, and avoid prosecution or legal action. Compounding is an alternative to facing legal proceedings.

3.Adjudicating Authority:

The adjudicating authority under FEMA has the power to impose penalties for violations. The authority conducts adjudication proceedings to determine whether a violation has occurred and the appropriate penalty to be imposed.

4.Factors Considered for Penalty:

The adjudicating authority takes into consideration various factors while determining the penalty, including the nature of the contravention, the amount involved, the individual/entity's cooperation, past record of violations, and the impact on the economy and financial system.

5.Penalties for Different Violations:

The penalties under FEMA can vary depending on the type of violation. They can range from monetary fines to confiscation of foreign exchange, assets, and instruments involved in the contravention.

6.Repeat Offenses:

Penalties can increase for repeat offenses. If an individual or entity has a history of violations, the penalties for subsequent violations can be more severe.

7.Imprisonment:

In certain cases of serious violations, imprisonment can also be imposed if the penalty is not paid within a specified time. Imprisonment can be for a term as prescribed under the relevant section of the act.

8.Appeals:

Individuals or entities facing penalties have the right to appeal against the adjudication order. They can appeal to the Appellate Tribunal and further to the High Court, if necessary.

2.3.2 Categories of Authorized Persons under FEMA

Under the Foreign Exchange Management Act (FEMA) in India, "Authorized Persons" are entities or individuals authorized by the Reserve Bank of India (RBI) to deal in foreign

exchange transactions and carry out certain activities related to foreign exchange management. Authorized Persons play a crucial role in facilitating foreign exchange transactions and ensuring compliance with FEMA regulations. There are several categories of Authorized Persons defined under FEMA:

1. Authorized Dealers (ADs):

Authorized Dealers are entities, typically banks, that are authorized by the RBI to deal in foreign exchange transactions. They act as intermediaries between individuals or entities and the RBI for various foreign exchange-related activities, such as currency exchange, remittances, trade-related transactions, and investments.

2. Authorized Money Changers (AMCs):

Authorized Money Changers are entities that are authorized to deal in foreign exchange for specific purposes, such as providing foreign currency to travellers, tourists, and individuals for travel-related expenses. AMCs play a role in providing foreign exchange services at airports, hotels, and other locations.

3. Full-Fledged Money Changers (FFMCs):

Full-Fledged Money Changers are entities that are authorized by the RBI to provide a wider range of foreign exchange services beyond the scope of Authorized Money Changers. They can offer services related to money changing, travellers' cheques, prepaid forex cards, and more.

4. Authorised Dealer – Category II (AD Cat II):

AD Cat II entities are financial institutions that are authorized to deal in foreign exchange transactions other than those covered by ADs and FFMCs. They may include cooperative banks, regional rural banks, and others.

5. Bureau de Change (BdCs):

Bureau de Change refers to entities authorized to conduct currency exchange operations in certain specified locations. They play a role in providing foreign currency to traveller's and tourists in specific areas.

6. Offshore Banking Units (OBUs):

Offshore Banking Units are units set up by banks in designated areas for conducting foreign exchange transactions. They are primarily focused on providing financial services to non-residents and handling international banking operations.

7. Authorized Representatives (ARs):

Authorized Representatives are individuals who are authorized to represent a foreign principal party in certain foreign exchange transactions in India. They facilitate transactions on behalf of the foreign entity they represent.

8. Other Categories:

FEMA may also specify other categories of entities or individuals that can be authorized by the RBI to deal in foreign exchange transactions based on specific purposes or activities.

2.3.3 Importance of FEMA in India

1. The Foreign Exchange Management Act (FEMA):

It 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. Here are some key reasons highlighting the importance of FEMA in India:

2. Regulation of Foreign Exchange Transactions:

FEMA provides a structured framework for regulating foreign exchange transactions, ensuring that they are conducted in a transparent and accountable manner. This helps maintain the integrity of the financial system and prevents unauthorized and illegal activities.

3. Facilitating International Trade and Investment:

By streamlining foreign exchange transactions, FEMA supports the facilitation of international trade and investment. It enables businesses to engage in cross-border transactions, imports, exports, and investments in a well-regulated environment.

4. Currency Stability:

FEMA contributes to maintaining stability in the value of the Indian rupee. It ensures that foreign exchange transactions are managed in a way that prevents excessive fluctuations in the exchange rate, which is crucial for economic planning and investor confidence.

5.Attracting Foreign Investment:

The provisions in FEMA make India an attractive destination for foreign investors. The act defines the rules and regulations for foreign direct investment (FDI) and foreign portfolio investment (FPI), encouraging capital inflow into the country.

6.Preventing Money Laundering and Illegal Activities:

FEMA plays a vital role in preventing money laundering, unauthorized foreign exchange transactions, and other financial crimes. Its provisions deter individuals and entities from engaging in illegal activities that could harm the economy and national security.

7.Ease of Doing Business:

FEMA's liberalized approach to foreign exchange transactions contributes to the ease of doing business in India. It simplifies procedures for cross-border transactions and reduces bureaucratic hurdles for individuals and businesses.

8.Global Integration:

FEMA aligns India's foreign exchange management practices with international standards. This integration is important for promoting global trade, investments, and collaborations.

9.Conservation of Foreign Exchange Reserves:

The act ensures the conservation of foreign exchange reserves and their optimal utilization. This is essential for maintaining a stable balance of payments and safeguarding India's external financial position.

10.Financial Market Stability:

FEMA contributes to the stability of the financial markets by regulating foreign exchange transactions and preventing disruptions that could impact economic stability.

11.Compliance and Accountability:

The act establishes a clear legal framework for foreign exchange transactions, ensuring that individuals and entities comply with regulations. This fosters accountability and transparency in financial activities.

12.Supporting Economic Growth:

Through its facilitation of trade, investments, and international financial activities, FEMA supports overall economic growth and development in India. Evaluation.

The objective is to achieve goal congruence, in which divisional managers will want to transfer product-when doing so maximizes consolidated corporate profits, and at least one manager will refuse the transfer when transferring product is not the profit-maximizing strategy for the company. When multinational firms transfer product across international borders, transfer prices are relevant in the calculation of income taxes, and are sometimes relevant in connection with other international trade and regulatory issues.

- Trans least one of the related parties is a non-resident. after the year finalization.
- Transfer Pricing in Multinational Companies
- Internal auditors play key roles in multinational corporations, including providing valuable input regarding effectiveness of business operations.
- They can help multinational corporations by assessing the effectiveness of corporate policies regarding international transfer pricing.
- International transfer pricing is a major issue for multinational corporations, as transfer pricing is a key element in corporate taxation strategies. Effective transfer pricing policies are very important to sustaining effective global business operations. Transfer pricing, if done correctly, can improve the overall success and value of an international company.
- The creation of foreign subsidiaries and bases of operation for cross border flow of products, services, trademarks, funding and technology have a significant impact on the issue of transfer pricing in international business. The transfer pricing problem for multinationals is of great significance. There are different income tax rates in different countries. So, it becomes desirable from the view point of overall corporate strategy to show higher profits in low-tax countries

and lower profits in high-tax countries. One way to do so is through transfer prices.

- The resale price method begins with the price at which a product is resold to an independent enterprise (IE) by an associate enterprise.

5.1 Unit-Summary

In conclusion, the foreign exchange market is a dynamic and essential component of the global financial system. It serves as a platform for the exchange of currencies between countries, facilitating international trade and investment. Understanding how the foreign exchange market works is crucial for businesses, investors, and individuals alike, as it impacts exchange rates and can influence economic conditions.

FEMA permits only authorized person to deal in foreign exchange or foreign security. Such an authorized person, under the Act, means authorized dealer, money changer, off-shore banking unit or any other person for the time being authorized by Reserve Bank. The Act thus prohibits any person who deal in or transfer any foreign exchange or foreign security to any person not being an authorized person. Make any payment to or for the credit of any person resident outside India in any manner. Receive otherwise through an authorized person, any payment by order or on behalf of any person resident outside India in any manner.

Enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person is resident in India which acquires, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.

2.5 Check your progress:

Q 1. Foreign Exchange transactions involve monetary transactions

- A. Among residents of the same country
- B. Between residents of two countries only
- C. Between residents of two or more countries
- D. Among residents of at least three countries

Q 2. Under FEMA, the RBI has been authorized to make ----- to carry out the provisions of the Act.

- A. Rules

B. Regulations

C. Both Rules and Regulations Notifications

Q 3. A foreign currency account maintained by a bank abroad is its

A. Nostro account

B. Vostro account

C. Loro account

D. Foreign bank account

Q 4. 'Non-resident Bank Accounts' refer to

A. Nostro account

B. Vostro account

C. Accounts opened in offshore centres

D. None of the above

Q 5. Non-resident bank accounts are maintained in

A. The permitted currencies

B. The currency of the country of the bank maintaining the account

C. The currencies in which FCNR accounts are permitted to be maintained

D. Indian rupee

Q 6. FEMA, 1999 aims to consolidate and amend the law relating to foreign exchange with the objective of

A. To facilitate external trade and payments and promoting the orderly development and maintenance of foreign exchange market in India.

B. To regulate the acceptance and utilisation of foreign contribution or foreign hospitality by certain individuals or associations or companies

C. To prohibit acceptance and utilisation of foreign contribution or foreign hospitality for any activities detrimental to the national interest

D. All of the above.

Q 7. The preamble to the Foreign Exchange Management Act, 1999 states that it is an Act to _____ the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India.

A. Consolidate

B. Amend

C. Consolidate and amend

D. None of these

Q 8. The objective of the Act is to _____ and for promoting the orderly development and maintenance of foreign exchange market in India.

A) Facilitating external trade and payments.

B) Promote the orderly development of foreign exchange market in India

C) Promote the maintenance of foreign exchange market in India

D) All of these

Q 9. The Act came into force on _____.

A) 1st May, 1999

B) 1st June, 1999

C) 1st October, 1999

D) 1st June, 2000

Q10. While determining as to whether a person is a resident in India or not, the period for which he has resided in India in the is to be considered.

A) Current financial year

B) Current calendar year

C) Preceding financial year

D) Preceding calendar year

Q 11. Markets in which derivatives are traded are classified as

A. Assets backed market

B. Cash flow backed markets

C. Mortgage backed markets

D. Derivative securities markets

Q 12. Situation in which large portion of majority is borrowed from broker of investor is classified as

- A. Future investment
- B. Forward investment
- C. Leveraged investment
- D. Non leveraged investment

Q 13. Type of contract which involves future exchange of assets at a specified price is classified as

- A. Future contracts
- B. Present contract
- C. Spot contract
- D. Forward contract

Q 14. Packing Credit can be allowed in excess of the Export value, in which of the following circumstances:

- A. Where by-product can be exported
- B. Where partial domestic sale is involved
- C. Export of de-oiled/defatted cakes
- D. Any of the above.

Q 15. Type of unit which guarantees that all buying and selling will be made by traders of exchange is called

- A. Trading house
- B. Guarantee house
- C. Clearing house
- D. Professional house

Q 16. Foreign Exchange rates in India are determined by:

- A. Finance Ministry
- B. RBI
- C. FEDAI
- D. Market forces of demand/supply

Q 17. Who regulates the foreign trade in India.

- A. RBI
- B. DGFT

- C. FEDAI
- D. SEBI

Q 18. Foreign Currency Non-Resident (Banks) account can be opened in the name of the following:

- A. Non-resident Indian
- B. Person of Indian origin
- C. Overseas Corporate Bodies
- D. Both a and b

Q19. Withdrawal of foreign Exchange by a person in India is not permitted in respect of which of the following:

- A. Transactions with persons resident in Nepal and Bhutan
- B. Travel to Nepal and Bhutan
- C. Transactions given in Schedule 1 of FEMA
- D. All the above.

Q 20. Which of the following methods is applied for quoting the foreign exchange rates in India?

- A. Cross rates
- B. Direct rate
- C. Indirect rate
- D. Buying rate
- E. Selling rate

21. The statutory basis for administration of foreign exchange in India is

- A. Foreign Exchange Regulation Act, 1973
- B. Conservation of foreign Exchange and Prevention of Smuggling Act.
- C. Foreign Exchange Management Act, 1999
- D. Exchange Control Manual

22. Full fledged money changers are authorized to undertake

- A. Only sale transactions
- B. Only purchase transactions

- C. All types of foreign exchange transactions
 D. Purchase and sale of foreign currency notes, coins and travellers cheques

23. The acronym FEDAI stands for

- A. Foreign Exchange Dealers' Association of India
 B. Federal Export Dealers' Association of India
 C. Fixed Earners' Draft Agreement on Interest
 D. None of the above

2.6 Glossary

Cross Rate	An exchange rate between two currencies neither of which is the U.S. dollar. A cross rate is usually constructed from the individual exchange rates of the two currencies with respect to the U.S. dollar.
Cross Hedging	Hedging a commodity by using a futures contract on a different but related commodity. A cross hedge is based on the premise that the price movements of the two commodities are related.
Speculator	A trader whose objective is to make profits by successfully anticipating future price movements.
Foreign Exchange Broker	An individual who introduces the two parties in a currency or deposit transaction to each other. The parties could be a buyer and a seller of foreign currencies or a borrower and a lender of a given currency. The broker charges a fee for this service. Brokers seldom take a position for themselves; they only arrange for transactions among other parties.
Hedging	The process of reducing the variation in the value (from price fluctuations) of a total portfolio. Hedging is accomplished by adding to an original portfolio items such as spot assets or liabilities, forward contracts, futures contracts, or options contracts in such a way that the total variation of the new portfolio is smaller than that of the original portfolio.

2.7 Self -Assessment questions

1. Distinguish between forward market and spot market.
2. State the names of World Bank affiliates.
3. Define indirect quote with suitable example
4. Define absolute form of purchasing power parity
5. Which are the different factors which influence foreign exchange rates?

ii) Answer the Essay question

- 1.Explain the foreign exchange market
- 2.Describe the exchange rate mechanism.
- 3.Determine the spot and forward market.
- 4.Explain the features of FEMA.
- 5.What is FEMA? Explain its importance.

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Unit- III

International Investments

3.1 International Investments

International Investments are those investments that are made outside the domestic markets and offer portfolio diversification and opportunities for risk minimization. An investor can make international investments, thereby broadening his portfolio and expanding his horizon of returns.



International investments also serve as a means of adding different financial instruments to the list when domestic markets are confined and limited by their variety. International investments aim to assure investors of two probabilities; the counter of domestic market risks and the opportunities in foreign markets.

Types of international investments

Best international investments types can be broadly classified into the following categories:

Government Funds/Aids –

These are funds that flow from one economy to the other with the purpose of aid or assistance to the economy as a whole. These transactions are carried out between the governments.

Cross Border Loans –

A loan arrangement where a government or institution seeks loan financing from a foreign bank is known as cross border loans. Cross-border financing became a popular financing vehicle because of its easier accessibility and fewer collateral restrictions.

Foreign Portfolio Investment –

When investors express investment interests in foreign companies, they are known as FPIs. These investors may not have long-term interests necessarily but can be traded easily through exchanges.

Foreign Direct Investment –

FDIs are investments made by foreign multinational companies in an economy. Foreign direct investment is more of a long-term concern and takes any form of investing from equities and debts to property and assets.



3.1.2 Foreign Direct Investment (FDI):

The term foreign direct investment (FDI) refers to an ownership stake in a foreign company or project made by an investor, company, or government from another country. FDI is generally used to describe a business decision to acquire a substantial stake in a foreign business or to buy it outright to expand operations to a new region. The term is usually not used to describe a stock investment in a foreign company alone. FDI is a key element in international economic integration because it creates stable and long-lasting links between economies.

Introduction

With the rapidly changing world economy, every country across the globe is trying to integrate its economy with rest of the world and the process is known as globalization. Globalization, as a process of integration of economies across the globe, usually encompasses many ways and one such visible way is the inflow of Foreign Direct Investment (FDI). In recent times, FDI has come out as a buzzword in international trade and have received significant consideration in the foreign trade policies.

It represents movement of capital, both short term and long term, in and out of a country with the purpose of buying physical and financial assets to start a business. It specifies the transfer of bundle of resources across the national boundaries, which includes capital, technology, management and marketing expertise. Although the process

of FDI is universal phenomenon, the developing countries, however, are trying hard to attract more of it to bridge the resource gaps for their economic development.



“The Foreign Direct Investment (FDI) is the process by which the resident of one country (generally the source country) acquires the ownership of assets for the purpose of controlling the production, distribution and other productive activities of a firm in another country (generally the host country)”.

Today the world is rapidly becoming interdependent. Not only the goods and services but the financial transactions are also moving beyond the boundaries of the countries. Today, in fact the world has become a small village. With the emergence of integration of global markets, international financial flows have so far been in excess for the goods and services among the countries dealing in international business. Out of different types of financial inflows, the FDI has played a vital role in the process of economic development of the country.

Further FDI is also considered as an important element in the development strategy of the developing countries among the various forms of foreign assistance. Usually FDI and FII flows are preferred over the other form of external financing because they are not debt creating, non-volatile in nature and their returns are also depending upon the projects financed by the investor.

3.1.3 Meaning and Concept of Foreign Direct Investment

Foreign Direct Investment (FDI) is defined as *“investment made to acquire lasting interest in enterprises operating outside the economy of the investor.”* It is the process whereby residents of one country acquire ownership of assets for the purpose of controlling the production, distribution, and other activities of a firm in another country.

The International Monetary Fund's (IMF) balance of payment manual defines FDI as *“an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor”*. The FDI creates the relationship of 'a parent company' and 'a foreign affiliate' which jointly form a Multinational corporation (MNC).

Foreign Direct Investment will be considered when the investment is made by the parent company which has direct control over its foreign affiliate. FDI plays a pivotal role in the growth of global business. It opens new vistas for a firm in the form of new international markets and marketing channels, cheaper production facilities, access to new technologies, products, financing and skills

The firm which receives the investment or for a host country, it can provide a source of new technology, capital, product, management skills and also can provide a strong drift to economic development.



<http://www.businessinsider.in/photo/50866992.cms>

In the recent past Foreign Direct Investment has played a key role in the internationalization of business. In response to changes in technology, liberalization of the national regulatory framework which governs investment in multinational companies and changes in capital markets, fundamental modifications have occurred in the scope, size and methods of Foreign Direct Investment.

Growth of ICT and decline in the global communication costs has made the foreign investments far easier than in the past. Major changes in international trade and investment policies, tariff liberalization, easing of restrictions in foreign investment, global regulatory environment in the past decade and the deregulation and privatization of many industries, has been considered as the most significant catalyst for FDI's expanded role.

3.1.4 Forms of FDI

Foreign Direct Investment involves a range of investment activities, including:

1. Greenfield Investment:

Greenfield investment occurs when a foreign investor establishes a new company or facility in the host country. It involves building operations, infrastructure, and establishing a presence from scratch.

2. Mergers and Acquisitions:

Mergers and acquisitions (M&A) involve foreign investors acquiring or merging with an existing company in the host country. This can lead to the transfer of ownership, management control, and access to local resources and markets.

3. Joint Ventures:

Joint ventures occur when foreign investors and domestic entities collaborate to establish a new company or undertake a specific project together. Both parties contribute resources, expertise, and share risks and rewards.

3.1.5 Foreign Direct Investment brings several benefits to both the host country and the investing entity:

1. Economic Growth:

FDI contributes to economic growth by attracting capital investment, stimulating job creation, and enhancing productivity in the host country. It boosts the overall production capacity and efficiency of the economy.

2. Technology Transfer:

FDI facilitates the transfer of advanced technologies, technical know-how, and managerial expertise from the investing entity to the host country. This helps enhance domestic capabilities, foster innovation, and improve the competitiveness of local industries.

3. Employment Opportunities:

FDI often leads to the creation of new job opportunities in the host country. Direct employment is generated through the establishment of new companies or the expansion of existing ones, while indirect employment is created through the supply chain and supporting industries.

4. Infrastructure Development:

FDI can contribute to the development of physical infrastructure in the host country. Investors often invest in building factories, transportation networks, utilities, and other necessary infrastructure, which benefits the local economy and supports future economic activities.

5. Access to Global Markets:

FDI enables companies in the host country to gain access to global markets through the investor's international networks, distribution channels, and marketing expertise. This can boost exports, expand market reach, and promote international trade.

3.1.6 FDI has a significant impact on host countries:

1. Foreign Exchange Inflows:

FDI brings foreign currency into the host country, contributing to foreign exchange reserves and stabilizing the balance of payments. This can help support the host country's currency and strengthen its economic stability.

2. Increased Tax Revenues:

FDI generates tax revenues for the host country through corporate taxes, employee income taxes, and other forms of taxation. These revenues can be used to fund public infrastructure, social welfare programs, and public services.

3. Knowledge and Skill Transfer:

FDI facilitates the transfer of knowledge, skills, and best practices to the host country's workforce. This can enhance the local human capital and build a skilled workforce capable of supporting diverse industries.

4. Spillover Effects:

FDI often leads to spillover effects, where positive impacts from the presence of foreign investors extend beyond the immediate investment project. This can include technology spillovers, knowledge diffusion, and improved industry standards.

3.1.7 How Does Foreign Direct Investment (FDI) Work?

As noted above, foreign direct investment is a stake in a company or project by a foreign entity. Companies or governments considering an FDI generally consider target firms or projects in open economies that offer a skilled workforce and above-average growth prospects for the investor. Light government regulation also tends to be prized.

FDI frequently goes beyond mere capital investment. It may also include the provision of management, technology, and equipment. A key feature of FDI is that it establishes effective control of the foreign business or at least substantial influence over its decision-making.

The net amounts of money involved with FDI are substantial, with roughly \$1.28 trillion of foreign direct investments made in 2022. In that year, the United States was the top FDI destination worldwide, followed by China, Brazil, Australia, and Canada.

In terms of FDI outflows, the U.S. was also the leader, followed by Japan, China, Germany, and the United Kingdom. FDI inflows as a percentage of gross domestic product (GDP) are a good indicator of a nation's appeal as a long-term investment destination.

China's economy is currently smaller than the U.S. economy in nominal terms. FDI as a percentage of GDP in 2022 was 1.0% for China, compared with 1.5% for the U.S. For smaller, dynamic economies, FDI as a percentage of GDP is often significantly higher. For instance, it represented 359.2% for the Cayman Islands and 33.6% for Hong Kong in 2022.

3.1.8 Types of FDI

Types of FDI

By Direction	Inward FDI
	Outward FDI
By Target	investment
	Mergers and Acquisitions
	Horizontal FDI
	Vertical FDI
By Motive	Resource-Seeking
	Market-Seeking
	Efficiency-Seeking
	Strategic-Asset-Seeking

◆ ON THE BASIS OF DIRECTION

Inward FDI

Inward foreign direct investment (FDI) is a peculiar form of inbound investment when foreign capital is invested in local resources.

Inward FDI is encouraged by:

- Subsidies, tax breaks, low interest loans, lifting of certain restrictions and grants etc.

- The thought is that the worth of long term gain is more than the short term income loss.

Inward FDI is restricted by:

- Differential performance requirements
- Ownership restraints or limits

Outward FDI

Outward foreign direct investment (FDI), also called as direct investment abroad, is an investment when local capital is invested in foreign resources. It can also be used to invest in the commodities of foreign country in the form of imports and exports.

Outward FDI is encouraged by:

- Insurance to cover the future risk backed by the Government

Outward FDI is restricted by:

- Subsidies for local businesses
- Tax incentives or disincentives on firms that invest outside the boundary of the home country or repatriations of the profits.
- Collectivists government policies that support the nationalization of industries
- Security industries are often kept safe from outwards FDI to ensure localized state control of the military industrial complex
- Societal sectors who are supported by inward FDI or state investment, e.g. agriculture and labour markets.

◆ ON THE BASIS OF TARGET

Greenfield Investments

Greenfield investments are the main target of a host country's promotional efforts because it creates new production capacity, jobs, technology transfer and knowhow, and can lead to linkages to the international marketplace. The Organization for global Investment acknowledges the benefits of Greenfield investment for regional and national economies which is helpful to increase the employment opportunities even at higher wage rates than domestic firms, investments in research and development projects and additional capital investments. Greenfield investments are criticized because it includes the loss of market share for competing domestic companies, profits are perceived to bypass local economies and instead flow back entirely to the multinational's home country.



http://www.thehindubusinessline.com/multimedia/dynamic/03129/fdi_3129875f.jpg

Mergers and Acquisitions

Cross-border mergers occur when the operations and assets of firms from multiple countries are combined to establish a new entity i.e. when the control business including assets and operations of domestic company is transferred to a foreign company and the domestic company becomes an affiliate of the foreign company. In this type of FDI acquisitions provide no long term benefits to the host country's economy as in the case of Greenfield Investment. In most of the deals, the owners of the local firm are paid in

stock from the acquiring firm i.e. the money realized from the acquiring firm could never reach the local economy. But still mergers and acquisitions are very important form of FDI.



<http://www.edupristine.com/wp-content/uploads/2015/06/crowdfunding-mergers-acquisitions.jpg>

Horizontal FDI

Horizontal FDI occurs when the multinational company undertakes the same production activities in multiple countries i.e. an investment made by a MNC in different countries across the globe. The investment is made for conducting the same type of business as already operated by the company in different countries. For example, if a pharmaceutical company set up its plant outside its national boundary then it is horizontal Foreign Direct Investment. Horizontal FDI results in the expansion of parent company's business and brings FDI in the other economy.

Vertical FDI

As discussed above horizontal FDI is the investment in same kind of industry in different countries. Vertical FDI is investment in the related industries in the chain of vertical integration. Here Vertical integration refers to the expansion of a firm into a stage of the production process other than that of the original business. For example a company such as TATA Steel which makes steel can integrate vertically by expanding its activities toward the source of raw materials such as iron, coal and limestone production, or toward the sale of the end product as Tata iron. So in this context, Tata Steels could have backward FDI if it opened a new iron mine in Indonesia, or forward FDI if it opened a subsidiary in the US to sell its steel.

◆ ON THE BASIS OF MOTIVE

FDI can also be classified based on the motive behind the investment from the perspective of the investing firm:

Resource Seeking

Investments which seek to acquire factors of production that is more efficient than those available in the home economy of the firm is called as Resource Seeking FDI. Sometimes these resources are not available in the home country at cheaper rates like labour and other natural resources. This increases the dependence of under developed countries to developed countries for natural resources, skilled human resources and cheap labour.



<http://www.agh.fi/sites/default/files/imagecache/isokuva/Mergers%20and%20Acquisitions.jpg>

Market-Seeking Investments which aim at either discriminating new markets or maintaining existing ones is called as Market Seeking FDI. Foreign Direct Investment of this kind may also be employed as defensive strategy because it is generally argued that the companies are tend towards this type of investment out of fear of losing a market rather than discovering a new one. Such type of FDI can be characterized by the foreign Mergers and Acquisitions in the 1980's by Accounting, Law and Advertising firms.

Efficiency-Seeking

Investments which firms expect will increase their efficiency by exploiting the benefits of economies of scale and economies of scope and also those of common ownership is called as Efficiency Seeking FDI. This type of Foreign Direct Investment comes after either resource or market seeking investments have been realized, with the expectation that it will further increase the firm's profitability.

Strategic-Asset-Seeking

Strategic Asset Seeking FDI is a tactical investment to prevent the gain of resource to a competitor. For example the producer of oil whom may not need the oil at present, but look to prevent their competitors from having it in order to have the competitive edge.

3.1.9 Advantages of Foreign Direct Investments



Economic development:

Foreign Direct Investment helps in the economic development of the host country where the investment is being made. FDI is especially applicable for the economically developing countries. During the decade of the 90s FDI was one of the major external sources of financing for most of the countries that were growing from an economic perspective. It has also been seen that foreign direct investment has helped several countries when they have faced economic hardships which could be clearly seen in some countries of the East Asian region.

During the financial crisis of 1997-98 it was observed that the amount of foreign direct investment made in these countries was pretty steady. But the other forms of cash inflows in a country like debt flows and portfolio equity had suffered major setbacks. Similarly, it has been observed that in Latin America during 1980s and in Mexico during 1994-95.

Human capital resources:

When foreign direct investment is received from another country the host country can also develop its human capital resources by providing training to its employees on

the operations of a particular business from foreign country. The profits generated due to the foreign direct investments can also be used by the country for developing its human capital base.

Transfer of technologies:

Foreign direct investment also permits the transfer of technologies. Transfer of technologies is done basically in the way of provision of capital inputs. Technology cannot be transferred by merely trading of goods and services as well as investment of financial resources. Transfer of technologies can only be made under a legal binding contract between two countries. It also assists in the promotion of the competition within the local input market of a country.

Job opportunity:

Foreign direct investment helps in creating new jobs in a particular country. FDI also helps in increasing the salaries of the workers which enables them to get access to a better lifestyle and more facilities in life. It has normally been observed that foreign direct investment allows for the development of the manufacturing sector of the recipient country. FDI can also bring in advanced technology and skill set in a country. Foreign direct investment brings the venture capital into the country and also increases the scope for new research activities being undertaken.

Export-Import:

Foreign direct investment also opens up the new vistas for imports and exports that allow countries the opportunity to export their superior products, services and technologies to foreign countries. It has also observed that as a result of receiving foreign direct investment from other countries, it has been made possible for the recipient countries to keep their interest rates at a lower level.

Income generation:

Foreign direct investment assists in increasing the income that is generated through revenues realized through taxation. FDI also plays a crucial role in increasing the

productivity of the host countries. In case of countries that make foreign direct investment in other countries this process has positive impact as well. The corporates of these countries get an opportunity to explore newer markets and thereby generate more income and profits.



<http://www.pjefc.org/wordpress/wp-content/uploads/2013/08/money-tree.jpg>

FDI makes easier for the business entities to borrow finance at lesser rates of interest. The biggest beneficiaries of these facilities are the small and medium-sized business enterprises. Foreign direct investment leads to increase in profits within different industries as well as tax cuts and expanded marketability for singularly differing industries.

Many times procurement of material, buildings, and labour can be obtained at a fraction of the cost in host countries than would be the case within the company's home country. But it is always good to keep in mind the host countries economy and market. Corporates are often forced to abide by local regulations rather than the regulations of their home country.

On the other hand, the host country benefits due to the increase in jobs, increase in the productivity and increase in the capital base due to investment made by the foreign country. Often times dying economies can be revived in the process of becoming a host for certain industries or markets in which that industry or market had not previously been. This is especially the case with third world countries that are trying to catch up to industrial nations or who need a boost due to changes in regional climates or in the advent of recovery from the aftermath of civil or world war.

3.1.10 Disadvantages of Foreign Direct Investment

Although Foreign Direct Investment has bundle of advantages but still certain issues are evolved with the emergence of investment made by the foreign country in the host country's economy. The disadvantages of FDI occur usually in case of matters related to operation, distribution of the profits made on the investment and the human resource.

One of the most indirect disadvantages of foreign direct investment is that the economically weaker section of the host country is always put out when the stream of foreign direct investment is adversely affected. The situations in countries like Singapore, Chile, Ireland and China corroborate such an opinion. It is normally the responsibility of the host country to limit the extent of impact that may be made by the foreign direct investment.

The host country should make sure that the entities making the foreign direct investment in their country are following the environmental, cultural, governance and social regulations that have been laid down in the country.

The other disadvantages of foreign direct investment are discussed as follows:

- Many times it has been observed that certain foreign policies are adopted that are not appreciated by the workers of the recipient country. Foreign direct investment sometimes is also not favourable for the countries which are investing in the host country.
- Foreign direct investment may impose high travel and communications expenses. The difference in the socio-culture environment that exists between the country of the investor and the host country could also pose certain problems in case of foreign direct investment.
- At times it has been observed that there is considerable instability in a particular geographical region.

This causes a lot of inconvenience to the investing country.



<http://mrscelis6.weebly.com/uploads/2/5/0/4/25044925/377113889.jpeg>

- Another major disadvantage of foreign direct investment is that there is a chance that a company may lose out on its ownership to an overseas company. This may cause many companies to approach foreign direct investment with a certain amount of caution.
- The size of the market, as well as, the condition of the host country could be important factors in the case of the foreign direct investment. In case the host country is not well connected with their more advanced neighbours, it poses a lot of challenge for the investors.
- At times it has been observed that the governments of the host country are facing problems with foreign direct investment. It has less control over the functioning of the company that is functioning as the wholly owned subsidiary of an overseas company. This leads to serious issues. The investor does not have to be completely obedient to the economic policies of the country where they have invested the money.
- The foreign direct investments may also have adverse effects on the balance of payments of a country.

Even in view of the various disadvantages of foreign direct investment it may be said that foreign direct investment has played an important role in shaping the economic fortunes of a number of countries around the world.

Examples of Foreign Direct Investment

Foreign direct investments may involve mergers, acquisitions, or partnerships in retail, services, logistics, or manufacturing. They indicate a multinational strategy for company growth.

They also can run into regulatory concerns. For instance, in 2020, U.S. company Nvidia announced its planned acquisition of ARM, a U.K.-based chip designer. In August 2021, the U.K.'s competition watchdog announced an investigation into whether the \$40 billion deal would reduce competition in industries reliant on semiconductor chips. The deal was called off in February 2022.

3.2 International Capital Budgeting

Capital budgeting is a process of investigation and analysis that leads to a key financial decision for both purely domestic firms and MNCs. More broadly, capital budgeting is defined as the process of analyzing capital investment opportunities and deciding which, if any, to undertake.

While calculating the cash flows for international capital budgeting the following accounts must be taken into accounts while calculating the incremental cash flows.

Cannibalization

Sometime the new projects causes the existing cash flows to diminish because of the new projects ; these diminish cash flows are considered as the cash out flows for the new projects and these cash out flows are deducted in the final analysis ; this is known as cannibalization.

Fees and Royalties

Some time you have to pay extra fee of license and other royalties to domestic government these are considered as cash out flows.

Opportunity Cost

Sometimes the opportunity cost is also considered as the cash out flows.

Transfer Pricing

In the international transfer major portion of some product is manufactured in some other subsidiary and the host country little value to finished product. The parent country and the host country are involved in transfer pricing.

So all this discussion implies that:

Incremental Cash flow of International = Global corporate Cash flow with project t- Global corporate Cash flow without project.

3.2.1 Introduction to International Capital Budgeting

Capital budgeting is a process of investigation and analysis that leads to a key financial decision for both purely domestic firms and MNCs. More broadly, capital budgeting is defined as the process of analyzing capital investment opportunities and deciding. It refers to the allocation of scarce resources or making investment in fixed assets e.g., real estates, development expenditures etc. Capital budgeting is a process of evaluating investments and huge expenses in order to obtain the best returns on investment

An organization is often faced with the challenges of selecting between two projects/investments or the buy vs replace decision. Ideally, an organization would like to invest in all profitable projects but due to the limitation on the availability of capital an organization has to choose between different projects/investments. Capital budgeting for a foreign project uses the same theoretical framework as domestic capital budgeting i.e., using the various capital budgeting techniques like NPV, IRR, PI, Payback period etc.

Meaning of International Capital Budgeting

International Capital Budgeting is the process of making investment decisions in real productive assets in foreign countries. International Capital budgeting is used by companies to evaluate on the inflows and outflows associated with prospective long-term investment projects.

3.2.2 Importance of International Capital Budgeting

1) Long-term Strategic Goals:

A capital budgeting decision has its effect over a long-time span and inevitably affects the company's future cost structure and growth. A wrong decision can prove disastrous for the long-term survival of firm. On the other hand, lack of investment in asset would influence the competitive position of the firm. So, the capital budgeting decisions determine the future destiny of the company.

2) Involvement of large amount of funds:

Capital budgeting decisions need substantial amount of capital outlay. In case of international investment projects, the investments are usually larger than domestic investments. This underlines the need for thoughtful, wise and correct decisions as an incorrect decision would not only result in losses but also prevent the firm from earning profit from other investments which could not be undertaken.

3) Future Uncertainty:

Capital budgeting decision is surrounded by great number of uncertainties. Investment is present and investment is future. The future is uncertain and full of risks. Longer the period of project, greater may be the risk and uncertainty. The estimates about cost, revenues and profits may be affected not only by domestic economic environment but international environment.

4) Difficult to decide:

Capital budgeting decision making is a difficult and complicated exercise for the management. International capital budgeting is more complicated than domestic capital budgeting because usually which invest in overseas projects are typically large and the projects are highly capital intensive and the process involves a larger number of parameters and decision variables.

5) High Risk:

Foreign projects differ from purely domestic projects concerning and several factors like the foreign currency dimension, different economic indicators in different countries, and different risk characteristics with which the companies entering foreign market are not familiar as those of domestic projects. All these differences lead to a higher level of risk in evaluating international projects than evaluating domestic capital budgeting projects.

3.2.3 Factors Affecting International Budgeting

Some of these issues in foreign investment analysis are as follows:

1.Foreign Exchange Risk:

Firms investing abroad are exposed to foreign exchange risk the risk that the currency will appreciate or depreciate over a period of time. Understanding of foreign exchange risk is important in the evaluation of cash flows generated by the project over its life cycle.

To incorporate the foreign exchange risk in the cash flow estimates of the project, first an estimate is made of the inflation rate in the host country during the life span of the project. The cash flows, in terms of local currency, are then adjusted upwards for the inflation factor. The cash flows are converted into the parent's currency at the spot exchange rate multiplied by an expected depreciation or appreciation rate.

2) Changes in Exchange Rate:

The cash flow of the parent firm going to be affected on account of change in the exchange rate between parent firms' currency and foreign subsidiary unit's currency. Such changes in the exchange rate also affect the competitive position of the parent firm and in turn impact the long-term cash flow of the project.

3) Tax Issue:

In capital budgeting, only after-tax cash flows are relevant. This is true both for domestic and overseas projects. The tax issue for multinational capital budgeting purposes is complicated by the existence of host country and home country taxes as well as a number of factors. Thus, earnings on foreign projects, first of all, fall in host country tax net. Then on distribution, it is subjected to withholding tax and finally, in the home country the earnings are further taxed.

4) Effect of Inflation:

The rate of inflation in host country and parent country must also be anticipated to decide the real return and exchange rate forecasts. The impact of inflation on the parent's and subsidiary's cash flows can be volatile from year to year for some countries.

It may cause the, currency to weaken and hence influence a project's cash flows. Also, inaccurate inflation forecast by a country, can lead to inaccurate cash flow forecasts. Thus, MNC's cannot afford to ignore the impact of inflation on the cash flows.

5) Segmented Markets:

Segmented Markets refers to market that is isolated from other markets. Since the project is being implemented in a different country, the capital markets are segmented by space. Markets usually become segmented through government intervention.

For example, a government can erect investment barriers. Use of segmented capital markets may provide an opportunity for growth or may involve higher costs. The financing aspect has to be carefully examined, by considering the regulating framework in respective countries.

6) Changes in Disclosure and Accounting Rules:

Investors looking to invest in foreign markets must be aware that foreign governments may not have the same level of regulations that are followed in home country. Each country will have different disclosure and accounting rules. This makes it harder and time-consuming for investors to assess the capital budgeting projects.

7) Remittance Restrictions:

Where there are restrictions on the repatriation of income, substantial differences exist between project cash flows and cash flows received by the parent firm. Only those flows that are remittable to the parent are relevant from the parent firm perspective. Many countries impose a variety of restrictions on transfer of profits, depreciation and other fees accruing to the parent company.

8) Blocked Funds:

Blocked Funds are cash flows generate by a foreign project that cannot be immediately transferred to the parent, usually because of exchange controls imposed by the government of the country in which the funds are held. Some countries require that

the earnings generated by the subsidiary be reinvested locally for at least a certain period of time before they can be remitted to the parent.

Blocked funds cause a discrepancy between the project value from the parent's and local perspective. Also, this can possibly affect the accept/reject decision for a project

9) Complexities of Regulatory Environment:

The differences exist between the parent company cash flow and the project's cash flow because of tax laws and other regulatory environment. For parent company, the cash flows to the parent are relevant because the shareholders expect higher rate of return. Therefore, it is necessary to make a distinction between parent firm cash flow and that of the project.

10) Salvage Value:

The salvage value of a project has an important impact on the NPV of the project. When the salvage value is uncertain, the cash flows will not be accurate and the MNC may need to calculate various possible outcomes for the salvage value and estimate the NPV based on each possible outcome. The feasibility of the project may then depend upon the present value of the salvage value.

11) Political Risk:

In order to attract foreign investments in key sectors, the governments of developing economies generally provide support in the form of subsidy. Likewise, international agencies entrusted with the responsibility of promoting cross-border trade sometimes offer financing at below - market rates.

The value of the subsidized loan should be added to the project while making the investment decision if the subsidized financing is inseparable from the project. But when the government changes the officers given by previous government may change. The additional value from the subsidized financing should not be allocated to the project.

3.2.4 Influence of Inflation on Capital Budgeting Decisions

Inflation affects profitability in four ways. It changes the cost of funds used to finance an enterprise; it increases costs of labor, materials and the price of the product; it affects the tax to be paid; it causes shifts in demand patterns.

1. Cost of borrowing:

When the interest rate rises, the cost of borrowing rises. This makes borrowing expensive. Hence borrowing will decline and as such the money supply (i.e., the amount of money in circulation) will fall. A fall in the money supply will lead to people having lesser money to spend on goods and services. Hence, they will buy a lesser amount of goods and services. This, in turn, will lead to a fall in the demand for goods and services. With the supply remaining constant and the demand for goods and services declining; the price of goods and services will fall.

2) Cost of input:

Cost push inflation is inflation caused by an increase in prices of inputs like labour, raw material, etc. The increased price of the factors of production leads to a decreased supply of these goods. While the demand remains constant, the prices of commodities increase causing a rise in the overall price level. The overall price level increases due to higher costs of production which reflects in terms of increased prices of goods and commodities which majorly use these inputs. This is inflation triggered from supply side i.e., because of less supply. The opposite effect of this is called demand pull inflation where higher demand triggers inflation.

3) Impact on accounting practice:

Inflation has an impact on how a business is valued by investors and prospective purchasers who do not value inflation profits highly. A business that fails to take this factor into account in its financial planning may see the value of the business decline, despite steady or modestly rising profits.

Companies that fall under this category may be required to update their statements periodically in order to make them relevant to current economic and financial conditions, supplementing cost-based financial statements with regular price-level

adjusted statements. Although accountants apply different accounting standards like IFRS and GAAP, consistency is required within a particular business. However, different policies in different businesses can affect their reported results and distort the picture of where your business stands in relation to other businesses.

4) Increases costs of labour:

Inflation affects labour market efficiency by influencing firms' wage-setting practices and compensation schemes. In economies with competitive labour, capital and product markets, comparable workers at equivalent jobs will tend to be compensated similarly.

If an employer sets wages too low, it will lose employees; the resulting turnover will lead to lower profits. If an employer pays too much, it will either suffer a profit loss or be forced to lay off workers because it will be unable to price products competitively. Thus, any factor that interferes with firms' accurate wage setting can raise unemployment, worker turnover, or company failures. Since labour is typically a large component of companies' costs, such widespread interference in this market can impair the efficiency of the economy.

5) Effects on discount rate:

A discount rate is the rate at which any given entity can expect to earn on their money invested. The discount rate has become one of the central concepts of finance. Setting a high discount rate tends to have the effect of raising other interest rates in the economy since it represents the cost of borrowing money for most major commercial banks and other depository institutions. This could be considered a contractionary monetary policy. Exactly how much a high discount rate affects the economy as a whole depends on the relationship between the discount rate and the normal market rate of interest for loans to banks.

6) Effects on corporate finance and tax on capital return:

Inflation refers to price increases and currency depreciation. It mainly means that if inflation occurs within a certain period of time, not only will the purchasing power of the currency continue to decline, but also the overall price level will rise. Therefore, under the influence of inflation, the company will not only lack funds, but also cause poor

purchasing power of funds. Therefore, in order to do a good job in the company's financial management, especially to better cope with inflation, it should ensure that the company's reasonable cash holdings.

For quantity, scientifically and reasonably determine the quantity of inventories and the status of collecting and responding to accounts as soon as possible, a longer-term investment strategic plan should also be formulated. Only by adopting effective methods to control the tax burden can the economic losses caused by inflation be truly reduced and can the sustainable development of enterprises be realized.

7) Declines purchasing power of corporate funds:

During the period of inflation, the amount of monetary assets tends to be less than that of the same period, and the amount of goods or labour obtained is less, so the purchasing power of currency continues to decline. If the degree of monetary liabilities will cause business difficulties. As prices continue to rise and change, the value of non-monetary assets and liabilities of enterprises will continue to increase, and even limit the normal operation of enterprises.

8) Affects production capacity:

During the period of inflation, due to the underestimation of capital and the overestimation of profits, there production capacity of enterprises was severely damaged. For example, insufficient capital compensation and compensation funds cannot make the enterprise function normally, which leads to the continuous shrinking of the production scale of the enterprise. Because the enterprise bears excess tax burden, resulting in a false increase in profits, in the end, if the company's profits increase, shareholders will demand the right to allocate more work, but the profit is less, this causes the company's effects companies financial strength

3.2.5 Benefits of International Capital Budgeting

- Valuable learning experience.
- Knowledge
- Globalization etc.

3.3 International Portfolio

An international portfolio is a selection of stocks and other assets that focuses on foreign markets rather than domestic ones. If well designed, an international portfolio gives the investor exposure to emerging and developed markets and provides diversification.

3.3.1 Understanding the International Portfolio

An international portfolio appeals to investors who want to diversify their assets by moving away from a domestic-only portfolio. This type of portfolio can carry increased risks due to potential economic and political instability in some emerging markets, There also is the risk that a foreign market's currency will slip in value against the U.S. dollar.

The worst of these risks can be reduced by offsetting riskier emerging-market stocks with investments in industrialized and mature foreign markets. Or, the risks can be offset by investing in the stocks of American companies that are showing their best growth in markets abroad.

The most cost-effective way for investors to hold an international portfolio is to buy an exchange-traded fund (ETF) that focuses on foreign equities, such as the Vanguard FTSE Developed Markets ETF (VEA) or the Schwab International Equity ETF (SCHF).

Risky and Less Risky Choices

The recent growth of the economies of China and India greatly exceeded those of the U.S. That created a rush to invest in the stocks of those countries. Both are still growing fast, but an investor in the stocks of either nation now would have to do some research to find stocks that have not already seen their best days.

The search for new fast-growing countries has led to some winners and losers. Not long ago, investors going for fast growth were looking to the CIVETS nations—Colombia, Indonesia, Vietnam, Egypt, Turkey, and South Africa. Not all those countries would still be on any investor's list of promising economies.

3.3.2 About Foreign Portfolio Investments

Investment in financial assets of a foreign nation, such as stocks or bonds listed on an exchange, is known as foreign portfolio investment (FPI). Since portfolio investments can be easily sold off and are therefore perceived as a short-term effort to

make money instead of a long-term investment in the economy, this sort of investment is sometimes viewed less positively than direct investment. Compared to direct investments, portfolio investments often have a shorter time to maturity.

Foreign portfolio investors typically anticipate seeing a return on their assets quite fast, just like with any stock investment. The liquidity of portfolio assets makes them simpler to sell compared to direct investments because securities are widely traded. Because they demand significantly less investment cash and due diligence than direct investments, portfolio investments are much more affordable for the typical investor. The investor does not have an influence on the business firm in which the investment is made, in contrast to direct investments.

Making and keeping a hands-off, or passive, investment in a portfolio of assets is done with the hope of getting a return. These securities can be equities or global depositary receipts of corporations with headquarters from outside the investor's country in foreign portfolio investment. Holding also comprises mutual funds or exchange traded funds (ETFs) that invest in foreign or international assets, as well as bonds or other debt issued by these businesses or foreign governments. The likelihood of an individual investor using an FPI to invest in possibilities located outside of their home nation is high.

On a larger scale, a country's foreign portfolio investment is reflected on its balance of payments as part of its capital account (BOP). The BOP calculates the amount of money that moves from one nation to another throughout a single fiscal year.

Foreign portfolio investments can be done by individuals, companies or even government agencies. Such investments help entrepreneurs in diversifying their portfolios, giving them an edge in international markets. An FPI will be featured in a country's capital account and is part of the balance of payments which takes stock of money flowing in and out of the country over a specific period of time.

Pros of Foreign Portfolio Investments are as follows:

- **Portfolio diversification:**

FPI enables investors to diversify their portfolios on the international stage.

- **International Credit:**

FPI can give creditors a large credit base as it provides access to credit in foreign nations.

- **Benefits from the Exchange rates:**

If an investor has an FPI in a foreign country with a stronger currency than their own country, the difference in exchange rates between the two countries can benefit the investor.

- **Feasibility:**

Foreign Portfolio Investment option is feasible with retail investors as the amount of money is much less than that of the FDI and involves simpler legalities in general.

- **Returns:**

Foreign Portfolio Investments give quicker returns as compared to that FDI. basically, the investor can sell his or her portfolio investments as and when he/she wants on the prevailing prices of that asset.

Cons of Foreign Portfolio Investments are as follows:

- **Control:**

In contrast to FDI, in FPI the investor has no control over the management or functioning of the firm or business entity whose asset is bought.

- **Volatile:**

Foreign Portfolio Investments are much more volatile to adverse shocks and thus their asset prices fluctuate every second.

- **Economic Disruption:**

Foreign Portfolio Investments are not a dependable option as it is prone to panic sell or whale/shark selloffs thereby reducing the asset price and leading to money crunch on a large scale which may disrupt the economy.

- In a foreign portfolio investment, it is not necessary for an investor to actively manage the investment or the companies that issue the investment. In other words, they don't have direct control over the assets.
- Through foreign direct investment, an investor is allowed to purchase a direct business interest in a foreign country. For example, an investor based in Bangalore purchases a restaurant chain in Tokyo to lease to an American company that needs space to expand its operations. The investor's goal is to create a long-term income stream while helping the company increase its profits.
- This [Foreign Direct Investment \(FDI\)](#) investor controls their investments directly and plays an active role in deciding where the company puts the money. The investor helps in setting up the business and nurtures it to the point where he/she can ascertain there is a viable return on investment (ROI). Since the investor's money is fully committed to the business, they will face liquidity and more risk when selling the interest.

3.3.3 Differences between FPI and FDI

Difference between Foreign Portfolio Investment and Foreign Direct Investment	
Foreign Portfolio Investment	Foreign Direct Investment
Foreign Portfolio Investment or FPI refers to the investment made in the financial assets of an enterprise, based in one country, by the foreign investors	Foreign direct investment or FDI pertains to international investment in which the investor obtains a lasting interest in an enterprise in another country
An investor is inactive	An investor is active

Indirect investments in assets are made	Direct investments in assets are made
Investments made are short term in nature	Investments made are long term in nature
FPI are volatile in nature	FDI are stable in nature

3.3.4 Advantages and Disadvantages of an International Portfolio

Advantages

- Market Cycle Timing
- May Reduce Risk
- Diversify Currency Exposure

Disadvantages

- Political and Economic Risk
- Increased Transaction Cost
- Currency Exchange Rate Risk

Advantages Explained

May Reduce Risk:

An international portfolio can be used to reduce investment risk. If U.S. stocks underperform, gains in the investor's international holdings can smooth out returns. For example, an investor may split a portfolio evenly between foreign and domestic holdings.

The domestic portfolio may decline by 10%, while the international portfolio could advance 20%, leaving the investor with an overall net return of 10%. Risk can be reduced further by holding a selection of stocks from developed and emerging markets in the international portfolio.

Diversifies Currency Exposure:

When investors buy stocks for an international portfolio, they are also effectively buying the currencies in which the stocks are quoted. For example, if an investor purchases a stock listed on the London Stock Exchange, the value of that stock may rise and fall with the British pound. If the U.S. dollar falls, the investor's international portfolio helps to neutralize currency fluctuations.

Market Cycle Timing:

An investor with an international portfolio can take advantage of the market cycles of different nations. For instance, an investor may believe U.S. stocks and the U.S. dollar are overvalued and may look for investment opportunities in developing regions, such as Latin America and Asia, that are believed to benefit from capital inflow and demand for commodities.

Disadvantages Explained

Political and Economic Risk:

Many developing countries do not have the same level of political and economic stability that the United States does. This increases risks to a level many investors don't feel they can tolerate. For example, a political coup in a developing country may result in its stock market declining by 40%.

Increased Transaction Costs:

Investors typically pay more in commission and brokerage charges when they buy and sell international stocks, which reduces their overall returns. Taxes, stamp duties, levies, and exchange fees may also need to be paid, which dilute gains further. Many of these costs can be significantly reduced or eliminated by gaining exposure to an international portfolio using ETFs or mutual funds.

Currency Exchange Rate Risk:

Exchange rate is the value of one country's currency to another's. Exchange rates fluctuate, so it is possible to lose money if rates drop significantly.

Benefits of an International Portfolio

International portfolios give you more diversification, let you access liquidity in other markets, and can help you reduce the risks of the market you invest in the most.

An investment portfolio can help you achieve your long-term financial dreams. For example, build a nest egg for your retirement, repay your mortgage early, or pay university fees for your children. While savings accounts offer easy access and the security of guaranteed capital, the returns can be small.

3.4 Unit Summary:

In this module we have learnt that FDI has come out as a buzzword in international business and have received significant consideration in the foreign trade policies. It represents movement of capital, both short term and long term, in and out of a country with the purpose of buying physical and financial assets to start a business. It specifies the transfer of bundle of resources across the national boundaries, which includes capital, technology, management and marketing expertise.

The module also put light on the role of FDI in the development of economy as it plays a pivotal role in the growth of international business. It opens new vistas for a firm in the form of new international markets and marketing channels, cheaper production facilities, access to new technologies, products, financing and skills. The firm which receives the investment or for a host country, it can provide a source of new technology, capital, product, management skills and also can provide a strong drift to economic development.

Foreign Direct Investment plays a critical role in promoting economic growth, technology transfer, job creation, and international cooperation. It benefits both the host country and the investing entity by driving economic development, enhancing competitiveness, and fostering global integration. With the potential for mutual gains and

positive spillover effects, FDI serves as a catalyst for economic transformation and prosperity.

3.5 Check your progress

1. India is facing a continuous deficit in its balance of payments in the foreign exchange market rupee is expected to _____

- A. Appreciate
- B. Depreciate
- C. Show no specific tendency
- D. All of the above

2. _____ is not a characteristic of speculation.

- A. Hedging
- Advertisement
- B. Risk-taking
- C. Profit motive
- D. Exchange rate fluctuation

3. The responsibility for the administration of FEMA is vested with _____

- A. Central government
- B. State government
- C. RBI
- D. National banks

4. A source of supply of foreign exchange is _____

- A. Imports
- B. Exports
- C. Donations

D. Gifts

5. The foreign direct investment includes _____

- A. tangible good
- B. intangible good
- C. intellectual property
- D. human resources

6. The three disputes of FDI are over _____

- A. hobby
- B. interest
- C. regard
- D. concern

7. More expansion of foreign direct investment can boost _____

- A. demand
- B. money circulation
- C. employment
- D. unemployment

8. Who determines foreign exchange rates in India?

- A. RBI
- B. FEDAI
- C. market forces of demand and supply
- D. finance ministry of India

9. Who regulates foreign trade in India?

- A. SEBI

B. FEDAI

C. RBI

D. DGFT

10. The statutory authority which administers the exchange control in India _____

A. RBI

B. ministry of commerce

C. DGFT

D. FEDAI

11. The main objective of international financial Management is to arrange sufficient funds for meeting the _____ goals of an organization.

A. short term

B. long term

C. medium term

D. all of the above

12. Which Indian industries have been hit by globalization?

A. Jute

B. toy making

C. information technology

D. cement

13. When did government remove the barrier to investment in India?

Advertisement

A. 1193

B. 1992

C. 1991

D. 1990

14. Foreign income received in India during the previous year is taxable in the case of _____

- A. Non resident
- B. resident
- C. not ordinarily resident
- D. all of the above

15. CCIL stands for _____

- A. The clearance code of India
- B. The clearing corporation of India
- C. The clearing committee of India
- D. The clearing consignment of India

16. _____ refers to converting illegal money into legitimate money.

- A. money laundering
- B. tax evasion
- C. black money
- D. demonetization

17. If portable devices made in India are imported into the United States, the Indian manufacturer is paid with _____

- A. euros
- B. dollars
- C. international monetary credits
- D. rupees

18. Which of the following is known as paper gold?

- A. Bitcoin
- B. US dollar

- C. demand draft
- D. special drawing right

19. Tax on imports can be treated as _____

- A. foreign trade
- B. collateral trade
- C. trade barriers
- D. terms of trade

20. IMS is the full form of _____

- A. International monetary source
- B. International monetary system
- C. International monetary structure
- D. International monetary society

21. _____ offers the exporter the greatest level of safety.

- A. Cash in advance
- B. Letter of credit
- C. Wire transfer
- D. UPI

22. The globalization of business activities has _____ the complexity as well as the importance of the financial managers' duties.

- A. Increased
- B. Decreased
- C. Ignored
- D. Vanished

23. Due to globalization, the financial management function has become _____.

- A. Less demanding and complex

- B. More demanding and complex
- C. Less important and complex
- D. Outdated and complex

24. International finance mainly discusses the issues related with monetary interactions of at least_____.

- A. one country
- B. two or more countries
- C. five countries
- D. None of the above

25. International finance is concerned with_____

- A. exchange rates of currencies
- B. monetary systems of the world
- C. foreign direct investment
- D. all of the above

3.6 Glossary

Deep offshore drilling	it typically defined as drilling in a water depth that is greater than 500 feet (150 meters). In general, rigs drilling in this environment are drill ships and semisubmersibles. Wells being drilled in deep offshore environments are typically extended reach and use cutting edge industry technology.
Foreign Direct Investment (FDI)	A foreign direct investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country. It is thus distinguished from foreign portfolio investment by a notion of direct control.
Gross Domestic Product (GDP)	GDP is the total value of everything produced by all the people and companies in the nation state.
Industrial Production Index (IPI)	The industrial production index (abbreviated IPI and sometimes also called industrial output index or industrial volume index) is a business cycle indicator which measures monthly changes in the price-adjusted output of industry. This report uses

	the industrial production index as it is calculated in the European Union (EU-28). The Industrial Production Index (IPI) is also an economic indicator published by the Federal Reserve Board of the United States that measures the real production output of manufacturing, mining, and utilities. It is not clear if both the EU and the US use exactly the same method of calculation.
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3.7 Self Assessment

i) Answer the short answers

1. What are international investments
2. What do you understand by foreign exchange risk?
3. What are the different external exposure management techniques which are used by importers and exporters?
- 4) What is portfolio investment?
- 5) What is the problem of international investment?

ii) Answer the Essay question

1. Distinguish between 'Foreign direct investments' (FDI) and 'Portfolio Investment' and discuss the different strategies of portfolio investment
2. What factors drive investors to go in for portfolio investment?
3. Explain the concept of Balance of Payments (BOP) and discuss the different accounts of BOP. Can a country run a current account deficit (surplus) indefinitely? Give reasons.
4. Explain with the help of an imaginary illustration, how capital budgeting decisions of any MNC may be different from domestic firms.
5. Minimization of global tax liability is not the only objective of transfer pricing. Discuss.
6. Explain the need for the advantages of centralized cash management for a company which is involved in international business.
7. An export company wants to raise capital from international markets. What are the basic considerations the firm should take into account while making this international financing decision? Explain.

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UNIT-IV

International Finance Decision

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

4.1 Understanding International Finance

International finance deals with the economic interactions between multiple countries, rather than narrowly focusing on individual markets. International finance research is conducted by large institutions such as the International Finance Corp. (IFC), and the National Bureau of Economic Research (NBER). Furthermore, the U.S. Federal Reserve has a division dedicated to analyzing policies germane to U.S. capital flow, external trade, and the development of global markets.

Introduction:

The international financial market is the worldwide marketplace in which buyers and sellers trade financial assets, such as stocks, bonds, currencies, commodities and derivatives across national borders. Over recent decades, there has been a steady increase in cross-border financial flows around the world.

There are two main reasons for the integration of markets. First, various financial institutions including banks and institutional investors have expanded their activities geographically. In this process, they acted as an intermediary to channel funds from lenders to borrowers across national borders.

Second, the more mature securities markets have gained a clear cross-border orientation. In many instances, newly issued securities are designed and offered to the public in such a way as to maximize their appeal to international investors.

These developments reflected the progressive dismantling of controls on cross-border financial flows as well as the liberalization of national financial markets more generally.



http://www.unifr.ch/cgf/assets/images/unigalerie/photo_intfin.jpg

Technological advancement and financial innovation played a key role in developing globalization of financial markets for the last two decades. Information systems have become able to compute and store more data. Telecommunications networks have extended their ramifications and increased their capacity while more reliable data exchange protocols have made it possible to connect computing machines in more efficient ways. As a result, cross-border financial deals have become easier and more secure.

Moreover, over the last two decades, more innovative financial products are evolved in the financial market, called as “derivative” instruments. These products make it possible for borrowers and lenders to customize their risk exposures as well as adjust them over time. With derivative products, borrowers and lenders can therefore, customise their contracts and hedge their risk by entering into a legally binding contract. Derivatives provide an effective solution to the problem of risk caused by uncertainty and volatility in underlying asset.

4.1.1 Nature of International Finance

International finance is a distinct field of study and certain features set it apart from others. The important differentiating features of international finance are explained as follows:

1. Foreign Exchange Risk
2. Expanded Opportunity Sets
3. Political Risk
4. Market
5. Imperfection



1) Foreign Exchange Risk:

An understanding of foreign exchange risk is essential for managers and investors in today's dynamic environment, characterized by unpredictable fluctuations in foreign exchange rates. In a domestic economy, this risk is generally disregarded due to a single national currency that serves as a country's primary medium of exchange. When different national currencies are exchanged for each other, there is a clear risk of volatility in foreign exchange rates.

The present International Monetary System is characterized by a combination of floating and managed exchange rate policies, which are adopted by each nation based on their respective interests. This variability of exchange rates is widely regarded as the most serious international financial problem facing corporate managers and policymakers.

2) Political Risk:

One of the potential challenges that firms may face in the realm of international finance is political risk. Political risk includes a wide range of potential losses or gains resulting from unforeseen government actions or other politically driven events, including acts of terrorism, as well as the outright expropriation of assets held by foreign entities. [Multinational companies](#) (MNCs) must diligently evaluate the political risks in countries where they are currently doing business and where they expect to establish subsidiaries.

3) Expanded Opportunity Sets:

When companies expand their operations globally, they also benefit from increased opportunities that are available now. They can raise funds in a capital market where the cost of capital is the lowest. In addition, firms can also gain from enhanced economies of scale by expanding their operations globally.

4) Market Imperfections:

The final feature of international finance that distinguishes it from domestic finance is the significant imperfections prevalent in today's global markets. There are profound differences among nations' laws, business practices, tax systems, and general cultural environments of different countries. Imperfections in the world financial markets hinder investors from fully diversifying their portfolios. Though there are risks and costs in coping with these market imperfections, they present to managers of international firms.

4.1.2 Principles of International Finance

The financial manager has three major functions:

1. Financial planning and control,
2. The [acquisition](#) of funds, and
3. The allocation of funds.

However, each of these three functions shares most principles of global finance and their relationships. Seven important principles of global finance are given as follows:

1) Risk-Return Trade-Off:

The maximisation of stockholders' wealth depends on the trade-off between risk and profitability. Generally, the higher the project risk, the higher the expected return from the project. For example, if anyone is offered a chance to invest in a project that offers an extremely high rate of return, you should immediately suspect that the project is very risky. The risk-return trade-off does not apply to 100 per cent of all cases, but in a free enterprise system, it probably comes close. Thus, the financial manager must determine the optimal balance between risk and profitability to maximize returns.

2) Market Imperfections:

Perfect competition exists when sellers of goods and services have complete freedom of entry into and exit any national market. Under such conditions, the mobility and transferability of goods and [services](#) would be unhindered. Unrestricted mobility fosters cost and return equality among nations. This cost-return uniformity everywhere in the world would eliminate the [motivation](#) for international trade and investment.

3) Portfolio Effect (Diversification):

The portfolio effect states that as more assets are added to a portfolio, the overall risk of the portfolio diminishes. This principle underscores the notion that diversification can lead to a reduction in risk. This principle explains much of the rationale for large MNCs to diversify their operations across industries, countries, and currencies. Some MNCs, such as Nestle of Switzerland, have established operations in countries as varied as the United States, Mexico, Nigeria, Hong Kong, Japan, Russia, France, Brazil, Vietnam and North Korea. Because it is impossible to predict which countries will outperform other countries in the future, these companies are adopting a strategy of hedging their bets.

4) Comparative Advantage:

Comparative advantage states that trade between the two countries can boost living standards in both. Trade allows countries to specialise in what they do best and to

enjoy a wider array of goods and services. At the same time, companies earn profits from trade because individual companies conduct most trade transactions.

5) Internationalisation Advantage:

The advantages of internationalisation influence companies to invest directly in foreign countries. These advantages depend on three factors:

1. Location,
2. Ownership, and
3. Internationalization

Exxon Mobil has ownership advantages, such as technology, marketing expertise, capital and brand names. Venezuela has location advantages, including vast crude oil reserves, a plentiful labour force, and favourable tax rates. The advantages of internationalization enable MNCs to enjoy superior earnings performance over domestic companies.

6) Economies of Scale:

There are economies of scale in the use of multiple assets. Economies of scale are realized through a synergistic effect, which is said to exist when the whole is greater than the sum of individual components. When companies produce or sell their primary product in new markets, they may increase their earnings and shareholder's wealth due to economies of scale. Companies can benefit from greater economies of scale when strategically allocating their tangible and financial resources globally. The expansion of a company's operations beyond national borders allows it to acquire necessary management skills and effectively disseminate existing expertise across a broader operation.

7) Valuation:

The valuation principle states that the value of an asset is equal to the present value of expected earnings. The value of an MNC is usually higher than the value of a domestic company for reasons:

1. Research indicates that multinational corporations (MNCs) earn more profits than domestic companies.
2. The earnings of larger companies are capitalised at lower rates.

The securities of multinational corporations (MNCs) generally possess superior marketability in comparison to domestic companies. MNCs are also better known among investors. These factors lead to a lower required rate of return and higher price-earning ratios. When MNCs attempt to maximise their overall company value, they also face various constraints. Those constraints that hamper an MNC's ability to maximize its shareholders' wealth encompass significant agency costs and environmental disparities.

4.1.3 Importance of Managing International Finance

International financial management deals with the financial decisions made within [international business](#). The growth in international business is first of all, evident in the form of the highly inflated size of international trade. The need for international financial management has increased because of the following factors:

1) Complex Financial Decisions:

One of the reasons for the need for international financial management is the complexity of the financial decisions of MNCs. Today's MNCs are more interested in maximising the value of global wealth. And to manage it quite well, international financial management helps a lot.

2) Lending of Funds:

Another reason for the need is the vast magnitude of lending international and regional development tasks. The movement of funds from developed countries and the reverse movement of funds in the form of interest and amortisation payments need proper management.

3) Expansion Of Multinational Companies:

By expansion of the operations of multinational companies, the cross-country flow of funds increased substantially. The two-way flow of funds, outward in the form of investment and inward in the form of repatriation divided royalty, and technical service fees requires proper management. And for doing it, efficient international financial management is a must.

4) Others:

Some other points that emphasise the importance of international financial management are as follows:

1. Increase in the volume of international trade.
2. The globalisation of businesses.
3. Increase in the movement of capital and labour with fewer restrictions.
4. Increase in speed of [communication](#) and transport.
5. The emergence of international capital and [money markets](#).

4.1.4 Types of International Financial Markets

International Financial Markets can be classified as:

1. Foreign Exchange Market :

Foreign Exchange is a market where participant buy and sell foreign currencies i.e. in this market one currency is exchanged for other currency. The foreign exchange market (Forex or Currency market) is a worldwide decentralized over-the-counter financial market for the trading of currencies.

Financial centres around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekends. The foreign exchange market determines the relative values of different currencies. The primary purpose of the foreign exchange market is to assist international

trade and investment, by allowing businesses to convert one currency to another currency.

For example, it permits a US business to import British goods and pay Pound Sterling, even though the business's income is in US dollars. It also supports speculation, and facilitates the carry trade, in which investors borrow low-yielding currencies and lend (invest in) high-yielding currencies, and which (it has been claimed) may lead to loss of competitiveness in some countries.



https://androidinsider.ru/wp-content/uploads/2015/05/shutterstock_136007171.jpg

In a typical foreign exchange transaction, a party purchases a quantity of one currency by paying a quantity of another currency. The modern foreign exchange market started forming during the 1970s when countries gradually switched to floating exchange rates from the previous exchange rate regime, which remained fixed as per the Bretton Woods system.

The foreign exchange market is unique because of its following features:

- huge trading volume, leading to high liquidity
- geographical dispersion
- continuous operation: 24 hours a day except weekends,
- the variety of factors that affect exchange rates
- the low margins of relative profit compared with other markets of fixed income

- the use of leverage to enhance profit margins with respect to account size.

2. Option Market



http://archive.fortune.com/assets/i2.cdn.turner.com/money/2011/10/07/pf/call_options_profit.fortune/profit_from_market_volatility.top.jpg

Option market is a market where option contracts are traded. Option is a contract for the future delivery of a specific financial asset in exchange for another, in which the option holder has the right to buy/sell the financial asset at agreed price, exercise price or strike price but is not required to do so. The right to buy is a Call Option and right to sell is a Put Option.

For such a right the option buyer pays the amount called as Option Premium. The option seller receives the premium and is obliged to make (or take) the delivery at an agreed upon price, if the buyer exercise his option. There are two types of option contracts:

- **American Option** are the contracts in which the buyer of the option has the right to exercise his option at any time before the maturity date of the contract.
- **European Option** are the contracts in the which the buyer of the option can only exercise his option on the maturity date of the contract.

There are two types of option markets-organized exchange and over the counter market. Exchange traded options are standardized contracts with predetermined prices, standard maturity period with fixed maturity months. The entire dealing is through clearing house.

But over the counter market is related to the inter bank option contracts. These contracts are tailored as per the needs of the clients. No clearing houses are required for functioning of the market.

3. Future Market

Future market is a market where future contracts are traded. A future contract is an agreement to buy or sell a standard quantity of a specific financial asset on a future date at a specified price agreed upon between the parties through a transaction on the floor of organized future exchange. It is an organized market where contracts are undertaken by the parties for the future commitment of prices. It is an organized market where a recognized exchange is involved for the future delivery. Moreover, future contracts are standardized contracts, which must be settled through a clearing house of the stock exchange. These contracts are adjusted through daily mark to market basis.



<http://easy-stock-market.com/wp-content/uploads/2016/03/futures-market.jpg>

Euro Currency Market “Euro” refers to the funds outside the country of the currency in which these funds are denominated. Euro currency market is a market where Euro banks accept deposits and make loan which are essentially denominated in a currency other than the currency of the country where that Euro banks are located e.g. Eurodollars are dollar ‘denominated deposits in the banks outside the United States. Usually,

Euro currency market includes all Euro currency liabilities, inter-bank deposits and transactions between Eurobond and non-bank users. But in its actual sense, it includes only those deposits and loans which take place between Euro banks and non-bankers. Initially, Euro currency market was originated as dollar denominated Euro deposits and Euro loans. But now it is not confined only to Euro dollar market. So many other currencies have taken the form of Euro currency.



http://cbsnews2.cbsstatic.com/hub/i/r/2011/11/29/a460c784-a644-11e2-a3f0-029118418759/thumbnail/620x350/4d3262fb9d2e4bfb3e154b22e0f8cbf6/euro_generic_1069671.jpg

Euro market includes both capital market and money market. Euro banking involves attracting funds from non-residents and “making loans to other non-residents. Initially it was confined only to dollar deposits and loans but now it has taken so many shapes i.e. GDRs, ADRs, FRNs, EMTNs, FRCs, ECPs, EBs and so many other instruments. Euro market continued to grow by attracting both borrowers and depositors by offering much better rates as compared to domestic market. So many countries have eased exchange controls and also encouraged offshore banking.

Funds have found their way into Euro currency arena. As a result, the size of Euro market is growing day by day. In case of currencies, which are relatively free convertible into other currencies, deep Euro markets exist. Euro banks are generally located in those canters that refrain from regulating foreign currency banking activities. Though so many currencies have entered in Euro market yet Euro dollar market remains the major players in Euro currency market London is main centre of Euro Currency.

4. Participants in Financial Markets

Borrowers/Issuers, Lenders/Investors and Intermediaries are the major players of the international markets. The role of these players is discussed below:

Borrowers/issuers

These are primarily corporates, banks, financial institutions, government and quasi-government bodies and supranational organizations, which need forex funds for various reasons. The important reasons for corporate borrowings are, need for foreign currencies for operation in markets abroad, duly saturated domestic market and expansion of operations into other countries.

Governments borrow in the global financial market for adjusting the balance of payments mismatches, to gain net capital investments abroad and to keep a sufficient inventory of foreign currency reserves for contingencies like supporting the domestic currency against speculative pressures.



<http://currencytradingfacts.com/wp-content/uploads/2016/05/loans6.jpg>

Further, the supranational organizations like the International Monetary Fund (IMF), World Bank, International Finance Corporation, Asian Development Bank, etc., borrow usually, long-term funds to finance diversified financing, sometimes linked to swaps for hedging current/interest rate exposures. These supranational are also typical examples of large entities appearing in the global markets as both issuers and borrowers.

Lenders/Investors

In case of Euro-Loans, the lenders are mainly banks who possess inherent confidence on the credibility of the borrowing corporate or any other entity mentioned above. In case of a GDR, it is the institutional investors and high net worth individuals who subscribe to the equity of the corporates. For an ADR, it is the institutional investor or the individual investor through the Qualified Institutional Buyer who puts in the money in the instrument depending on the statutory status attributed to the ADR as per the statutory requirements of the land. Investors in the global markets come in a large range who invests to suit their own requirements, investment objectives, risk taking abilities and liabilities. The investor range includes private individuals investing through Swiss Banks, the IMF and the World Bank. The other major investors are insurance companies, professional pension fund managers and investment trusts.

In the United Kingdom, with London still a major force in the international finance market, it is the pension fund and insurance companies which are the major investors in the equity markets and bond markets. In the USA and Japan, the private player has an important role in the equity markets. In Germany, on the other hand, commercial banks play a dominant role as investors.



<https://resources.stuff.co.nz/content/dam/images/1/7/q/z/5/m/image.620x349.17qdx.png>
[/1446071398353.jpg](#)

Speculators

Speculators are type of investors' who take higher than average risks, seeking for abnormal profits, as they are mainly concerned about speculating which might be the futuristic prices of a certain asset e.g. currency or a commodity; mainly they are involved in buying and selling future and option contracts in the short term, as they represent almost 70% of investors'; which might be known by "Risk Seekers".

Hedgers

Hedgers are types of investors' who tries to avoid or cancel any risks that can be accompanied with certain investment, they try to take positions that might prevent them from any potential losses, these types of investors' are widely found in markets that are full of uncertainties and high volatility. There are many types of hedging positions like natural hedges, hedging credit risk, hedging currency risk, hedging equity and equity futures. Which are also known by "Risk Neutrals".

Arbitragers

Arbitragers are types of investors' who buy securities in one market then immediately resell it in another market in order to profit from prices divergence, as this type of dealing is only suggested only for well experienced investors' as any delay in transactions could result of huge losses; the effect of these transaction would result in adjusting price differences between markets.

Intermediaries

The There are a number of market intermediaries known as financial intermediaries or merchant bankers, operating in financial system. These are also known as investment managers or investment bankers. The objective of these intermediaries is to smoothen the process of investment and to establish a link between the investors and

the users of funds. Corporations and Governments do not market their securities directly to the investors.

Instead, they hire the services of the market intermediaries to represent them to the investors. Investors, particularly small investors, find it difficult to make direct investment. A small investor desiring to invest may not find a willing and desirable borrower. He may not be able to diversify across borrowers to reduce risk. He may not be equipped to assess and monitor the credit risk of borrowers.



http://knowledge.wharton.upenn.edu/wp-content/uploads/1999/05/19_0.jpg

Market intermediaries help investors to select investments by providing investment consultancy, market analysis and credit rating of investment instruments. In order to operate in secondary market, the investors have to transact through share brokers. Mutual funds and investment companies pool the funds (savings) of investors and invest the corpus in different investment alternatives.

These market intermediaries provide different types of financial services to the investors. They provide expertise to the securities issuers. They are constantly operating in the financial market. Small investors in particular and other investors too, rely on them. It is in their (market intermediaries) own interest to behave rationally, maintain integrity and to protect and maintain reputation, otherwise the investors would not be trusting

them next time. In principle, these intermediaries bring efficiency to corporate fund raising by developing expertise in pricing new issues and marketing them to the investors. Some of these are discussed as follows:

- **Lead Managers:**

The responsibilities of a Lead Manager include undertaking due diligence and preparing the offer circular, marketing the issues including arranging the roadshows. Lead manager, sometimes in consultation with the issuer, can choose to invite a syndicate of investment banks to buy some of the Bonds,/DRs (Depository Receipts) and help sell the remainder to other investors. 'Co- managers' are thus invited to join the deal, each of whom agrees to take a substantial portion of the issue to sell to their investor clients.

Quite often there will be more than one lead manager as mandates are sometimes jointly won, or the investment bank which actually won the mandate from the issuer may decide that it needs another institution to ensure a successful launch. Two or more managers may also reflect the fact that a geographical spread of placing power is required or deemed appropriate. One of the lead manager will 'run the books' for the issue. This essentially involves arranging the whole issue, sending out invitation telexes, allotting Bonds /DRs, etc.

- **Underwriters:**

The lead managers and co-managers act as underwriters for the issue, taking on the risk of interest rates or markets moving against them before they have placed Bonds/DRs. Lead managers may also invite additional investment banks to act as sub-underwriters, thus forming a larger underwriting group. A third group of investment banks may also be invited to join the issue as members of selling group, but these institutions only receive a commission in respect of any Bonds/DRs sold and do not act as underwriters. The co-managers and the underwriters are also members of the selling group.



<https://www.google.co.in/url?q=http%3A%2F%2Fwww.firstamtech.com%2Findex.php%2F2011%2F09%2Ftitle-insurance-underwriters-myth-or-fact%2F&usg=AFQjCNEsPBvd9x2LMhiY1Nr3bi4rIQUsVA>

- **Agents and Trustees:**

These intermediaries are involved in the issue of bonds/ convertibles. The issuer of bonds/convertibles, in association with the lead manager must appoint 'paying agents' in different financial centers, who will arrange for the payment of interest and principal due to investors under the terms of the issue. These paying agents will be banks

- **Lawyers and Auditors:**

The lead manager will appoint a prominent firm of solicitors to draw up documentations evidencing Bond/DRs issue. The various draft documents will be scrutinized by lawyers acting for the issuer and in due course by the co-managers and any other party signing a document related to the issue. Many of these documents are prepared in standard forms, but each needs to be reviewed carefully to ensure that all parties to the transactions are fully satisfied with the wording. The issuer will also appoint legal advisors to seek advice on matters pertaining to Indian/English/ American law and to comment on necessary legal documentation. Auditors or reporting accountants will become involved as well, supplying financial information, summaries and an audit report which will be incorporated into the 'offering circular'. The auditors provide comfort letters

to the lead manager on the financial health of the issuer. Further, they also provide a statement of difference between the UK and the Indian GAAP in case of GDR issue.



http://2.bp.blogspot.com/-krW__Xc0hwo/VkYWvwgDk5I/Q/FWSIDTKuT8M/s1600/audit-law.jpg

- **Listing Agents and Stock Exchanges:**

The listing agent facilitates the documentation and listing process for listing on stock exchanges and keeps on file information regarding the issuer such as Annual Reports, Articles of Association, the Depository Agreement, etc.

- **Depository Bank:**

Depository Bank is involved only in the issue of DRs. It is responsible for issuing the actual DRs, disseminating information from the issuer to the DR holders, paying any dividends or other distributions and facilitating the exchange of DRs into underlying shares when presented for redemption.

- **Custodian:**

The custodian holds the shares underlying DRs on behalf of the Depository and is responsible for collecting rupee dividends on the underlying shares and repatriation of the same to the Depository in US dollars/foreign currency.

Printers:

The printers are responsible for printing and delivery of the preliminary and final offering circulars as well as the DRs/Bond certificates.

Example of International Institutions of International Finance**1.The Bretton Woods System**

The Bretton Woods system was created at the Bretton Woods conference in 1944, where the 40 participating countries agreed to establish a fixed exchange rate system. The collective goal of this initiative was to standardize international monetary exchanges and policies in a broader effort to create post World War II stability.

The Bretton Woods conference catalyzed the development of international institutions that play a foundational role in the global economy. These include the International Monetary Fund (IMF), a consortium of 189 countries dedicated to creating global monetary cooperation, and the International Bank for Reconstruction and Development, which later became known as the World Bank.

2.Special Considerations

International trade is arguably the most important influencer of global prosperity and growth. But there are worries related to the fact the United States has shifted from being the largest international creditor, to becoming the world's largest international debtor, absorbing excess amounts of funding from organizations and countries on a global basis. This may affect international finance in unforeseen ways.

3.International Financial Institutions

Several international financial institutions contribute to global financial stability by providing funding and guidance to member nations, working to reduce barriers to trade and establishing international policies and agreements that keep international trade open and transparent.

4.2 International Monetary Fund (IMF)

The origins of the IMF date back to the Bretton Woods conference. Governed by and accountable to its 190 member countries, the IMF facilitates international trade, promotes employment and works to reduce global poverty. Its 3 critical missions are:

- Furthering international monetary cooperation
- Encouraging the expansion of trade and economic growth
- Discouraging policies that would harm prosperity

To fulfill these goals, IMF member countries work collaboratively and with other international organizations.

World Bank

The World Bank can also trace its beginnings to the Bretton Woods conference. Originally called the International Bank for Reconstruction and Development, its articles of agreement included rebuilding the economies of countries devastated by war and increasing the economic development of developing countries.

Continuing its work in global economic development, the World Bank also works in the areas of conflict prevention, post-conflict resolution and assistance to countries after major political change.

World Trade Organization (WTO)

Established in 1995, the WTO's overarching objective is to help its members use international trade as a means of raising living standards, creating jobs and improving people's standard of living. The WTO operates the global system of trade rules, having its origins in the negotiations aimed at progressively reducing barriers to trade.

At the heart of this organization are the WTO agreements signed by the majority of the world's trading nations. The agreements provide the rules for international commerce and bind governments to keep their trade policies within agreed limits. The WTO's main purpose is to help trade flow as freely as possible, keep the rules around trading transparent and make sure there are no sudden changes in policy.

The Future of International Finance

For professionals interested in pursuing a career in international finance, the future holds some interesting opportunities and challenges. Among them are the continuing advances in financial technologies, or fintech, continued globalization and the effects of climate change on international markets.

Fintech

The tools, platforms and services that fall under the category of fintech have a role to play in the future of international finance. In 2018, the World Bank and IMF launched the Bali Fintech Agenda Paper, which proposes a framework of high-level fintech-related issues that countries should consider in their domestic policy discussions. The paper consists of 12 policy proposals and covers issues related to enabling fintech, ensuring resilience in the financial sector, addressing risks and promoting international cooperation.

The World Bank has undertaken a series of initiatives focusing on fintech, including the use of fintech to deepen financial markets, enhance access to financial services and improve cross-border payments and remittance transfer systems. The World Bank's Fintech and the Future of Finance report covers data trends and market perceptions related to fintech, policy issues and products.

Acknowledging another aspect of fintech with implications in global finance, a representative of the IMF said that over the next couple of decades, digital money will transform the way we think about currency and how it operates, thanks to the advancements in technologies such as distributed ledger technology, encryption, analytics of big datasets and artificial intelligence. These technologies will enable cross-border payments to become cheaper, faster and easier, allow them to cross borders more seamlessly and be more accessible to those who need access to credit.

4.2.1 International flow of funds

The international flow of funds refers to the movement of capital across national borders, including investments, loans, and remittances. These financial flows play a crucial role in global economic activity and are influenced by various factors, such as

investment opportunities, interest rates, exchange rates, and economic conditions. In this blog, we will delve into the concept of international flow of funds and its significance.

International Flow of Funds

- The transactions arising from international business cause money flows from one country to another.
- The balance of payments is a measure of international money flows.
- The balance of payments can indicate the volume of transactions between specific countries and may even signal potential shifts in specific exchange rates.
- Thus, it can have a major influence on the long-term planning and management by MNCs.

4.2.2 Types of International Capital Movements

1. Foreign Direct Investment (FDI):

FDI involves the establishment or acquisition of a lasting interest in an enterprise in one country by an entity based in another country. It includes activities such as setting up subsidiaries, mergers and acquisitions, and joint ventures. FDI is a long-term investment that provides companies with control and influence over foreign operations.

2. Portfolio Investment:

Portfolio investment refers to the purchase of financial assets, such as stocks, bonds, and other securities, in foreign markets. Unlike FDI, portfolio investment does not involve direct control or management of the invested assets. Investors seek returns and diversification opportunities through portfolio investments.

3. Loans and Credit:

International flow of funds also includes lending and borrowing activities between countries. Governments, corporations, and individuals borrow funds from international sources to finance various projects or meet financial needs. International loans can be in the form of bank loans, corporate bonds, sovereign bonds, or syndicated loans.

4. **Remittances:**

Remittances are the transfer of money by individuals working in foreign countries to their home countries. These funds are often sent to support families and contribute to the economic development of recipient countries. Remittances are an essential source of income for many developing nations.

4.2.3 Factors Influencing International Flow of Funds

1. **Interest Rates and Inflation:**

Differences in interest rates and inflation rates between countries affect the attractiveness of investing or borrowing in a particular country. Higher interest rates can attract capital inflows, while lower rates may encourage capital outflows.

2. **Economic and Political Stability:**

Countries with stable economies and political systems tend to attract more international investments. Investors seek stable and predictable environments that minimize risks and uncertainties.

3. **Market Size and Growth Potential:**

Larger markets with strong growth prospects often attract more investments. Companies seek opportunities to expand their customer base and tap into emerging markets with rising consumer demand.

4. **Exchange Rates:**

Exchange rate fluctuations impact the profitability of international investments and can influence the decision to invest or repatriate funds. A favourable exchange rate can enhance returns for investors.

5. **Regulatory Environment:**

Regulatory policies, including investment regulations, tax policies, and legal frameworks, influence the flow of funds across borders. Favourable regulatory environments that promote investment and protect investor rights attract more capital inflows.

4.2.4 Significance of International Flow of Funds

1. Capital Allocation:

The international flow of funds allows capital to move from countries with excess savings to those with investment opportunities. This facilitates efficient allocation of resources and supports economic growth and development.

2. Global Economic Integration:

Capital flows contribute to the integration of national economies into the global marketplace. They facilitate trade, investment, and technological transfer, fostering economic interdependence between nations.

3. Economic Development:

International investments and capital inflows can provide financial resources for infrastructure development, job creation, and technological advancements in recipient countries. They contribute to the overall economic development and welfare of nations.

4. Diversification and Risk Management:

Investors can diversify their portfolios and manage risks by allocating funds across different countries and asset classes. International investments offer opportunities to access diverse markets and reduce dependence on a single economy.

4.2.5 IMPORTANCE OF INTERNATIONAL FLOW OF FUNDS

- Economic development
- Foreign exchange earnings
- Market expansion and increase in competition
- Increase in local and foreign investment
- Increase national income and employment
- Lower production costs.

4.3.What is a Multilateral Development Bank (MDB)?

A multilateral development bank (MDB) is a financial institution established by multiple member countries and falls under international law. The owners of multilateral development banks are a national government and other international institutions and organizations.



Source

The purpose of MDBs is to facilitate financing and provide advisory services for developing countries. Multilateral development banks are also referred to as an international financial institution (IFI).

4.3.1 Understanding Multilateral Development Banks

Multilateral development banks are established to help stabilize the global financial system. They now work as financing institutions that provide stable and long-term financing for various projects within developing countries. The projects promote the growth and modernization of less wealthy countries. The projects include:

- Infrastructure projects
- Energy projects
- Education
- Environmental sustainability projects

Commercial banks provide financing services with the objective of making a profit, while MDBs provide lower-cost financing with the goal of improving economic conditions in developing countries. MDBs are unique in that they do not seek to gain substantial

profits for [shareholders](#). Instead, they set objectives and development goals to reduce economic inequality within the world.

MDBs consist of member nations from various developed countries. The member countries provide funding for MDBs in the form of donor commitments. The donations are used to fund operating costs, and they provide loans and grants to the poorer countries.

Multilateral development banks also borrow funds from the international [capital markets](#) to lend to developing countries. MDBs can borrow from international markets with secured financing since they are backed by the member governments.

4.3.2 Importance of MDBs

Since MDBs are not organizations associated with specific countries, they are subject to international law. They are seen as an international pillar to stabilize the global economy. As an example, MDBs provided \$222 billion in financing during the [2008 Global Financial Crisis](#) when liquidity was in dire need, and very little financing was being provided by commercial banks. It was very important in stabilizing the global economy during a time of crisis and uncertainty.

Examples of MDBs

There are many different forms of MDBs. However, they can be broken down into two main forms, the first of which are the most prominent MDBs – the [Bretton Woods institutions](#). They are the best-known MDBs that were established after World War II to facilitate international cooperation within the global financial system. The following are well-known Bretton Woods institutions:

- World Bank
- International Monetary Fund (IMF)
- International Bank for Reconstruction and Development (IBRD)
- International Finance Corporation (IFC)
- International Development Association (IDA)
- General Agreement on Tariffs and Trade (GATT)

There are also regional MDBs that are focused on the development of specific countries and low-income nations that can borrow collectively from the MDB, such as the following (note that there are many others for various localities):

- European Investment Bank (EIB)
- Asian Development Bank (ADB)
- New Development Bank (NDB)
- Eurasian Development Bank (EDB)
- Islamic Development Bank (IsDB)
- Inter-American Development Bank (IDB)
- Asian Infrastructure Investment Bank (AIIB)

Additional Resources

CFI is the official provider of the global Commercial Banking & Credit Analyst (CBCA)[™] certification program, designed to help anyone become a world-class financial analyst. To keep advancing your career, the additional CFI resources below will be useful:

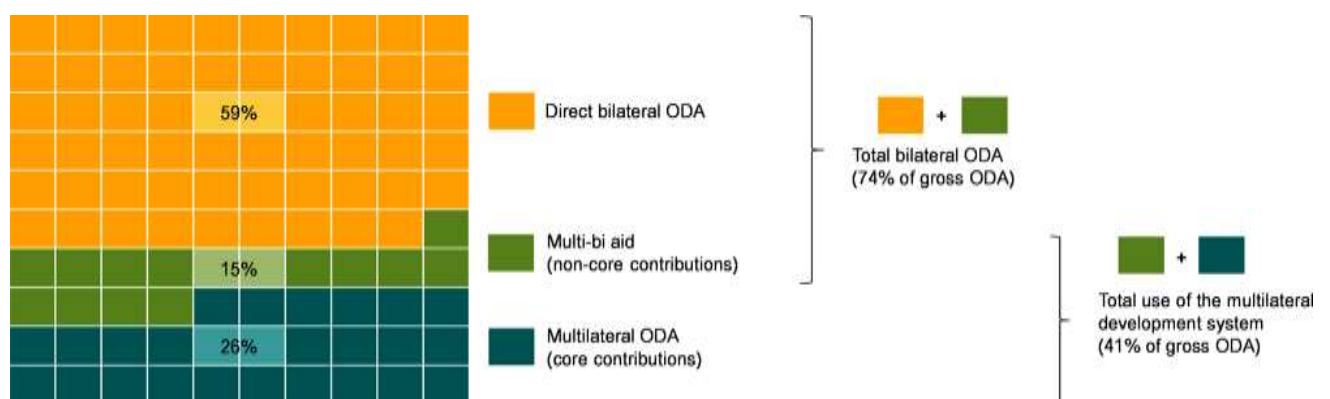
- Corporate Social Responsibility (CSR)
- Economic Indicators
- Gross National Product (GNP)
- International Chamber of Co

4.3.3 Multilateral development finance in context

Multilateral development organisations are at the heart of the development co-operation system. They channel a large and growing share of total official development assistance (ODA). The volume of ODA channelled through multilateral development organisations amounted to USD 78.6 billion in 2020, or 41% of total ODA ([Figure 1.1](#)). This amount is made up of: (i) contributions to the budgets of multilateral organisations (known as “core” or “multilateral ODA”), representing 26% of total ODA; and (ii) non-core contributions earmarked through multilateral organisations (so-called “multi-bi aid”),

accounting for 15% of total ODA. These non-core, or earmarked, contributions are resources channelled through multilateral organisations over which the donor retains some degree of control and that can be earmarked for a specific country, project, region, sector or theme. Although smaller in volume and share, earmarked contributions have been rising steadily over the past two decades, while the share of core contributions has remained constant.

Figure 1.1. More than 40% of total ODA is channelled through multilateral development of organisation



DAC countries' and other official providers' bilateral and multilateral ODA

Note: Calculations based on gross disbursements, in 2020 constant prices.

Source: Authors' calculations based on the OECD Creditor Reporting System, (OECD, 2022[1]), <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>.

Multilateral development organisations form a complex ecosystem. The analysis in this report shows that the number of active multilateral entities has grown steadily over the past few decades. Today, the multilateral development system comprises more than 200 entities. In the long run, this continued fragmentation could pose risks to systemic coherence and accountability, especially if new ad hoc structures continue to be created and superimposed on the pre-existing multilateral architecture.

The centre of gravity of the multilateral development system remains in a handful of multilateral organisations. Ten multilateral entities, out of more than 200, account for 70% of total financing from the multilateral development system. The largest multilateral development banks (MDBs) are over-represented among these "vital few", along with the development institutions of the European Union. The multilateral development system also includes a multitude of smaller and more specialised entities. United Nations (UN) funds and programmes, UN agencies and vertical funds account for

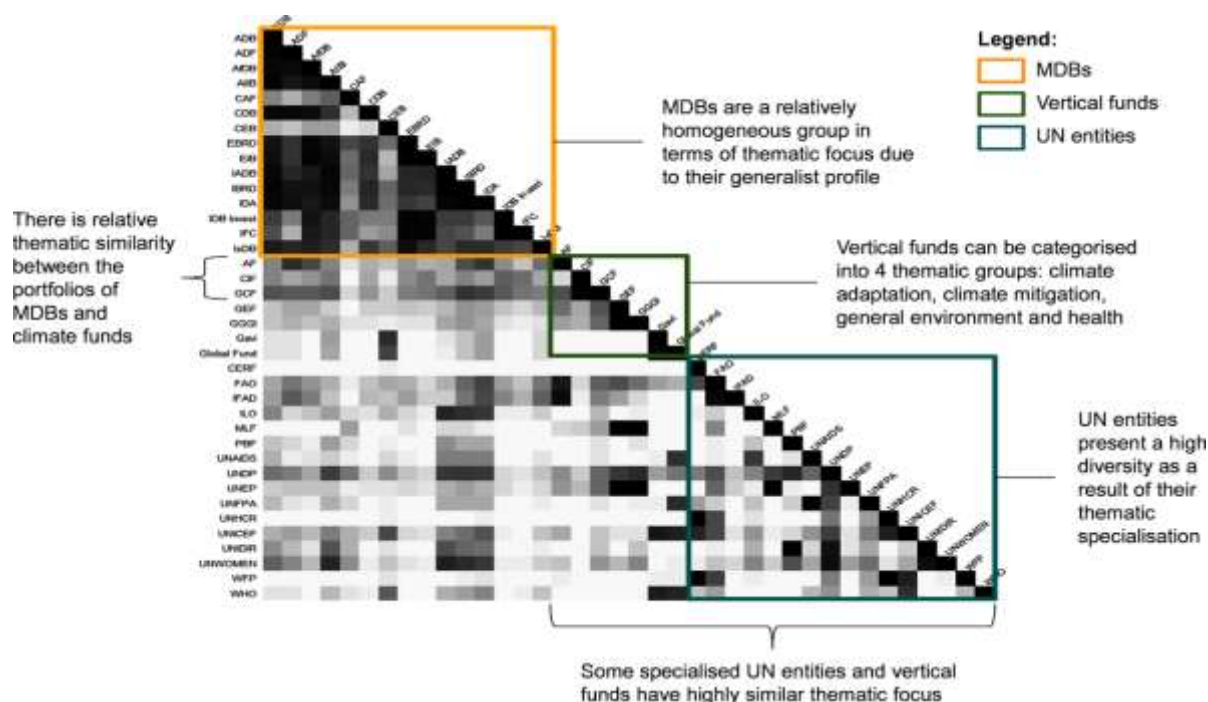
a large share of the remaining 30% of multilateral financing. This part of the system is more fragmented and includes entities with smaller portfolios and greater thematic specialisation, which often channel funds earmarked by bilateral providers.

The large number of organisations that make up the multilateral development system has resulted in a multifaceted and versatile architecture.

Rather than a monolithic structure, the multilateral development system is an intricate institutional patchwork of entities with diverse constituencies (global, regional or South-South), geographic scope (regional or global), thematic focus (single-focus or wide-ranging), financing instruments (grants, concessional and non-concessional loans, equity, guarantees) and operational models (banks, funds, agencies). While this contributes to the versatility of multilateral development finance, the increasingly crowded and complex multilateral architecture makes it difficult to obtain a clear understanding of the division of roles and to identify potential overlaps in the organisations’ portfolios (Figure 1.2).

Figure 1.2. **Multilateral development organisations form an intricate patchwork with diverse thematic focus**

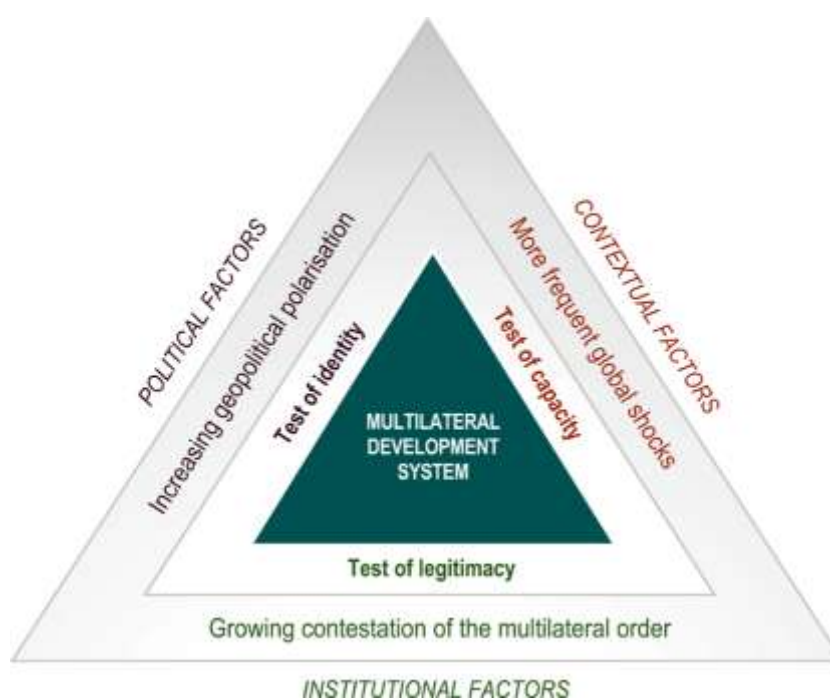
Matrix of portfolio similarity scores across multilateral development organisations (2012-20 average)



Note: Calculations are based on commitments, in 2020 constant prices. Darker shading reflects a high level of thematic similarity between two portfolios. The portfolio similarity scores of multilateral development organisations are calculated with cosine similarity, following the approach used in *Comparing multilateral and bilateral aid: a portfolio similarity analysis* (OECD, 2022[2]), <https://www.oecd.org/dac/2022-mdf-comparing-multilateral-bilateral-aid.pdf>.

Source: Authors' calculations based on OECD Creditor Reporting System, (OECD, 2022[1]), <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>.

Multilateral development finance faces growing pressures in an unstable global context. A combination of three forces (contextual, institutional and political) is putting the system to the test (Figure 1.3). First, successive crises are stretching multilateral resources across an ever-increasing list of development priorities and testing the system's capacity to remain relevant in a more shock-prone world. Second, growing geopolitical polarization is affecting the multilateral space and may result in tensions between diverging and competing values and priorities. Third, the rules-based multilateral order inherited from the Second World War is seeing its legitimacy challenged, and faces mounting contestation and criticism, including from some of its former champions. Failure to adjust to these forces could put the multilateral development system on the verge of a triple crisis of capacity, legitimacy and identity.



Source: Authors' illustration.

The new global context calls for reassessing the adequacy of the current multilateral architecture and governance. The triple crises of the COVID-19 pandemic, Russia's invasion of Ukraine and the threat of climate change have exposed some key shortcomings of the multilateral development system and highlighted the need to better equip its organisations. As a result, greater attention has been drawn to the need to scale up multilateral development finance, as evidenced by recent calls to reform the global financial architecture and revisit the toolkit and operational model of the major international financial institutions (US Department of the Treasury, 2022[3]) (Government of Barbados, 2022[4]). However, some other parts of the reform agenda appear to have lost steam. This includes efforts to rationalise and improve the coherence of the multilateral architecture, as well as to increase funding to the core functions of the system to build its resilience to deal with future crises (UN, 2022[5]).

Looking forward, the three global forces may further complicate the reform of the multilateral system. First, as already observed during the COVID-19 pandemic, more frequent crises could increase policymakers' short-term focus on emergency responses at the expense of longer-term investments to strengthen the multilateral development system. In addition, the increased financing needs from successive shocks could translate into a further expansion, fragmentation and complexity of the multilateral system. Second, the shift to a more polarised geopolitical order could make it even more difficult to achieve the level of consensus required to undertake fundamental reforms. Finally, the reduced trust in multilateral approaches could in the long term affect the willingness of member states to continue investing in the multilateral development system.

4.3.4 Funding to the multilateral development system

Despite DAC member countries' tightening budget constraints during the pandemic, inflows to the multilateral system continued to rise in 2020.

Over the past decade, the multilateral development system has channelled growing volumes of ODA to developing countries. Between 2012 and 2019, core and non-core contributions to multilateral development organisations increased from USD 56.8 billion to USD 70.6 billion (up 24%). The outbreak of the COVID-19 pandemic in 2020 seems to

have accelerated this trend, with DAC members' multilateral contributions reaching an all-time high of USD 76.4 billion in 2020.

However, the increase in multilateral contributions was not enough to meet the growing funding needs resulting from multiple concurrent crises.

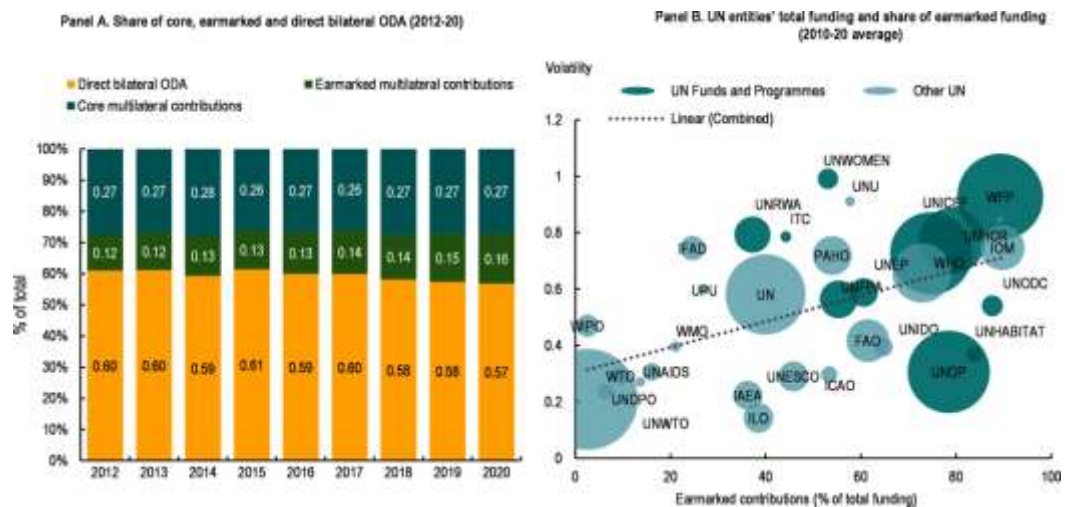
Funding shortages plagued humanitarian agencies throughout 2021, especially as scale-up was required for several concurrent emergencies, including in Afghanistan and Ethiopia, and the ongoing effects of the COVID-19 crisis continued to impact vulnerable communities. The funding gap increased further in 2022 as developing countries faced soaring food and energy prices and the additional impact of Russia's war against Ukraine. As of early October 2022, the UN Office for the Coordination of Humanitarian Affairs (UNOCHA) reported a record shortfall of USD 31.4 billion, corresponding to 63% of total funding requirements ([UNOCHA, 2022\[6\]](#)).

In addition, some worrying funding patterns risk constraining multilateral development organisations' flexibility to respond and adapt to new challenges. This is, for example, the case of donors' increasing tendency to earmark their contributions. Funds earmarked through the multilateral development system represent a growing share of Development Assistance Committee (DAC) members' ODA.

The share of DAC members' non-core (earmarked) contributions in their total ODA grew from 13% to 16% between 2015 and 2020, while the share of their core contributions increased only slightly, from 26% to 27% ([Figure 1.4](#)). With a growing portion of development finance channelled through the multilateral development system earmarked for specific objectives, core functions are receiving less funding proportionally.

In the long run, this could lead to a gradual erosion of the critical functions of the multilateral system, such as providing strategic and long-term oversight of key reforms, and adapting to the evolving and expanding nature of global development challenges.

Figure 1.4. **The rise of earmarked ODA contributes to volatile funding for multilateral organisations**



Note: Calculations are based on gross disbursement, in 2020 constant prices. In Panel B, the vertical axis corresponds to a measure of volatility, calculated as the relative standard deviation (also known as coefficient of variation). The horizontal axis shows earmarked contributions as a share of total funding (core and non-core, earmarked, contributions) received by UN entities. The size of the bubbles corresponds to the average annual funding volume of the different UN entities.

Source: Authors' calculations based on the OECD Creditor Reporting System (OECD, 2022[1]), <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>.

The UN Development System (UNDS), which is very reliant on earmarked contributions, has been seeking to overcome these vulnerabilities through system-wide reforms and greater engagement of private actors. UN member states adopted the Funding Compact in 2019 as a framework to align their financial support to the UNDS with the 2030 Agenda for Sustainable Development. However, the Funding Compact has seen mixed progress so far. In order to respond to growing demand from developing countries, many UN entities are increasingly seeking to diversify their funding base, including through contributions from the private sector. In fact, for some UN entities, the share of contributions received from private stakeholders, foundations and NGOs already represents more than 20% of total donor contributions (Figure 1.5).

While the diversification of funding sources is a positive development, an over-reliance on private actors could ultimately have the same adverse effects as an

4.3.5 Criticisms of Multilateral Development Banks

Multilateral development banks (MDBs) used to receive criticisms for being US-focused since the United States was the major member and donor to the most prominent MDBs. However, in 2017, under the Trump Administration, proposals to cut \$650 million of funding over three years that were made during the Obama administration weakened U.S. ties with MDBs. New alternative MDBs can now be found in **emerging markets**, including the Chinese-led Asian Infrastructure Investment Bank (AIIB) and the New Development Bank.

Critics of MDBs also argue that the organizations focus on moving capital instead of achieving results. The main criticism is that they are not nearly transparent enough, and their impacts are not always clearly noticed.

Since MDBs are not subject to the oversight of one single governing body, critics feel that they are not held to a high enough standard, and that there is the uncertainty of where the capital is being spent.

That being said, proponents of MDBs argue that aiding developing countries, no matter if the process is inefficient, is still the morally right thing to do. In addition, it helps developing countries make progress in health and education and provides new, fast-growing markets for investors and business leaders to expand.

4.4. International Banking

The term international banking refers to the practice of providing financial services across international boundaries. Banks provide services such as accepting deposits, issuing loans, facilitating payments, and offering investment products to customers around the world. International banking allows businesses to access capital from global markets and make investments overseas. It also enables customers to make transfers between foreign countries without having to use local currency exchange services.

4.4.1 Understanding the International Banking System

Meaning

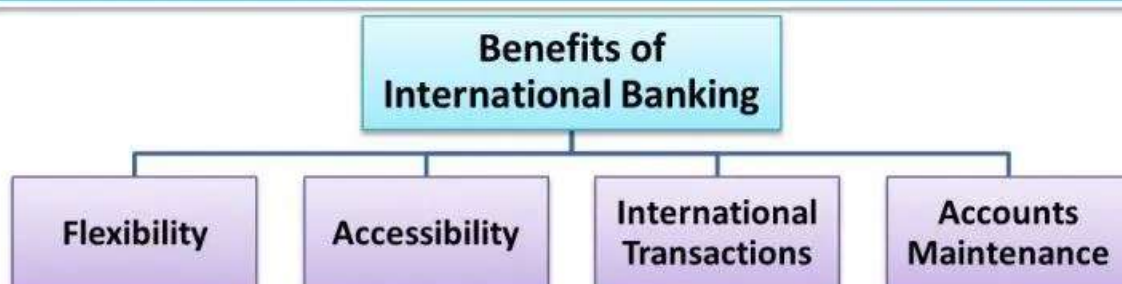
International banking is like any other banking service, but it takes place across different nations or internationally. To put it another way, it is an arrangement of financial services by a residential bank of one country to the residents of another country. Most multinational companies and individuals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

There are a number of different functions that the international banking system can provide. Three important core services provided through international banking include letters of credit, export credit, and foreign exchange. Each of these services plays an important role in enabling international trade and facilitating international investment.

Example

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

Definition: International banking is just like any other banking service, but it takes place across different nations or internationally. To put in another way, international banking is an arrangement of financial service by a residential bank of one country to the residents of another country.



Features and Benefits

Flexibility

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

Accessibility

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

International Bank Transfers/Transaction

International banking allows the business to make international bill payments. The currency conversion facility allows the companies to pay and receive money easily. Also, benefits like overdraft facilities, loans, deposits, etc., are available every time for overseas transactions. [Correspondent banking](#) is very useful in such transactions.

Accounts Maintenance

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

4.4.2 Functions of International Banking

Some functions of international banking are as follows:



- Helping in hedging the exchange rate risk
- Helping in borrowing and lending in the Eurocurrency market
- Helping global businesses by lending, financing projects and enabling their economic growth
- Participating in underwriting of Eurobonds and foreign bonds issues
- Offering advice and consultancy services on hedging strategies, interest rates, currency swap financing and global cash management

4.4.3 Types of International Banking Offices

Correspondent Bank

A correspondent bank is a bank that provides services on behalf of another bank. The two banks maintain a bank account with each other. This enables businesses to conduct their operations globally through a local bank or its contacts.

Representative Office

A representative office is a small service facility staffed by the personnel of the parent bank to help businesses by providing them information on credit evaluation of customers, local business practices and norms, updates on current economic market conditions, etc.

Foreign Branches

A foreign branch operates like a local bank but is actually a part of the parent bank. Foreign branches are subject to banking regulations of both the home country and the country in which they function.

Subsidiary and Affiliated Banks

A subsidiary bank is a locally affiliated bank that is completely or partially owned by a foreign parent bank. An affiliate bank, on the other hand, is one that is partially owned but not controlled by its parent bank. Both subsidiary and affiliate banks function under the banking laws of the country in which they are incorporated.

Offshore Banking Centres

An offshore banking centre is a country whose banking systems are organised to allow external accounts beyond the normal scope of the local economic activity in the country. The International Monetary Fund (IMF) has identified Bahrain, the Cayman Islands, Hong Kong, the Netherlands, Antilles, Panama and Singapore as prime offshore banking centres.

Offshore banks function as branches or subsidiaries of the parent bank, and their key role is to seek deposits and grant loans in currencies other than the currency of the host country. These banks are unregulated institutions, that is, they have low reserve needs and no deposit insurance. In addition, they are not subject to interest rate ceilings. These banks benefit from low taxation, low margins, low overheads, little or no pressure from domestic governments, etc.

Internalisation of Banks

The last five or six decades have seen a rise in globalisation, increased trade and spread of multinationals. When companies started to relocate or expand to various parts of the world, banks also started to go global and set up their units in different regions. Companies usually maintain cordial relations with the banks they deal with regularly.

Whenever a bank's client company diversifies its operations into a foreign country, the bank too likes to accompany the company so that it can establish its network on a

wider scale and also provide services to its client company. In the process, the bank establishes several branches across the globe, which helps it to widen its customer base.

In other words, the migration of the local multinational customers of the bank paves the way for the bank to go global. Banks that go global are called multinational banks or MNBs. Through internationalisation, banks can expand their operations across the globe. They provide innovative, cost-effective products and services to gain customer loyalty.

The other benefit of internationalisation is improvement in the flow of capital. Apart from this, internationalisation helps banks create linkages with new investors and borrowers. Such linkages help banks in expanding their businesses in both home and foreign countries.

Authorised Dealers in Foreign Exchange

An authorised forex dealer is any institution that has been authorised by a significant governing body to act as a dealer involved with the trading of foreign currencies. In simple terms, any dealer authorised to deal in forex is called an authorised dealer.

As per Section 10 (1) of the FEMA, 1999, the RBI may, on an application made to it on behalf, authorise any person to be known as an authorised dealer. The person can deal in foreign exchange or in foreign securities as an authorised dealer, money changer or an off-shore banking unit or in any other manner as it deems fit. Authorised dealers ensure that the transactions are being executed in a lawful and unbiased manner.

Some functions of authorised dealers are as follows:

- Issuing guidelines and rules for forex business
- Conducting training of bank personnel in the areas of foreign exchange business

- Accrediting forex or foreign exchange brokers
- Providing advice and assistance to member banks in settling issues/matters in their dealings
- Representing member banks on Government/RBI/other bodies
- Announcing the daily and periodical rates to member banks

Role of Foreign Exchange Dealers

A dealer should not engage in any transaction involving any foreign exchange, which is not in conformity with the terms of the dealer's authorisation.

The dealer should not undertake any transaction in foreign exchange on behalf of any person, which is designed for the purpose of any contravention or evasion of the policies and provisions of any rule, Act or notification. The dealer should report the matter to the RBI.

Some key roles of foreign exchange dealers are as follows:

- The dealer helps in the exchange of foreign currencies.
- The dealer facilitates arrangements with foreign correspondent.
- The dealer performs buying and selling foreign currencies.
- The dealer handles trade and service-related transactions denominated in foreign currencies and rupees and also operates Nostro accounts.
- The dealer is involved in handling of inward and outward remittances.
- The dealer takes care of opening of the letter of credit and settlement of payment.

- The dealer handles investment in foreign trade.
 - The dealer aids different customers in opening and maintaining of accounts with foreign banks.
 - The dealer is involved in export documents handling.
-

Foreign Exchange Dealers Association of India (FEDAI)

The Foreign Exchange Dealers Association of India (FEDAI), which was set up in 1958, is an association of banks dealing in foreign exchange in India as a self-regulatory body. It is incorporated under Section 25 of The Companies Act, 1956. The major activities of FEDAI include framing of rules governing the conduct of the inter-bank foreign exchange business among banks in relation to public and liaison with the RBI for reforms and development of forex market.

Due to the continuous integration of the global financial markets and increased pace of de-regulation, the role of self-regulatory organisations such as FEDAI has also been transformed. In such an environment, FEDAI plays an important catalytic role for smooth functioning of markets through closer co-ordination with the RBI and other organisations like the Fixed Income Money Markets and Derivatives Association (FIMMDA).

FEDAI maximises the benefits derived from synergies of member banks through innovation in areas such as new customised products, benchmarking against international standards on accounting, risk management systems and market practices, etc.

FEDAI regulates the governing rules and determines the commissions and charges associated with the inter-bank foreign exchange business. It is also responsible for certifying India's foreign exchange brokers and the exchange rates for its member banks. FEDAI regulates day-to-day rules of the forex transactions in India. Furthermore, FEDAI succours member banks by acting as an advisor and supports them with the training of personnel.

Authorised Money Changers

Authorised money changers are the entities that are authorised by RBI under Section 10 of the FEMA, 1999. They are allowed to deal in foreign exchange for specified purposes. The main objective of incorporating authorised money changers is to broaden the access of foreign exchange facilities for residents and tourists while ensuring efficient customer service through competition.

Different types of authorised money changers are as follows:

- Authorised Dealer Category -I Banks (AD Category–I Banks)
- Authorised Dealer Category – II (AD Category–II)
- Full Fledged Money Changers (FFMCs)

Authorised money changers should have licence to carry out money changing business. If any person is found to be involved in money changing business without a valid licence, the person is liable to be penalised. In order to become an authorised money changer, the applicant has to be registered under the Companies Act, 1956. The minimum amount, which is also called Net Owned Funds (NOFs), required for consideration as FFMC is ₹25 lakhs for single branch FFMC and ₹50 lakhs for multiple branch FFMC.

Following are the various money changing facilities currently available in India:

- Conversion of travellers' cheques, currency notes, or coins designated in foreign currency into Indian Rupees and vice versa is possible through AD Category-I banks, AD Category-II and FFMCs.
- All the AD Categories and FFMCs may appoint franchisees (also known as agents) to undertake the purchase of foreign currency.

Role of Correspondent Banking

Banking in general terms refers to local services offered by a bank to its customers, which include account servicing, payments, deposits and loans. A bank may need to have a branch or a network if it wishes to render the same services to the customers who want to travel outside the area of its bank branch.

This can be done if the bank either opens a new branch or makes an arrangement with another bank. Opening of a new branch is not a feasible option if the bank is not looking for expansion. Besides, it will call for a large investment. Entering into a banking arrangement with another bank provides a convenient solution in many banking situations globally.

The banks with which such banking arrangements are made to fulfil the banking requirements of customers are called correspondent banks. Thus, we can say that correspondent banking is an agreement between a foreign bank and a domestic bank where the foreign bank carries out the services on behalf of the domestic bank.

A correspondent bank acts like an agent for another bank. It provides services and products in the area(s) where the other bank does not operate. The customer can even have deposits with and avail loans from the correspondent bank on behalf of his/her domestic bank account.

This helps businesses of all sizes to expand in other regions or countries without having a new foreign account with another bank. Any bank or financial institution irrespective of its size can act as a correspondent bank to provide services on behalf of smaller banks with less reach.

Correspondent banking is an important part of the global payment system. This banking arrangement facilitates foreign currency exchange and payments. The correspondent bank plays a very critical role in transactions that involve international buying, selling or money transfers.

Basic services provided by correspondent banks include:

- Foreign currency exchange
- Foreign remittances

- Trade documentation
- Money transfers

Correspondent banking enables easy exchange of foreign currency that occurs commonly in the international banking business. Let us take an example to explain the process involved in correspondent banking.

Suppose Mr. A residing in India purchases some products from the US. He makes a request to his bank to pay for products purchased from the American dealer.

Following is the process for making payment through the correspondent bank:

- **Step 1:** The bank initiates the necessary foreign currency exchange transaction to facilitate appropriate payment in the currency of the seller after seeking all the required information from the customer.
- **Step 2:** The bank deducts the appropriate and agreed amount from the customer's account as the fee to carry out the transaction.
- **Step 3:** The bank sends complete desired information in the agreed format to its correspondent bank in the supplier's country.
- **Step 4:** The correspondent bank pays out the corresponding amount to the supplier on the basis of all the instructions punched in the format.
- **Step 5:** The supplier receives the payment in its own currency from the domestic bank's correspondent account with the foreign bank.

4.4.4 International Banking Services

International banks can provide Evan the same banking services that he can get at any hometown bank. Evan can deposit money in checking, savings and money market accounts. Evan can also obtain loans and lines of credit for his business. Evan's international bank can also provide some specialized services that Evan's import-export

business may need. An international bank can provide trade financing, such as lending, letters of credit and export credit.

A letter of credit is an instrument that a buyer, like Evan, can request from his bank that guarantees that the bank will make a payment for goods purchased once the conditions found in the letter are met. For example, in order for payment to be received, the seller may have to produce certain shipping documents as proof that the goods have been shipped to Evan. Export credit is a line of credit given to an importer by a bank in the exporter's country. For example, Evan's bank may give Evan a line of credit in China to facilitate his import of goods from a Chinese manufacturer.

Evan's bank can also help with foreign exchange. Foreign exchange refers to the exchange of one country's currency for the currency of another. For example, Evan may be importing goods from a member of the European Union. The foreign manufacturer doesn't want to be paid in dollars, but instead, wants to be paid in Euros. Evan's bank can exchange the amount of dollars in Evan's bank account to the requisite number of Euros to complete the transaction.

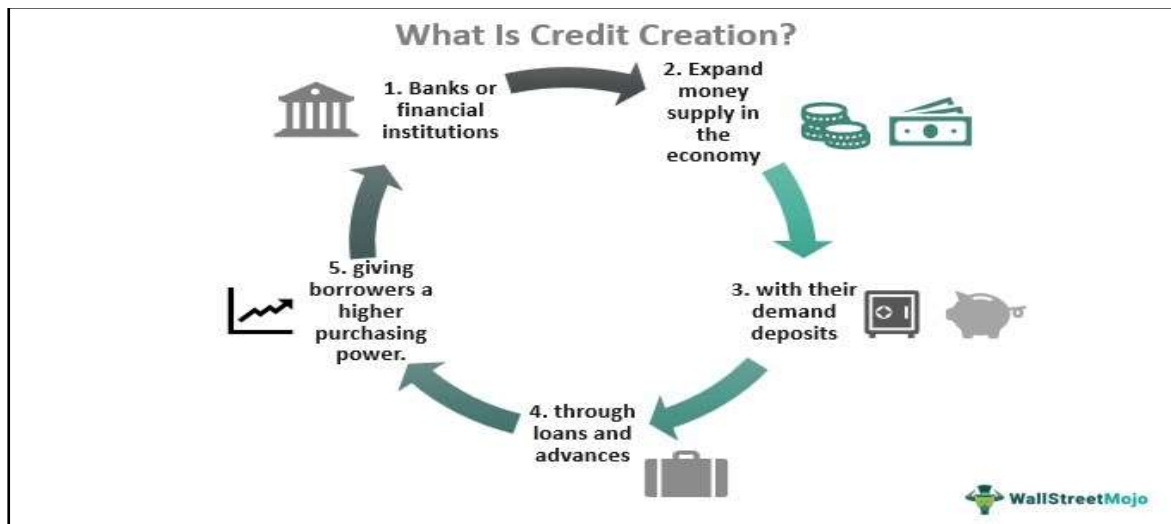
4.4.5 Types of International Banks

There are different types of international banking structures and relationships. A correspondent bank is a bank that provides services for another bank. Neither bank has an ownership interest in the other or has any control over the other. They just engage in a mutually beneficial relationship. For example, Evan's bank may have a relationship with a foreign bank in Paris that will conduct banking services in France on Evan's bank's behalf.

Representative offices are small satellite service offices established by a bank that has a relationship with an overseas correspondent bank. A representative office provides assistance to people, like Evan, in dealings with correspondent banks. A representative office may also be able to help Evan navigate local business customs and help him understand specific lending or regulatory requirements.

4.5 Credit Creation

Credit creation separates a bank from other financial institutions. In simple terms, credit creation is the expansion of deposits. And, banks can expand their demand deposits as a multiple of their cash reserves because demand deposits serve as the principal medium of exchange. In this article, we will talk about credit creation.



The two most important aspects of credit creation are:

Liquidity – The bank must pay cash to its depositors when they exercise their right to demand cash against their deposits.

Profitability – Banks are profit-driven enterprises. Therefore, a bank must grant loans in a manner which earns higher interest than what it pays on its deposits.

The bank's credit creation process is based on the assumption that during any time interval, only a fraction of its customers genuinely need cash. Also, the bank assumes that all its customers would not turn up demanding cash against their deposits at one point in time.

4.5.1 Basic Concepts of Credit Creation

- Bank as a business institution –
Bank is a business institution which tries to maximize profits through loans and advances from the deposits.
- Bank Deposits –
Bank deposits form the basis for credit creation and are of two types:
- Primary Deposits –

A bank accepts cash from the customer and opens a deposit in his name. This is a primary deposit. This does not mean credit creation. These deposits simply convert currency money into deposit money. However, these deposits form the basis for the creation of credit.

- Secondary or Derivative Deposits –

A bank grants loans and advances and instead of giving cash to the borrower, opens a deposit account in his name. This is the secondary or derivative deposit. Every loan create a deposit. The creation of a derivative deposit means the creation of credit.

- Cash Reserve Ratio (CRR) –

Banks know that all depositors will not withdraw all deposits at the same time. Therefore, they keep a fraction of the total deposits for meeting the cash demand of the depositors and lend the remaining excess deposits. CRR is the percentage of total deposits which the banks must hold in cash reserves for meeting the depositors' demand for cash.

- Excess Reserves –

The reserves over and above the cash reserves are the excess reserves. These reserves are used for loans and credit creation.

- Credit Multiplier –

Given a certain amount of cash, a bank can create multiple times credit. In the process of multiple credit creation, the total amount of derivative deposits that a bank creates is a multiple of the initial cash reserves.

4.5.2 Credit Creation

Explore the fascinating world of credit creation and its profound impact on macroeconomics in this comprehensive guide. You'll delve into the definition, advantages, and process of credit creation at [banks](#), gaining valuable insights from the theory to the real-world application. Further, you'll discover its limitations, understand its role in shaping [economic growth](#), and learn how it influences economic policies. Detailed case studies and FAQs will enhance your comprehension of this crucial financial concept. This multi-part guide addresses all you need to know about credit creation in the [financial sector](#)

4.5.3 Understanding Credit Creation in the Financial Sector

Credit creation is an essential concept to understand in macroeconomics and particularly in the financial sector. It is a mechanism whereby banks and financial institutions create new deposits out of thin air when they make loans.

Credit Creation: Simple Definition

Credit creation is the process through which banks increase the amount of deposits in their system by lending out money to borrowers. The bulk of "money" in circulation is created through this process. Basically, when a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money.

For example, if a customer takes out a loan of £10,000, the bank does not transfer existing money, but writes the amount into the customer's account. In this way, £10,000 of new, additional money is created.

The Key Advantages of Credit Creation

Credit creation offers several advantages, making it a mainstay in modern economies.

- It energises the economy: Banks being able to create more loans, boost investments and hence aid economic growth.
- Effective monetary policy: it gives central banks the ability to control the money supply, influencing interest rates, inflation and other economic variables.
-

4.5.4 Understanding the Process of Bank Credit Creation

Now, let's delve into how banks actually create credit. Remember, this is a process that involves several steps.

Step 1	Banks receive deposits
Step 2	Banks keep a fraction of those deposits as reserves
Step 3	Banks lend out the rest of the money
Step 4	The borrower spends the money, which becomes a new deposit for another bank
Step 5	The process repeats (steps 1 to 4), each time creating new money

4.5.5 Credit Creation Theory in Macroeconomics

In Macroeconomics, the credit creation theory is a model that states that every loan given out by the banking system leads to a corresponding increase in total deposits, facilitating growth in the money supply.

To delve deeper, it's important to note that the maximum amount of credit that banks can create is determined by the reserve ratio. In the formula, if RR is the reserve ratio, and $D1$ is the initial deposit, the total deposit DT is given by: $DT = D1 / RR$

This model is simplified and neglects other factors such as withdrawals or defaults. However, it portrays the inherent characteristic of the banking system to 'create' money and broaden the money supply.

4.5.6 Deep Dive into The Process of Credit Creation

You've seen a broad overview of credit creation, how it works and its role within the economy. It's now time to take a plunge into the nitty-gritty of the credit creation process, explore real examples, and demystify its formula.

Process of Credit Creation: An Overview

Every journey begins with a single step, and credit creation is no different. In essence, the process starts when a depositor places money into a bank.

This money is known as the primary deposit, and it marks the first 'step' in our process. Once the bank has these funds, it carefully reserves a portion (known as the reserve ratio). The rest of the primary deposit is now available for the bank to loan out to other customers, forming a secondary deposit.

Primary deposit	Depositor's original amount
Reserve ratio	Portion of the deposit the bank keeps
Secondary deposit	Remaining amount the bank can loan out

This lending activity, however, does not end with the creation of the secondary deposit. Rather, it repeats, successively creating deposits in the system and thereby increasing the total money supply.

Real-life Examples of Credit Creation

Abstract concepts often become clearer with concrete examples. Here are a few scenarios to help you understand how credit creation works in practice.

Suppose John deposits £5000 into his bank. The bank retains 10% (£500) as reserve and lends out the remaining £4500 to Alex. Alex then spends this loan by paying his contractor Sarah for a renovation job. Sarah, in turn, deposits this £4500 into her bank account. Now Sarah's bank can retain 10% (£450) and loan out the remaining amount (£4050) to another customer. This cycle continues, and with each cycle, the money supply in the economy expands.

Each transaction in this example represents a step in the process of credit creation. The banks here are creating credit by lending deposits they received to new borrowers, thereby increasing the total money supply.

The Formula of Credit Creation: Break Down

Now that you've walked through the process, let's put numbers to our concepts. The formula for credit creation multiplies the initial deposit by the money multiplier, which is the reciprocal of the reserve ratio:

$$Credit = InitialDeposit \times \frac{1}{ReserveRatio}$$

The money multiplier is crucial in calculating how much potential credit can be created from an initial deposit. It indicates to what extent a bank can increase its loans and subsequently the money supply. The higher the reserve ratio, the lower the multiplier, and the less credit a bank can create from each deposit.

For instance, to understand the maximum credit creation for a £1000 deposit and a reserve ratio of 0.2, you simply divide the deposit by the reserve ratio:

$$\text{Credit} = 1000 \times 10.2 = \text{£}5000$$

This illustrates that, theoretically, a Mear £1000 deposit could potentially lead to as much as £5000 in credit! Clearly, banks and the credit they create play a pivotal role in expanding an economy's money supply.

Understanding the Limitations of Credit Creation

While credit creation is a powerful tool for stimulating economic growth and expanding the money supply, it is not without its limitations. Even though banks have the ability to create credit, they must also take into account economic realities and regulatory constraints. Understanding these limitations allows for more informed perspectives on the extent of credit creation possibilities.

The Limitations of Credit Creation: A Detailed Look

Limitations of credit creation refer to factors that restrict the ability or incentive of banks to engage in credit creation. These limitations may arise due to regulatory measures, economic conditions, or banks' own financial and risk considerations.

Here's a detailed look into some important limitations:

- **Reserve Requirement:** Regulatory authorities may stipulate a minimum reserve ratio that limits the extent to which banks can lend. The higher the reserve requirement, the less money a bank can create.
- **Borrower's creditworthiness:** Banks lend only to those they consider able to repay the loan. If suitable borrowers are scarce, credit creation will be limited.

- **Capital Adequacy Ratios:** These global regulatory standards, known as Basel Accords, require banks to maintain a certain level of capital against their risk-weighted assets.
- **Interest Rates:** High-interest rates might discourage potential borrowers, limiting the demand for loans and consequently the potential for credit creation.

The Impact of Limitations on Bank Credit Creation

The limitations highlighted above can significantly hamper the ability of banks to create credit.

First, regulatory limitations such as reserve requirements and capital adequacy ratio mean that banks can't lend out all their deposits. They must hold back a portion as reserves. Consequently, this reduces the overall money multiplier effect and restrains the credit creation process.

However, not only regulatory restrictions but also economic considerations can impact credit creation. High-interest rates may discourage borrowing, while a lack of creditworthy borrowers may reduce the number of profitable lending opportunities for the bank. Both scenarios limit the demand for loans, thereby reducing credit creation.

Case Studies: Limitations of Credit Creation in Practice

For instance, during the 2008 global financial crisis, many banks found their capital adequacy ratios falling short. As a result, despite having deposits and willing borrowers, credit creation was hampered due to regulatory limitations, slowing down the economic recovery.

Conversely, in the case of small developing economies, the limited number of creditworthy borrowers coupled with high-interest rates can pose significant challenges. Even though banks may have adequate reserves, the dearth of suitable borrowers hinders the full potential of credit creation and economic growth.

Examining these case studies underlines the importance of understanding the limitations of credit creation. It reinforces the idea that while credit creation is a potent economic tool, it is not an omnipotent solution to monetary and economic challenges.

Exploring the Role of Credit Creation in Macroeconomics

Dealing with large-scale economic phenomena, macroeconomics examines a wide range of conditioning factors, which include production, consumption, savings, and investment. However, one of the dominant factors responsible for the numerical swell and shrink in an economy is credit creation. Let's explore this concept and its immense significance in moulding the economic landscape.

Critical Role of Credit Creation in the Financial Sector

The financial sector is the sector of an economy made up of firms that provide financial services to commercial and retail customers. This sector includes banks, investment funds, insurance companies and real estate. It serves as the backbone that facilitates transactions, savings and investment activities in an economy.

Credit creation plays a staggering role in the financial sector. It's not an exaggeration to say that banks, being the key player in this sector, act as the fuel for the engine of credit creation. The ability of banks to lend more than the actual amount of deposits they hold leads to a multiplication of 'money' in the system.

Consider this: If a bank has a reserve ratio of 10%, this means that for every £100 deposit it receives, it keeps £10 and lends out £90. This £90 when deposited in another or the same bank becomes a new deposit, and now this bank can lend 90% of £90 and the process continues, thereby increasing the total money supply in the economy.

This continuous lending and depositing process leads to an explosive expansion in the asset size of banks and fuels economic growth. In essence, it allows banks to punch above their weight, expanding their reach and influence far beyond their physical holdings.

How Credit Creation Shapes Economic Growth

Economic growth can be defined as an increase in a country's capacity to produce goods and service. It is measured as the percentage increase in real gross domestic product (GDP), which is the market value of all final goods and services produced in a country in a given period.

As puzzling as it might seem, credit creation is one of the lead actors on the stage of economic growth. By pumping more 'loanable funds' into the system, banks create avenues for businesses to launch, expand and innovate. These loans act as a catalyst

that triggers increased production, consumption and investment activities - three critical determinants of economic growth.

- It increases capital formation by making funds available for businesses.
- It boosts consumption as people can now borrow to finance their expenditures.
- It encourages investment activities, as businesses now have easy access to credit.

Bearing this in mind, credit creation, indeed, leaves indelible imprints on the trajectory of economic growth.

Credit Creation's Influence on Economic Policies

Credit creation doesn't just stick to influencing economic growth; it is closely intertwined with economic policies, especially monetary policy. Central banks, the institutions responsible for carrying out monetary policy, often use credit control measures to manage the money supply and influence economy-wide variables such as inflation and interest rates.

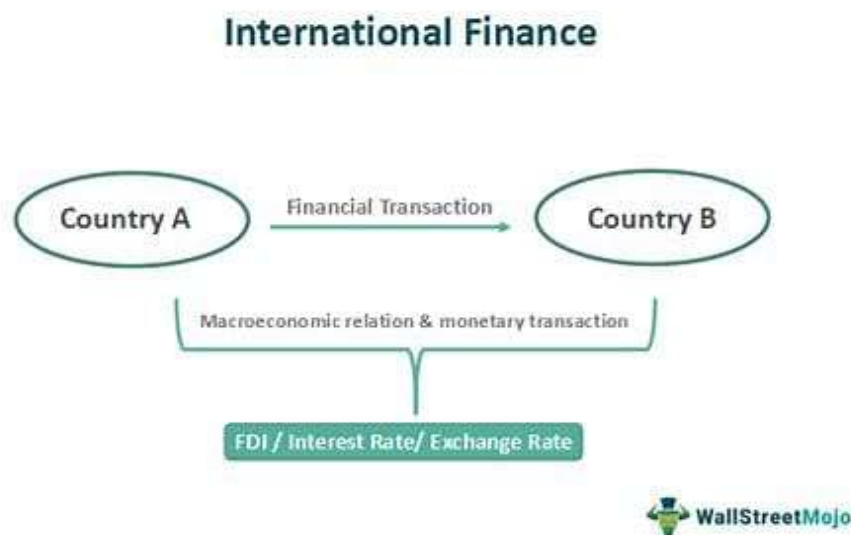
For instance, in situations of excess inflation, central banks may decide to increase the reserve ratio--the amount banks must hold back from their deposits. This action contracts the money supply by reducing the credit banks can create, thereby dampening inflationary pressures.

Monetary Policy	Management of the money supply to influence economy-wide variables
Inflation	A general increase in prices, eroding purchasing power
Reserve Ratio	The portion of total deposits that banks are required to hold as reserves

Similarly, during an economic recession, a central bank might lower interest rates to encourage borrowing and spending, boosting credit creation, and stimulating

economic growth. Such examples give a clear picture of how essential credit creation is as a tool for implementing economic policies.

4.6 International Bank



Meet Evan. He's an entrepreneur that has started an import-export business. He has developed contacts with suppliers in Asia, Western and Eastern Europe, the South Pacific and Africa.

Consequently, Evan needs access to banking services in several continents and numerous countries. He could establish banking relationships with local banks from each country in which he does business, but he is not that familiar with each country and the quality of the various banks.

Additionally, it would be a real pain for him to keep track of so many different banks and accounts. Instead, he wants to use an international bank that engages in banking transactions in several different countries. Evan finds a large U.S. bank that operates internationally in all countries where he conducts business. Since the bank is headquartered in the U.S. and subject to federal banking regulations, he feels safe using the bank for overseas transactions. He's also able to have all his banking and credit transactions conducted through one bank.

4.6.1 International Banking Services

International banks can provide Evan the same banking services that he can get at any hometown bank. Evan can deposit money in checking, savings and money market

accounts. Evan can also obtain loans and lines of credit for his business. Evan's international bank can also provide some specialized services that Evan's import-export business may need. An international bank can provide trade financing, such as lending, letters of credit and export credit.

A letter of credit is an instrument that a buyer, like Evan, can request from his bank that guarantees that the bank will make a payment for goods purchased once the conditions found in the letter are met. For example, in order for payment to be received, the seller may have to produce certain shipping documents as proof that the goods have been shipped to Evan. Export credit is a line of credit given to an importer by a bank in the exporter's country. For example, Evan's bank may give Evan a line of credit in China to facilitate his import of goods from a Chinese manufacturer.

Evan's bank can also help with foreign exchange. Foreign exchange refers to the exchange of one country's currency for the currency of another. For example, Evan may be importing goods from a member of the European Union. The foreign manufacturer doesn't want to be paid in dollars, but instead, wants to be paid in Euros. Evan's bank can exchange the amount of dollars in Evan's bank account to the requisite number of Euros to complete the transaction.

This section of the Manual of Examination Policies provides a broad perspective of international banking. It begins by addressing the concept of country risk, which is the primary risk associated with international banking activities.

The section then discusses common international banking products and services such as foreign loans, investments, placements,¹ currency exchange, and funds management. Within the discussion on foreign loans, significant attention is given to trade finance, which is an important, yet declining, segment of U.S. banks' international credit exposures. Due to increased globalization of international markets and competition from non-bank intermediaries,

U.S. banks have become less involved in trade finance and more involved in direct loans to foreign banks, participations in syndicated credit facilities, and loans to individuals and foreign businesses. This section also discusses the international banking operations of foreign banks in the U.S., the operational structures established by U.S. banks in order to conduct banking activities in foreign jurisdictions, and parallel-owned banking organizations (PBOs).

A PBO exists where there is common control or ownership of domestic and foreign banks outside of a traditional bank holding company structure (similar to chain banks). The PBO structure results in a global financial organization that may not be subject to comprehensive, consolidated supervision standards and could present unique supervisory concerns. Finally, this section discusses supervisory methods and examination guidance relating to the supervision of foreign banking organizations (FBOs) and provides references to applicable laws and regulations. The section concludes with a glossary of international banking terms.

4.6.2 Overview of International Bank Activities

While the number of U.S. banks involved in international finance is relatively small in comparison to the overall number of U.S. banks, many large institutions have notable cross-border exposure and significant international activities. Moreover, in certain markets, a considerable number of smaller banks continue to allocate significant resources to international banking. Many international banking activities parallel those conducted in domestic banking operations. For example, in both international and domestic markets, a bank.

4.6.3 Internal Control Objectives

Effective internal control provides bankers and examiners reasonable assurance that

- Bank operations are efficient and effective.
- Recorded transactions are accurate.
- Financial reporting is reliable.
- Risk management systems are effective.
- The bank complies with banking laws and regulations, internal policies,

and internal procedures.

Control systems can help bank managers measure performance, make decisions, evaluate processes, and limit risks. Good internal control can help a bank achieve its objectives and avoid surprises. Effective control systems may detect mistakes caused by personal distraction, carelessness, fatigue, errors in judgment, or unclear instructions in addition to fraud or deliberate noncompliance with policies. Effective and well-designed control systems are still subject to execution risk. In other words, human beings still must execute most control systems and even well trained personnel with the best of intentions can become distracted, careless, tired, or confused.

Internal control must be consistently applied and well understood by bank staff if board and management policies are to be effectively implemented.

Controls typically

- (1) limit authorities,
- (2) safeguard access to and use of records and bank assets,
- (3) separate and rotate duties, and
- (4) ensure both regular and unscheduled reviews, including testing.

4.7 Check your progress

1. Trade between two countries can be useful if cost ratios of goods are:

- A. Undetermined B. Decreasing C. Equal D. Different

2. 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

3. 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

4. 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

5. International trade and domestic trade differ because of:

A. Different government policies

B. Immobility of factors

C. Trade restrictions

D. All of the above

6. 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

7. 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

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

A. Commercial policy

B. Fiscal policy

C. Monetary policy

D. Finance policy

9. Which of the following is international trade?

A. Trade between countries

B. Trade between regions

C. Trade between provinces

D. Both (b) and (c)

10. Market in which currencies buy and sell and their prices settle on is called the

A. International bond market

B. International capital market

C. Foreign exchange market

D. Eurocurrency market

4.8 Glossary

<ul style="list-style-type: none"> Credit Creation 	<ul style="list-style-type: none"> The process by which banks generate new money through lending activities, creating more money than they physically possess in their reserves.
<ul style="list-style-type: none"> Credit Creation Theory 	<ul style="list-style-type: none"> A model in macroeconomics that states every loan given out by the banking system leads to a corresponding increase in total deposits, therefore facilitating growth in the money supply
<ul style="list-style-type: none"> Credit Creation Formula 	<ul style="list-style-type: none"> is expressed as $\text{Credit} = \text{Initial Deposit} \times (1/\text{Reserve Ratio})$, indicating how much potential credit can be created from an initial deposit

4.9 Self- Assessment

1) what is international financial markets?

2) what is international monetary funds?

3) Explain international flow of funds.

4) Describe international banking.

5) what is internal control objectives.

ii) Answer Essay questions

1. What are the concepts of international financial markets?

2. What is the role of the international financial market in promoting international business?

3. What are the sources of international financial flows?
4. What are the functions of multinational banking?
5. What are the functions of international banks?
6. What are the basic principles of credit creation by banks?
7. What are the benefits and limitations of credit creation?
8. What role does the central bank play in credit creation?

4.10 Reference

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Unit -5

International Financial Markets and Instruments...



5.1 Introduction:

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

5.1 Meaning 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

5.1.1 Segments of International Financial Markets

The International Financial Markets can be categorised into the following segments



International Bond Market

Foreign 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...

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....

International Equity Market

- Companies raise equity capital by issuing shares, which are also traded on the stock exchanges of their individual countries
- These shares are also listed on the stock exchanges of those countries....
- 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....

International Money Market:

International Money market is the market for transfer of shortterm funds. In international money market, transactions take place in a variety of different currencies. International banks and financial institutions across the world are the major suppliers of funds in these markets, while MNCs and governments of different countries are the major users of these funds. The European money market is an important part of the international money market.

International Credit Market...

- 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....
- 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...

Foreign Exchange Market

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

5.1.2 Instruments of International Financial Markets

There are different types of equity investment instruments in international market. International equity offering generally takes any one of the two forms, viz,

- i) Dual syndicate equity offering, where the equity offering is split into overseas and domestic trenches and each is handled by separate lead manager and
 - ii) Euro equity offering where one trench is placed overseas and managed by one lead manager
- GDRs, ADR AND IDRS (Global, American and international depository Receipts) are the prime modes of Euro-equity offerings

Global Depository Receipt (GDR)

A Global Depository Receipt (GDR) is a dollar denominated instrument traded on a stock exchange in Europe or the US or both. It represents a certain number of underlying equity shares.

The shares are issued by the company to an intermediary called depository in whose name the shares are registered. It is the depository which subsequently issues the GDRs. The physical possession of the equity shares is with another intermediary called the custodian who is an agent of the depository. Thus while a GDR represents the issuing company's shares, it has a distinct identity and in fact does not figure in the books of issuer.

The concept of GDRs has been in use since 1927 in Western capital markets. Originally they were designed as an instrument to enable US investors to trade in securities that were not listed in US exchanged in the form of American depository receipts (ADRs). Issue traded outside the US were called International Depository Receipt (IDR) issues.

Until 1983, the market for depository receipts was largely investor driven and depository banks often issued them without the consent of the company concerned. In 1983, the securities and exchanged commission (SEC) of the US made it mandatory for certain amount of information to be provide by the companies.

Till 1990, the companies had to issue separate receipts in the United states (ADRs) and in Europe (IDRs). Its inherent weakness was that there was no cross border trading possible as ADRs had to be traded, settled and charged through DTC (an international settlement systems in the US) while the IDRs could only be traded and settled via Euro clear in Europe.

In 1990, changes in Rule 144A and regulation 5 of the SEC allowed companies to raise capital without having to register the securities within the SEC or changing financial statements to reflects US accounting principles. The GDR evolved out of these changes.

Under Rule 144A, the purchaser may offer and resell those securities to any Qualified Institutional Buyer (QIB) If:

1) The securities are not same class as securities of the issuer quoted in NASDAQ or listed on a US stock Exchange.

2) The buyer is advised that the seller is relying on Rule 144A; and

3) Unless the issuer is a reporting company or is exempt from exchange Act registration under Rule 12g 3-2(b), the buyer, upon request, has the right to receive at or prior to the time of sale, specific financial statements of the issuer and information as to its business.

In view of the foregoing, it is permissible for a foreign private issues to sell its shares through an underwriter into the US provided the shares are eligible for Rule 144A treatment and US market is limited to QIBs. To accomplish this, the underwriter would purchase the securities from the issues in a transaction exempt from the registration requirements of the securities Act and relying upon Rule 144A, resell those securities to QIBs in the US. 191.

A leading south Korean trading company, Samsung co. Ltd. Which floated a truly global instrument in December 1990, tradable both in Europe and in the US, set the trend for GDR issues. The GDR issue allowed the company to raise capital both in US and Europe simultaneously through one security.

Depository Receipts (DRs) are offered for subscription as under:

- a) Unsponsored: Issued by one or more depositors in response to market demand. Today this is obsolete
- b) Sponsored: This is prominent today thanks to flexibility to list on a national exchange in the US and the ability to raise capital.

1.Private Placement (!\$\$A) DRs:

A company can access the US and other markets through a private placement of sponsored DRs. In this a company can raise³ capital by placing DRs with large institutional investors and avoid registering with the SEC. The National Association Of Securities Deal (NASD) of the US has established an Electronic Trading System similar to NASDAQ, called PORTAL within which Rule 144A eligible securities approved by NASD for deposit may traded by QIBs.

2.Sponsored Level DRs:

This is the simplest method for companies to access the US and non-US capital markets. Level-I DRs trade on the OTC market and as a result the company does not have to comply with US generally accepted accounting principles (US GAAP) or full securities and exchange commission (SEC) disclosures. Under this, companies enjoy the benefits of a publicly traded security without changing the current reporting process.

3.Sponsored Level II and III DRs:

Companies that wish to either list their securities on an exchange in the US or raise capital, use sponsored level II and III DRs respectively. Each level requires different SEC registration and reporting plus adherence to US GAAP. The companies must also meet the listing requirements of the National Exchange or NASDAQ whichever it chooses.

5.1.3 Need for GDR issues by Indian Companies

The specific needs of Indian companies to issue GDRs are as follows.

- i) To raise valuable foreign exchange,
- ii) To meet the expansion and diversification needs of these companies,
- iii) To globalize the demand for the scrips of these companies,
- iv) To leverage the corporate names of these companies in the global capital market,
- v) To mitigate the rising cost of domestic capital due to stringent monetary conditions at home and
- vi) To broad-base share holdings in these companies are the specific needs that were sought to be fulfilled by these GDR companies

Requirements for Issuing GDRs:

In a directive issued on November 12, 1993, the Government of India laid down certain provision governing issues of GDRs and foreign currency bonds. The key provisions are as follows:

- Prior permission from the department of Economic Affairs, ministry of Finance is mandatory.
- Company seeking such approval must have a consists track record of good performance.
- The custodian shall be a Domestic Custodian Bank.
- The aggregate of the foreign investment in the company, direct or indirect, shall not exceed 51% of the issued and subscribed capital of the issuing company (This is exclusive of general permission of offshore funds.

FIIIs to invest upto 24% or 30% as the case may be

In addition the notification contains details of taxation are mentioned in the text. Dividends are subject to a 10% withholding tax and capital gains (if the underlying shares are sold in India or to an India resident) at maximum marginal rate if short term (holding period less than 12 months) and 10% if long term are provided for Subsequently, in may 1994, the Government of India issued further guidelines intended to further regulate the access and the use of funds. The May 1994 guideliens specify inter alia:

- 1) A company can make a GDR issue only once in a period of 12 months. A group of companies can make no more than two issues.
- 2) The funds mobilized must be used within a year of the issue date for one or more of the following purposes:
 - a. Import of capital equipment.
 - b. Purchase of domestic plant, equipment and buildings.
 - c. Prepayment or scheduled repayment of an existing foreign currency liability.

d. Funds a joint venture or a project abroad provided the same has been approved by the Government.

e. Up to 15% of the issue proceeds can be utilized for “general corporate restructuring purposes”

3) On a case-by-case the Government may approve retention of the proceeds abroad to be used as prescribed. Otherwise the funds must be repatriated to India within two weeks of the issue.

4) In certain cases, GDR investment will be treated on par with foreign direct investment and hence will require prior clearance by the Foreign Investment Promotion Board (FIPB).

The guidelines are subject to review and revision every three months. GDR can be offered to US investors only if very stringent requirements of registration with the SEC are complied with.

However, under an exemption granted by Rule 144A of the securities Act, securities can be offered to Qualified Institutional Buyers (QIBs) without going through the registration process.

5.1.4 Parties to GDRs

The key involved in a GDR issue apart from the issuing company are:

- i) The lead manager (s0: An investment bank which has the primary responsibility for assessing the market and successfully marketing the issue. It helps the company at all stages from preparing the documentation, making investor presentation, selection of other manager (subscribers) and post-issue support. It also owes a responsibility to investors or presenting an accurate picture of the company's present status and future prospects, to the best of its knowledge. This means that it must exercise due diligence in collecting and evaluating all possible information which may have a bearing on the issue.

- ii) Others managers or managers or subscribers to the issue agree to take and market parts of the issue as negotiated with the lead manager.
- iii) Depository: A bank or financial institution, appointed by the issuing company which has certain duties and functions to be discharged vis-à-vis the GDR holders and the company. For this it receives compensation both from the company as well as the GDR holders.
- iv) Custodian: A bank appointed by the depository, generally in consultation with the issuing company which keeps custody of all deposited property such as share certificates, dividends, right and bonus shares etc. It receives its fees from the depository
- v) Clearing systems: EUROCLEAR (Brussels), CEDEL (London) are the registrars in Europe and Depository Trust company (DTC) is the registrar in USA who keep records of all particulars of GDRs and GDR holders.

5.1.5 Steps in issue of GDRs

The steps involved in the GDR mechanism can be summarized as follows:

- i) The amount of issue is finalized in US dollars. The company considers factors such as gearing, dilution effect on future earnings per share etc. The lead manager assesses the market conditions.
- ii) The lead manager and other managers agree to subscribe to the issue at a price to be determined on the issue date. These agreements are embodied in a subscription agreement signed on the issue date.
- iii) Usually, the lead manager has an option to subscribe to specified additional quantity of GDRs. This option called green shoe has to be exercised within a certain number of days.

iv) Simultaneously, the Depository and the Custodian are appointed and the issuer is ready to launch the issue.

v) The company issues a share certificate equal to the number of GDRs to be sold. This certificate is in the name of the Depository, kept in custody of the custodian. Before receipts of the proceeds of the issue, the certificate is kept in escrow.

vi) Investors pay money to the subscribers.

vii) The subscribers (i.e. the lead managers and other managers to the issue) deposit the funds with the Depository after deducting their commissions and expenses.

viii) The company registers the depository or its nominee as holder of shares in its register of shareholders.

ix) The Depository delivers the European Master GDR to a common depository for CEDEL and EUROCLER and holds an American Master GDR registered in the name of DTC or its nominee.

x) CEDEL, EUROVLRAR and DTC allot GDRs to each ultimate investors based on the data provided by the managers through the depository.

xi) The GDR holders pick up their GDR certificates. Anytime after a specified "cooling off " period after close of the issue they can convert their GDRs into the underlying shares by surrendering the GDR to the depository. The Custodian will issue the share certificates in exchange for the GDR.

xii) Once surrendered in exchange for shares, such shares can not be reconverted into GDRs. That is there is no fungibility.

xiii) The GDRs are listed on stock exchanges in Europe such as Luxembourg and London.

xiv) Dividends paid will be collected by the custodian converted into local currency and distributed to GDR holders.

The costs of the issue consist of various fees, commission and expenses paid to the lead manager and other managers, fees and expenses paid to the depository, preparation of documents, legal fees, expenses involved in investor presentation (road shows etc.) listing fees for the stock exchanges, stamp duties etc. Fees and commissions paid to managers vary but are generally in the neighbourhood of 3-4% of the issue amount. This is for less than issue costs in India which range between 8% to 15% of the issue size.

GDR holders have the right to dividends, the right to subscribe to new shares and the rights to bonus shares. All these rights are exercised through the depository. The depository converts the dividends from rupees to foreign currency. GDR holders have no voting rights. The depository may vote if necessary, as per the Depository Agreement.

American Depositary Receipt (ADR):

ADRs are financial assets that are issued by U.S. banks and represent indirect ownership of a certain number of shares of a specific foreign firm that are held on deposit in a bank in the firm's home country. The advantage of ADRs over direct ownership is that the investor need not worry about the delivery of the stock certificates or converting dividend payments from a foreign currency into U.S. dollars.

The depository bank automatically does the converting for the investor and also forwards all financial reports from the firm. The investor pays the bank a relatively small fee for these services. Typically non-Canadian firms utilize ADRs. For example, Mexican firms are traded in this manner in the United States – at yearend 1993, all 13 Mexican firms with their stock listed on the NYSE utilised ADRs. In March 1999, the first even ADR issue by an Indian firm took off. The Information Technology Ltd., floated ADRs which were received very well.

One study that examined the diversification implications of investing in ADRs found that such securities were of notable benefit to U.S. investors. Specifically, a sample of 45 ADRs was examined and compared with a sample of 45 U.S. securities over the period from 1973 to 1983.

Using an index based on all NYSE – listed stocks, the betas of the ADRs had an average value of .26, which was much lower than the average beta of 1.01 for the U.S. securities. Furthermore, the correlation of the ADRs returns with those of the NYSE market portfolio averaged 0.33, whereas U.S. securities had a notably higher average correlation of 0.53.

Given these two observations, it is not surprising that portfolios formed from U.S. securities and ADRs had much lower standard deviations than portfolios consisting of just U.S. securities. For example, portfolios consisting of 10 U.S. securities had an average monthly standard deviation of 5.50%, whereas a 10-security portfolio split evenly between U.S. securities and ADRs had an average monthly standard deviation of 4.41%. Thus in contrast to investing in multinationals, it seems that investing in ADRs brings significant benefits in terms of risk reduction.

The SEC currently requires that foreign firms prepare their financial statements using U.S. generally accounting principles (GAAP) if they want their shares or ADRs to be listed on a U.S. exchange or an NASDAQ. There are two consequences of this requirement. First, many foreign firms have their shares and ADRs traded in the part of the over-the counter market that does not involve NASDAQ. Second, many large and actively traded foreign firms have decided against listing their shares in the United States.

This has caused U.S. exchanges to fear that certain foreign exchanges which do not have such reporting requirements (particularly London) will reign as the financial centres of the world in the future. In response to the complaints of the exchanges, the SEC argues that this requirement is necessary to protect U.S. investors and that it would be patently unfair to U.S. firms if they had to meet such requirements but their foreign competitors did not have to do so.

Debt Instruments:

Debt instruments ADR. global debt market is much older than global equity market. earlier the multiparter and bilateral. debt instruments in full form. Debt instruments took several forms viz. straight bonds. Syndicated loans. Floating rate bonds. Convertible bonds etc.

5.2 Varieties of Global Market Debt Instruments

Debt investment guarantees periodic current return and priority repayment of capital over equity investment in the event of winding up. Of course, debt investments are redeemable after a fixed time period, usually 7 years or so. Security is there. Risk averse investors go for this investment. A brief description of debt instruments available in the Euro-market.

Bonds For starters, there is a veritable plethora of securities, such as Euro-bonds, Yankee bonds, Samurai bonds, and Dragon bonds which tap the European, US, Japanese, and Asia Pacific markets, respectively. More specifically, Eurobonds are unsecured debt securities maturing at least a year after the launch. Usually fixed-rate instruments, with bullet repayments-one-shot redemption-these bonds are listed on stock exchanges abroad. And borrowers access global investors with deep pockets: individuals with high net worth as well as institutions.

The volume of Eurobonds issues from the world's emerging markets hovered around the \$29-billion mark, with the average size of an issue being \$127 million some five years ago. The most popular instrument among emerging market borrowers: a Eurobond with a 144-A tranche. That is, a public offering in the Euro-market and a private offering in the US.

Foreign Commercial Paper:

Commercial papers are continuously offered unsecured debt by the borrower. Most FCPs mature in 30, 60, or 90 days and are sold at a discount to their face value. That reflects the interest on the instrument as well as the overall yield to the investor. It's extremely flexible, since commercial papers can be structured according to different maturities, amounts and rates according to the issuer's needs for funds.

Fixed/Floating Rate Notes:

This debt instrument matures in 90 days' time but it can be extended at the issuer's option for an additional period at each maturity date; simultaneously, the interest rate also increases. Several variations are possible; extendable bonds and stepped-up

coupon put table bonds. As the term suggests, hold on to the bonds for some more time usually at a higher coupon rate.

As for stepped-up coupon put table bonds, they are a hybrid between debt with warrants and extendable bonds or notes. After a specified period of time, investors can either put the bonds back up t the issuer or hold on to the bonds for a stated period at a higher-stepped-up-coupon rate.

Flip-Flop Notes :

A bond with reverse flexibility, a flip-flop note offers investors the option to convert to another debt instrument. And in some cases, investors can even go back to the original bond at a later date.

The option changes the maturity of the issue and the interest rate profile. It gives issuers the opportunity to persuade investors to accept lower interest rates, thus reducing their costs. Conversely, investors have options which come in handy when interest rates fluctuate sharply.

Dutch Auction Notes:

Here, investors bid for seven-year notes on which the coupon rate is re priced every 35 days. As a result, the notes are sold at the lowest yield possible. Bids are conducted through a real auction by dealers in the US markets. The main advantage is that these notes provide money for longer periods than commercial paper, since they are re priced only once every 35 days and, unlike commercial paper, are not redeemed and resold.

Bunny Bonds :

These bonds permit investors to deploy their interest income from a host bond into more bonds with the same terms and conditions. Since the option to reinvest interest at the original yield is attractive to long-term investors, like the pension fun ds, companies find it a cheap source of finance.

Euro-Rupee Bonds:

It doesn't exist yet, but several foreign institutions are toying with the idea of gobbling together such a tool for wary companies. Denominated in rupees, Euro-rupee bonds can be listed in, say, Luxembourg. Interest will be paid out in rupees, and investors play the risks of currency fluctuations.

Euro-Convertible Bonds:

It's the most exciting Euro-option available. Equity-linked debt instruments, which can be converted into GDRs. ECBs represent the best of both worlds. And they may soon overtake GDRs in terms of their popularity in this country.

Traditionally, investors have the option to convert any such bonds into equity according to a pre-determined formula-and, appropriately, even at a pre-determined exchange rate. Such bonds allow investors the flexibility to remain with the debt instrument if the share price refuses to rise. These bonds have also spawned subtle variations like those with call and put options, which allow the issuer to insist on conversion beyond certain limits or permit investors to sell the bonds back to the issuer. What's more significant are the structural variations that the Euro-market is becoming famous for.

Deep Discount Convertibles:

Such a bond is usually at a price which is 70 to 80 per cent of its face value. And the initial conversion prices and the coupon rate levels, are lower than that of a conventional Eurobond.

ECBs with Warrants:

Strictly speaking, these financial instruments are nothing but derivatives of Eurobonds. They are combination of debt, with the investor getting an option on the issuer's equity. The equity, or warrant, is detachable from the host bond and it can be

cased after specific points of time. However, the bonds, which have a debt life of seven to 10 year, remain outstanding until they mature. "There can be expectations of the issuer and the lender". For instance, they could be zero coupon which carry a conversion option as a predetermined price, which are called liquid yield option notes.

Bull Spread Warrants These warrants offer an investor exposure to the underlying share between a lower level, L, and an upper level, U,. The lower level is set to provide a return to investor above and dividend yield on the share. After maturity- usually three years – if the share is below the level L, then the investor receives the difference from the company.

Compensating for the downside protection, the issuer can cap the up-side potential on the share. When it matures, if the issuer's share price is above the level U, the issuer has to pay out only the amount U. If the stock is between L and U on maturity, the issuer has a choice of either paying the investor cash or delivering shares. As the minimum return is set above the dividend yield on shares, the structure works best for companies with a low dividend yield.

Money-back Warrants(MBW): MBWs entitle an investor to receive a certain predetermined sum from the issuer provided the investor holds the warrant until it matures, and does not convert it into shares. To the investor, the cost of doing so is not only the cash he loses, but also the interest foregone on the sum of the money. This means that companies must offer a higher premium than they normally do.

Syndicated Loan

The earlier to be evolved and, for a time, the most dominant form of cross border lending was the syndicated bank loan. Throughout the late seventies and early eighties most of the developing country borrowers relied on this source since their credit rating and reputation were not good enough for them to avail of other avenues such as bond issues. A large bank loan could be arranged in a reasonably short time and with few formalities. This was also a period during which banks found themselves being flooded with inflows of short term funds and a relatively repressed demand for loans from their traditional developed country borrowers.

Euro Market Instruments

To day instruments market is integrated and globalized one. the euro market speaks of the integrated nature of the global investment market. It is mainly interbank market dealing is euro currency deposit and euro currency loans. Some of the instruments dealt in the market are; euro bonds. Commercial pages, certificate of deposits. Floating rate notes etc. a brief description of these instruments are given here.

Eurocurrency Deposits

Eurocurrency deposit refers to the deposit if a currency with the banks outside the country where the currency is legal tender. Hence Eurocurrency deposit consists of all deposits of currencies placed with banks outside their home currency. Deposits are placed at call or for fixed periods as time deposits. Call deposits may be made for overnight, two days or seven days notices. Time deposits are accepted in the periods of 1,3,6, and 12 months. In general the deposits are accepted in the Eurocurrency market for a minimum of U. S. dollar 50,000/- or its equivalent in other currencies.

Certificate of Deposit

Certificate of deposit is a certificate issued by a bank evidencing receipt of money and carries the bank's guarantee for the repayment of principal and interest.

Certificate of deposits are negotiable instruments and are issued payable to bearer and are traded in the secondary market. The certificate of deposits are issued for a minimum denomination of U.S dollar 50,000/- and for a maximum period, generally, of 1 year.

Certificates of deposits provided an excellent avenue to the investors in Eurocurrency market who would like to park their surplus in the high interest instrument their liquidity. For example if an investor say bank has surplus fun which it would like to invest for a period of say 3 months it can buy a C.D. for 3 months. IF need be, the bank can sell the C.D. in the secondary market and liquidate it.

5.2.1 Types of Certificates of Deposits

1. Straight or Top CDs:

These are certificates of deposits with a fixed rate of interest and a fixed date of maturity (Generally 1-12 months). The interest is fixed in terms of LIBOR and interest rate depends on the issuing bank and liquidity position in the market.

2. Floating Rate CDs:

These are certificates of deposits which are issued with the interest rate linked to the LIBOR rate and are normally issued for a period of maximum of 3 years. Interest rate is reviewed at predetermined periodicity say every six months and adjusted in line with the base rate LIBOR rate.

3. Discount CDs:

These are issued at a discount and are paid at maturity for the face value, the difference between the issue price and face value represents the interest.

4. Tranches CDs:

A Tranche CD is a share in a programme of CD issues by a bank up to a predetermined level. Each Tranche CD carries the same rate of interest and matures on the same date.

They are normally placed directly with the investors and they represent short-term bonds. These CDs are issued with maturities up to 5 years.

5.2.2 Euro Credits

In the Eurocurrency market, most of the lending takes place in the form of Euro credit. These are medium and long-term loans given by the banks in currencies which need not necessarily be those of the lenders or borrowers.

Security Aspects of Euro credit

Euro credits are provided mostly without any collateral security but the emphasis is on the credit rating of the borrower. In view of the difficulties experienced in enforcing securities the lending is made on strength of the standing of the borrower in the market.

Nature of Facility

Euro credit are extended either as revolving credits or as term credits. Under revolving credit, a limit is fixed for a borrower and he can draw whenever he needs and interest will be levied only on the amount drawn. On the unutilized portion of the sanctioned limit, a commitment fee may be charged.

Under the term credit facilities, the credit is extended for a specified term like say 3 year, the amounts disbursed as per the term of the contract. The repayment takes place over a period of time as per the agreed schedule.

Euro credits are extended generally for a period of 5 to 8 years. In some cases it may go up to 15 year

Interest

A special feature of Euro credit is the method of fixing the interest rate. Interest rate are tied to bench mark of references rate. The bench mark is the London interbank Offered Rate. For dollar credits LIBOR is used as benchmark while LUXIBOR (Luxembourg Interbank Offered Rate) is used as benchmark rate for credits extended in Deutschemark and for credits in Pound Sterling Paris Interbank offered rate(PIBOR) is taken as the base rate.

The interest is quoted as so many basic points above the reference rate like 100 basic points above LIBOR above LUXIBOR etc, This is known as margin and the margin depends on the credit rating of the borrowing, and his bargaining power. The interest is reviewed every six months and changed in tune with the reference rate.

Currency

The credits are generally extended in U.S. dollar but other currencies are also used for lending. IN some cases, the credit agreement provides for currency option. Under the arrangement the loan is originally given in one currency with the option to the borrower to roll the loan in a different currency if need be. This helps the borrower to protect against exchange risk.

5.2.3 Euro Loan Syndication

Euro Loan syndication was one of the earlier forms of lending evolved and remains to be one of the dominant form of cross border lending. When the size of the lending is huge running into a few hundred million or billions, a few banks join together and provide the loan. This is loan syndication in simple term. It owes its evolution to U.S. Laws which fixed certain limits on lending exposure of a single bank on a single borrower.

A syndicated credit is the agreement between two or more lending institutions to provide a borrower a credit facility utilizing common loan documentation.

An appropriate definition will be. "International syndicated credits are managed and underwritten by one or more financial institution normally from a location other than domicile of the borrower to include lender from differing banking geographic which provides the borrower access to more than its own currency of domicile.

In arranging a syndicated loan the following player take a major role.

1. Managing Bank:

Managing bank is appointed by the borrower to arrange the credit. The managing bank helps the borrower to draw up the loan application, it negotiates the term and conditions with other banks and arranges the syndicate. The managing bank's role comes to an end with the signing of loan agreement by the borrower and the participating banks.

2. Lead Bank:

Lead Bank is the bank which provides the major chunk of the loan

3. Agent Bank:

Agent Bank is the bank appointed by the lenders to look after their interest once the loan agreement is signed. They take over from the managing bank.

The participants in a syndicated loan fall into the following segments.

a. The wholesale large commercial banks who arrange the credits, take lion's shares.

b. The retail sector small banks take whatever share is given to them and take a participation in the loan syndication.

Loan syndication is the most popular method of raising short term and medium term loans. Most of the developing country borrowers rely on this source of credits since their ratings and market standing are not good enough to avail of other avenues like bond issues etc, A large bank loan could be arranged in a reasonably short time and with few formalities. Minimum amount of syndicated loan raised is normally 50 million US dollar and the maximum amount is normally 5 billion US dollar and are given for a period ranging from 365 days to 20 years.

Apart from interest the following fees are payable in a syndicated loan

1. Management Fee is the fees payable to managing bank which arranges the credit. It is payable upfront and is fixed as a percentage of the loan arranged

2. Participation Fee is the fee payable to the participants in the syndicate. A part of the management fee is passed on to the participant banks in proportion to their share as participation fee.

3. Commitment fee is the charge paid on undrawn balances of the credit. This is also known as facility fee and is levied to compensate the banks for keeping funds ready.

4. Agency Fee is the fee payable to the agent bank which takes care of disbursement of the credit after sanction, recovery of loan instalments and distribution of principal plus interest to the participants and this is an annual fee.

5.2.4 Unique features of syndicated loans

Unique features of syndicated loans

1. Access to Euro-currency markets

a) Free from Regulatory Control

b) Offshore banking- global converge

c) Flexibility to suit the borrower's and lender's changing needs.

2. Recycling of Euro deposits from surplus to deficit areas. 3. Transform short term euro deposits to medium/long term euro credits.

5.2.5 Concepts of Loan Syndication

1. Agreement between two or more lenders

2. Common borrower.

3. Common documentation.

4. Different from syndicated or independent borrowings from multiple banks.

Advantages to Lenders

1. Spreading of risk.

2. Access to big borrowers.

3. Access to credit judgments/ marketing skills of sophisticated banks.

4. Sources of fees i.e. non interest income.

5. Advertisement.

Advantages to the Borrower

1. Ability to raise Jumbo loans in one stroke.

2. Single tap funding.

3. One set documentation. Hence less hassle.

4. Flexibility in the borrowing and speed which ensures timely delivery of credit.

Protection to the Lenders:

To protect their interest the lending bank lays down certain financial covenants which are included in the agreement. The covenants are financial values or ratios to be maintained by the borrower and the following are the few.

- a) Debt-equity ratio
- b) Dividend payout ration
- c) Debt service coverage ration

Normally the lending banks analysis before sanction the credit standing of the borrower, his country's credit standing, and his country's economic and political situation.

Even though all members of a syndicate sign a common loan agreement each lending bank is responsible for its own decision. Any misrepresentation of fact by the borrower or failure to perform the covenants is defaults by the borrower. Default with any single lending bank will be construed as default with all banks. Since the credits fall outside the jurisdiction of any court the legal recourse is difficult and hence settlement through political negotiation is normally resorted to in care of defaults.

5.2.6 Euro Bonds

Eurobonds constitute a major source of borrowing in the Eurocurrency market. A bond is a debt security issued by the borrower which is purchased by the investor and it involves in the process some intermediaries like underwriters, merchant bankers etc.

Eurobonds are bonds of international borrower's sold in different markets simultaneously by a group of international banks. The bonds are issued on behalf of governments, big multinational corporations, etc. Euro bonds are unsecured securities and hence normally issued by Governments, Governmental Corporations, local bodies which are generally guaranteed by the Governments of the countries concerned and big multinational borrowers of good credit rating. The bonds are sold by a group of international banks which form a syndicate.

The lead bank in the syndicate, advises the issuer of the bond on the size of the issue, terms and conditions, timing of the issue etc., and take up the responsibility of coordinating the issue.

Lead managers take the assistance of co-managing banks. Each issue is underwritten by a group of underwriters and then are sold.

Feature of Euro bonds

Eurobonds are mostly bearer bonds and are generally denominated in U.S. dollar, issued in the denominations of U.S. dollar 10,000/- The bonds are issued for a period of about 5 to 7 years though in some cases they are issued for a longer duration.

5.2.7 Types of Bonds

The following are the types of bonds:

1. Straight or fixed rate bonds
2. Convertible bonds
3. Currency option bonds
4. Floating rate bonds/Notes
5. Zero coupon bonds

(I) Straight or Fixed Rate Bonds:

These are the traditional bonds which are debt instruments carrying a fixed interest with a fixed maturity period with interest payable at a fixed predetermined interval, say 6 months or 1 year. The period of such bonds vary from 5 to 25 years but commonly bonds are issued by a period of 15 years. These are issued for a face value with a certain percentage of interest payable at a certain periodicity and are redeemable after the expiry of the period specified.

These bonds are traded in the secondary markets which provide liquidity to the bonds. Though the bonds are issued for a fixed maturity, some bonds are issued with a

clause that the bonds are redeemable by the issuer, at issuer's choice, prior to its maturity at a price which is above the face value (call price). There are known as callable bonds and are a simple variant of straight bond. This feature of the bond allows the issuers to restructure their liability and provides flexibility.

A puttable bond is another variant of straight bonds and is opposite to callable bond. It allows the investor to surrender the bonds to the issuer of the bond prior to maturity of the bonds, at the discretion of the investor, after a certain period after issue. This provides liquidity to the investor and may have to pay for this privilege in the form of lower interest.

Though the interest is fixed on the bonds, the yield varies with the purchase price of the bonds. The market price at which the bond is bought by the investor either in the primary market (new issue market) or in the secondary market (an existing issue made sometime in the past) is its purchase price which may be same as the face value of the bond or may be lower or higher than the face value depending upon whether the bond was purchased at a discount or at a premium. The yield varies with the purchase price of the bond.

(ii) Euro Convertible Bonds:

These are similar to fixed or straight bonds with an option to convert them at the discretion of the investor into the equity shares of the issuing company. The conversion will be done at a price (which determines the number of shares for which the bond will be exchanged) after expiry of a certain period of time. These convertible bonds are similar in nature to the convertible debentures in our country.

Conversion of the bond into equity shares is done at the discretion of the bond holder and he can opt for it if the market prices of the shares are higher than the conversion price. Convertible bonds are attractive from investment perspective because it gives the investor an opportunity to participate in the company's growth. Additionally, the bonds are normally issued in a currency other than the currency in which the shares are denominated and hence conversion into shares in a different currency provides the investor much needed currency diversification in investments.

This instrument is preferred by those who find the domestic (their country) debt market to be restrictive for short maturities, high rates of interest and various covenants of commercial loans in foreign currency unacceptable. This also favoured by those who wish to prevent immediate dilution of equity and possible loss of control over management.

Hence Euro convertible bonds are equity linked debt security instruments that can be converted into shares.

Warrants: This is a variant of the convertible bonds. The bond is issued with warrants which are detachable. The warrant gives the holder the right to purchase a financial asset say shares at a stated price. The warrants are tradable. The investor can keep the bond and trade the warrant for the shares.

(iii) Currency Option Bonds:

These bonds are similar in nature to the straight bonds with a difference that it is issued in one currency with an option to take interest and principal in another currency. The rate at which the conversion takes place from one currency into another depends upon the terms of the issue.

The rate may be fixed at the time of issue of bonds or at floating rates. Due to fluctuations observed in foreign exchange market the later option of floating rates are more popular and under this the rate of conversion is the spot rate quoted in the market three business days before the due date of payment of principal and interest.

(iv) Floating Rate Bonds/Notes:

These are similar to the straight or fixed rate bonds as far as maturity and denomination are concerned but the difference is that unlike the fixed rate bond where the interest rate is fixed, in this the interest rate is varying in nature. The interest rate is linked to a base rate like LIBOR and the interest payable on the bond for the next six months or one year is set with reference to the base rate. The rate of interest is adjusted every six months or one year depending on the terms for the issue.

In some cases, a ceiling is put on the interest rate on the bond and in some cases a floor rate is fixed. The floating rate bonds offer flexibility to the investors who can block their funds for a long term with benefits of the short term interest movements, i.e. if an investor invests for a period of say 10 years and if the money market shows gradual increase in the interest rates his funds do not get blocked at lower rates but interest keep changing with the changes in the interest rates in the market FRNs are normally issued by bankers.

(v) Zero Coupon Bonds:

These bonds are purchased at a substantial discount from the face value of the bond and are redeemed at face value on maturity. There are no interim interest payments. The difference between the purchase price and face value is the return on the investment.

These bonds are similar to cumulative deposits or cash certificates of banks in our country.

Distinction between Eurobonds, domestic bonds and foreign bonds:

Domestic bonds are bonds issued by a resident issuer in the country of its residence, denominated in the currency of the country.

Example: State Bank of India bonds sold in India to Indian residents denominated in Indian rupees is domestic bond.

Foreign bonds are bonds issued by a non resident entity denominated in the currency of the country where the bond is issued.

Example: India Development Bonds issued by State Bank of India in U.S.A. denominated in U.S. dollars are foreign bonds.

Eurobonds are bonds denominated in a currency other than the currency of the country in which they are issued.

Example: A German multinational issuing bonds in London denominated in U.S.

dollar qualifies for a Eurobond.

The foreign bonds and domestic bonds are subject to regulations by regulatory authorities and disclosure norms while Eurobonds are not governed by any such regulation or disclosure norms.

Many Eurobonds are listed on stock exchanges in Europe and this require filing of certain financial reports by the issuers to the exchange on a regular basis.

Other Euro-Instruments

Note Issuance Facility and Euro Commercial Paper are dealt her.

Note Issuance Facility

This is an innovation of early 80's. It combines the features of syndicated banks loans and floating rate notes issued to the investors. This instrument satisfies the investors' need for short term investment and borrowers' need for medium term funding.

In this instrument the issuer obtains medium term funding by issuing short term notes to the investor directly and keep them rolling over repeatedly. Thus every six months or one year, the previous issue would be redeemed and a fresh issue will be made.

In order to ensure that the issuer gets the fund whether or not the notes are taken up by the market, a group of underwriters (syndicate of banks) underwrite the issues and thereby undertake an obligation to take up the part of issue which is not subscribed to by the market. The issuer of the bond pays a fee for this underwriting facility.

Note issuance facility represents a combination that best suits all parties. Parties with good rating can raise funds at a rate lower than the rate at which banks lend. Investors who generally prefer short term investments find this attractive as they are redeemed in a short time by the issuer and reissued.

Underwriting facility ensures smooth flow of funds to the borrower. This ensures income to the banks by way of underwriting fees.

5.2.8 Commercial Papers

Commercial Paper (CP) is a short term unsecured promissory note that is generally sold by large corporations on discount basis to institutional investors and other corporates for maturities ranging from 7 to 365 days. Commercial paper is cheap and flexible source of fund for highly rated borrowers as it works out cheaper than bank loans. For an investor it is an attractive short term investment which offers higher interest than bank accounts.

In U.S.A. the commercial paper is in existence for more than 100 years and accounts more than 400 billion US dollars. U.S.A. is the largest commercial paper market. It is used extensively by U.S. and non U.S. corporations.

Any issuer who wants to launch a C.P. in U.S.A. has to get it rated by Moody's or by Standard and Poor's Corporation, the credit rating agencies. The commercial papers then can be placed either directly or through C.P. dealers. The major investors are Corporates, Trusts, Insurance Companies, Pension Funds and other funds, banks etc.

Commercial papers can be issued either directly in their own name or with third party support in the form of standby letters. Most C.P. programs have a back-up credit line of a commercial bank covering at least 50% of the issue.

In Europe, commercial paper evolved out of Euro notes like Note issuance facility, which are under-written facilities. As the underwriting facility is expensive, in 1984, Saint Gobain, an issuer and Banque Indo-Suez dealer issued Euro notes without underwriting facility and thus became the first Euro-CP issuer. The commercial paper issues in the Euromarkets developed rapidly in an environment of securitisation and disintermediation of traditional banking.

Euro CPs are not rated by rating agencies as the Euro investors are not keen about the ratings of issuers.

Advantages of Euro CP's to Borrowers

1. Cheaper source of funds.
2. Simplicity in documentation, low cost of arrangement, absence of rating requirements.

3. Flexible maturity.
4. Diversification of short term funding through market that is found attractive by wide variety of investors.
5. Flexibility in limits determined by the issuer's cash flow requirements at any point of time.
6. A successful Euro CP programme will enhance the reputation of the issuer worldwide among the investing community.

S.No	Euro CP Programme	U.S. CP Programme
1	Do not distinguish the issuer's nationalities	U.S. investors expect higher returns from foreign issuers of comparable rating with U.S. issuers
2	Low rated CPs are issued by U.S. issuers	Better rated CPs are issued by issuers
3	Central Banks, Corporate funds are the investors	Money market funds are the investors
4	Euro CP is traded in secondary market	Held by the investor until maturity
5	Very competitive	Less competitive
6	No credit rating required	Credit rating required
7	Priced in relation to Bank rate	Priced in relation to treasury bill, Bank CD rates
8	Time consuming process	Simple process

In recent years, the growth in the number of new issues and volume has slowed down in Euro commercial paper markets. As a result of some defaults, investors' concern about credit worthiness has increased dramatically.

5.3 In International financial markets- short-term and medium-term

Financial instruments play crucial roles in facilitating liquidity, managing risk, and financing various activities. Here's an overview of some common short-term and medium-term instruments:

1. Short-Term Instruments:

Treasury Bills (T-Bills):

Short-term debt securities issued by governments, typically with maturities ranging from a few days to one year.

Commercial Paper:

Unsecured promissory notes issued by corporations to finance short-term liabilities, usually with maturities ranging from one day to 270 days.

Certificates of Deposit (CDs):

Time deposits offered by banks to investors with fixed maturity dates, usually ranging from a few days to several months.

Repurchase Agreements (Repos):

Short-term borrowing arrangements where securities are sold with an agreement to repurchase them at a later date at a higher price, effectively serving as collateralized loans.

2. Medium-Term Instruments:

□ **Bonds:**

Debt securities issued by governments or corporations with maturities typically ranging from one to ten years. They pay periodic interest until maturity when the principal is repaid.

□ **Medium-Term Notes (MTNs):**

Debt securities with maturities ranging from one to ten years, typically issued by corporations and sold through private placements.

□ **Euro Medium-Term Notes (EMTNs):**

Similar to MTNs but issued and traded internationally, usually denominated in currencies other than the issuer's domestic currency.

□ **Floating Rate Notes (FRNs):**

Bonds with variable interest rates that adjust periodically based on a reference rate, such as LIBOR or the prime rate.

These instruments serve different purposes for investors and issuers, offering varying levels of risk and return profiles. Short-term instruments are often preferred for liquidity management and short-term financing needs, while medium-term instruments provide longer-term funding and investment opportunities.

5.3.1 SHORT TERM SERVICES OF INTERNATIONAL FINANCIAL TRANSACTION

Financing is a very important part of every business. Firms often need financing to pay for their assets, equipment, and other important items. Financing can be either long-term or short-term. As is obvious, long-term financing is more expensive as compared to short-term financing.

There are different vehicles through which long-term and short-term financing is made available. This chapter deals with the major vehicles of both types of financing.

The common sources of financing are capital that is generated by the firm itself and sometimes, it is capital from external funders, which is usually obtained after issuance of new debt and equity.

A firm's management is responsible for matching the long-term or short-term financing mix. This mix is applicable to the assets that are to be financed as closely as possible, regarding timing and cash flows

SHORT-TERM FINANCING:

Short-term financing with a time duration of up to one year is used to help corporations increase inventory orders, payrolls, and daily supplies. Short-term financing can be done using the following financial instruments –

1. Commercial Paper:

Commercial Paper is an unsecured promissory note with a pre-noted maturity time of 1 to 364 days in the global money market. Originally, it is issued by large corporations to raise money to meet the short-term debt obligations. It is backed by the bank that issues it or by the corporation that promises to pay the face value on maturity. Firms with excellent credit ratings can sell their commercial papers at a good price.

Asset-backed commercial paper (ABCP) is collateralized by other financial assets. ABCP is a very short-term instrument with 1 and 180 days' maturity from issuance. ABCP is typically issued by a bank or other financial institution.

2. Promissory Note:

It is a negotiable instrument where the maker or issuer makes an issue-less promise in writing to pay back a pre-decided sum of money to the payee at a fixed maturity date or on demand of the payee, under specific terms.

3. Asset-based Loan:
It is a type of loan, which is often short term, and is secured by a company's assets. Real estate, accounts receivable (A/R), inventory and equipment are the most

common assets used to back the loan. The given loan is either backed by a single category of assets or by a combination of assets.

3. Repurchase Agreements:

Repurchase agreements are extremely short-term loans. They usually have a maturity of less than two weeks and most frequently they have a maturity of just one day! Repurchase agreements are arranged by selling securities with an agreement to purchase them back at a fixed cost on a given date.

4. Letter of Credit:

A financial institution or a similar party issues this document to a seller of goods or services. The seller provides that the issuer will definitely pay the seller for goods or services delivered to a third-party buyer. The issuer then seeks reimbursement to be met by the buyer or by the buyer's bank. The document is in fact a guarantee offered to the seller that it will be paid on time by the issuer of the letter of credit, even if the buyer fails to pay.

5.3.2 INTERNATIONAL FINANCIAL SYSTEM - SHORT TERM

FINANCING:

Financing is defined as a means of obtaining the resources to purchase an item, then paying back the loan in a set time period for a set monthly, weekly, yearly.

SHORT TERM FINANCING:

Arranging of available external funds to meet the needs of a firm for a year or less time.

WHY DO FIRMS NEED SHORT TERM FINANCING?

- Cash flow from operations may not be sufficient to keep up with growth related financing needs.

- Firms may prefer to borrow now for their inventory or other short term assets needs rather than wait until they have saved enough.
- Firms may prefer short term financing instead of long term sources of financing.

5.3.3 SOURCES OF FINANCING

- Trade credit
- Accrued expenses
- Bank financing
- Factoring
- Commercial paper

1. TRADE CREDIT:

A trade credit is a business-to-business (B2B) agreement in which a customer can purchase goods on account without paying cash up front, paying the supplier at a later scheduled date. Usually businesses that operate with trade credits will give buyers 30, 60, or 90 days to pay, with the transaction recorded through an invoice.

Trade credit can be thought of as a type of 0% financing, increasing a company's assets while deferring payment for a specified value of goods or services to sometime in the future and requiring no interest to be paid in relation to the repayment period.

A trade credit is an advantage for a buyer. In some cases, certain buyers may be able to negotiate longer trade credit repayment terms which provide an even greater advantage. Often, sellers will have specific criteria for qualifying for trade credit. A B2B trade credit can help a business to obtain, manufacture, and sell goods before ever having to pay for them.

This allows businesses to receive a revenue stream that can retroactively cover costs of goods sold. Wal-Mart is one of the biggest utilizes of trade credit, seeking to pay retroactively for inventory sold in their stores. International business deals also involve trade credit terms. In general, if trade credit is offered to a buyer it typically always provides an advantage for a company's cash flow.

The number of days for which a credit is given is determined by the company allowing the credit and is agreed upon by both the company allowing the credit and the company receiving it. Trade credit can also be an essential way for businesses to finance short-term growth. Because trade credit is a form of credit with no interest, it can often be used to encourage sales. Since trade credit puts suppliers at somewhat of a disadvantage, many suppliers use discounts when trade credits are involved to encourage early payments.

A supplier may give a discount if a customer pays within a certain number of days before the due date. For example, a 2% discount if payment is received within 10 days of issuing a 30-day credit. This discount would be referred to as 2%/10 net 30 or simply just 2/10 net 30.

TRADE CREDIT ACCOUNTING:

Trade credits are accounted for by both sellers and buyers. Accounting with trade credits can differ based on whether a company uses cash accounting or accrual accounting. Accrual accounting is required for all public companies. With accrual accounting a company must recognize revenues and expenses at the time they are transacted.

Trade credit invoicing can make accrual accounting more complex. If a public company offers trade credits it must book the revenue and expenses associated with the sale at the time of the transaction. When trade credit invoicing is involved, companies do not immediately receive cash assets to cover expenses. Therefore, companies must account for the assets as accounts receivable on their balance sheet. With trade credit there is the possibility of default.

Companies offering trade credits also usually offer discounts which means they can receive less than the accounts receivable balance. Both defaults and discounts can require the need for accounts receivable write-offs from defaults or write-downs from discounts. These are considered liabilities a company must expense.

Alternatively, trade credit is a useful option for businesses on the buying side. A company can obtain assets but would not need to credit cash or recognize any expenses immediately. In this way a trade credit can act like a 0% loan on the balance sheet.

The company's assets increase but cash does not need to be paid until sometime in the future and no interest is charged during the repayment period. A company only needs to recognize the expense when cash is paid using the cash method or when revenue is received using the accrual method. Overall, these activities greatly free up cash flow for the buyer.

2. ACCRUED EXPENSES:

An accrued expense is an accounting term that refers to an expense that is recognized on the books before it has been paid; the expense is recorded in the accounting period in which it is incurred. Because accrued expenses represent a company's obligation to make future cash payments, they are shown on a company's

balance sheet as current liabilities; accrued expenses are also known as accrued liabilities. An accrued expense is only an estimate, and will likely differ from the supplier's invoice that will arrive at a later date.

Following the accrual method of accounting, expenses are recognized when they are incurred, not necessarily when they are paid. Unless an expense is substantial, it is generally not accrued because accrual accounting requires the work of multiple journal entries.

Example of Accrued Expenses:

A company pays its employees' salaries on the first day of the following month for services received in the prior month. So, employees that worked all of November will be paid in December. If on December 31, the company's income statement recognizes only the salary payments that have been made, the accrued expenses from the employees' services for December will be omitted.

Because the company actually incurred 12 months' worth of salary expenses, an adjusting journal entry is recorded at the end of the accounting period for the last month's expense. The adjusting entry will be dated December 31 and will have a debit to the salary expenses account on the income statement and a credit to the salaries payable account on the balance sheet.

When the company's accounting department receives the bill for the total amount of salaries due, the accounts payable account is credited. Accounts payable is found in the current liabilities section of the balance sheet and represents the short-term liabilities of a company. After the debt has been paid off, the accounts payable account is debited and the cash account is credited.

3. BANK FINANCING:

Bank overdraft:

An overdraft occurs when money is withdrawn from a bank account and the available balance goes below zero. In this situation the account is said to be "overdrawn". If there is a prior agreement with the account provider for an overdraft, and the amount overdrawn is within the authorized overdraft limit, then interest is normally charged at the agreed rate. If the negative balance exceeds the agreed terms, then additional fees may be charged and higher interest rates may apply.

Cash Credit:

Cash credit is a facility to withdraw money from a current bank account without having credit balance but limited to the extent of borrowing limit which is fixed by the commercial bank. This is a very common facility by banks. It is one of the important short term sources of finance for a business.

Purchase And Discounting Of Bills:

Bill purchase and bill discounting facility. When a Sale and Purchase Transaction takes place, the seller issues an Invoice (Bill) to the Purchaser. If this Sale is a Credit Sales, then the seller will get the money from the purchaser only after the expiry of credit period.

Short Term Loan:

A short-term loan is a type of loan that is obtained to support a temporary personal or business capital. As it is a type of credit, it involves a borrowed capital amount and interest that needs to be paid by a given due date, which is usually within a year from getting the loan.

Letter Of Credit:

A letter of credit (LC), also known as a documentary credit or bankers commercial credit, or letter of undertaking (LoU), is a payment mechanism used in international trade to provide an economic guarantee from a creditworthy bank to an exporter of goods.

Letters of credit are used extensively in the financing of international trade, where the reliability of contracting parties cannot be readily and easily determined. Its economic effect is to introduce a bank as an underwriter, where it assumes the counterparty risk of the buyer paying the seller for goods.

4. Factoring:

Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs.

Forfeiting is a factoring arrangement used in international trade finance by exporters who wish to sell their receivables to a forfeiter. Factoring is commonly referred to as accounts receivable factoring, invoice factoring, and sometimes accounts receivable financing. Accounts receivable financing is a term more accurately used to describe a form of assetbased lending against accounts receivable.

The Commercial Finance Association is the leading trade association of the asset-based lending and factoring industries.

In the United States, Factoring is not the same as invoice discounting (which is called an assignment of accounts receivable in American accounting – as propagated by FASB within GAAP).

Factoring is the sale of receivables, whereas invoice discounting ("assignment of accounts receivable" in American accounting) is a borrowing that involves the use of the accounts receivable assets as collateral for the loan. However, in some other markets, such as the UK, invoice discounting is considered to be a form of factoring, involving the "assignment of receivables", that is included in official factoring statistics. It is therefore also not considered to be borrowing in the UK.

In the UK the arrangement is usually confidential in that the debtor is not notified of the assignment of the receivable and the seller of the receivable collects the debt on behalf of the factor. In the UK, the main difference between factoring and invoice discounting is confidentiality. Scottish law differs from that of the rest of the UK, in that

notification to the account debtor is required for the assignment to take place. The Scottish Law Commission is reviewing this position and seeks to propose reform by the end of 2017.

5. Commercial Paper:

Commercial paper, in the global financial market, is an unsecured promissory note with a fixed maturity of rarely more than 270 days. Commercial paper is a money-market security issued (sold) by large corporations to obtain funds to meet short-term debt obligations (for

example, payroll) and is backed only by an issuing bank or company promise to pay the face amount on the maturity date specified on the note. Since it is not backed by collateral, only firms with excellent credit ratings from a recognized credit rating agency will be able to sell their commercial paper at a reasonable price.

Commercial paper is usually sold at a discount from face value and generally carries lower interest repayment rates than bonds due to the shorter maturities of commercial paper. Typically, the longer the maturity on a note, the higher the interest rate the issuing institution pays.

Interest rates fluctuate with market conditions but are typically lower than banks' rates. Commercial paper – though a short-term obligation – is issued as part of a continuous rolling program, which is either a number of years long (as in Europe) or open-ended (as in the US).

5.4.1 Meaning and Objectives of Receivables Management.

Receivables management is the process of making decisions relating to investment in trade debtors. If you want to increase sales turnover and profits of the firm, you have to sale goods on credit basis, which includes the risk of bad debts. The objective of receivables management is “to promote sales and profits until that point is reached where the return on investment in further funding of receivables is less than the cost of funds raised to finance that additional credit” .

Receivables represent amounts owed to the firm as a result of sale of goods or services in the ordinary course of business. These are claims of the firm against its customers and form part of its current assets. Receivables are also known as account receivables, trade receivables, or book debts. The receivables are carried for the customers. The period for credit and extent of receivables depends upon the credit policy followed by the firm. The purpose of maintaining or investing in receivables is to meet competition, and to increase the sales and profits.

Receivable management is a process of managing the account receivables within a business organization. Account receivables simply mean credit extended by the company to its customers and are treated as liquid assets. It involves taking decisions regarding the investment to be made in trade debtors by organization. Deciding the proper amount be lent by the company to its customers in the form of credit sales is quite important. It affects the overall cash availability for undertaking various operations.

Receivable management business ensures that a sufficient amount of cash is always maintained within the business so that operations can continue uninterrupted. It helps in deciding the optimum proportion of credit sales. The overall process of receivable management involves properly recording all credit sales invoices, sending notices on due date to collection department, recording all collections, calculation of outstanding interest on late payments etc.

Receivables management aims at raising the sales volumes and profit of the business by managing and providing credit facilities to customers. A proper receivables management process aims at monitoring and avoidance of occurrence of any overdue payment and non-payment. It is an effective way of improving the financial and liquidity position of the company. Credit facilities are important for attracting and retaining customers and this makes management of credit facilities by business crucial. Objectives of receivables management are as follows:

5.4.2 Objectives of Receivable Management:

- o Monitor and Improve Cash Flow
- o Minimizes bad debt losses

- o Avoids invoice disputes
- o Boost up sales volume
- o Improve customer satisfaction
- o Helps in facing competition.

Monitor and Improve Cash Flow:

□ Receivable management monitors and control all cash movements of organizations. It maintains a systematic record of all sales transactions. Receivable management helps business in deciding appropriate investment in trade debtors. It aims that a sufficient amount of cash needed for day-to-day activities is maintained at business. Credit facilities are extended by doing proper analysis and planning to ensure optimum cash flow in a business organization.

□ **Minimizes bad debt losses:**

Bad debts are harmful to organizations and may lead to heavy losses. Receivable management takes all necessary steps to avoid bad debts in business transactions. It designs and implement schedules for collection of outstanding amount timely and informs the collection department on due dates. Customers are notified for amount standing against them and charges interest on delay in payments.

□ **Avoids invoice disputes:**

Receivable management has an efficient role in avoiding any disputes arising in business. Disputes adversely affect the relationship between customers and business organizations. Complete and fair record of all transactions with customers are maintained on a daily basis. There is no chance of confusion and dispute arising as all sales transactions are accurately maintained. Automated receivable management systems present full evidence in a short time in case of dispute arising for resolving them.

□ **Boost up sales volume:**

Receivable management increase the sales and the profitability of the organization. By extending the credit facilities to their customers business are able to

boost up their sales volume. More and more customers are able to do transactions with the business by purchasing products on a credit basis. Receivable management helps business in managing and deciding their investment in credit sales. This leads to increase in the number of sales and profit level.

□ **Improve customer satisfaction:**

Customer satisfaction and retention are key goals of every business. By lending credit, it supports financially weakened customers who can't purchase business products fully on a cash basis. This strengthens the relationship between customer and organization. Customers are happy with the services of their business partners. Receivable management helps in organizing better credit facilities for their customers.

□ **Helps in facing competition:**

Receivable management helps in facing stiff competition in the market. Several competitors existing in market offers different credit options to attract more and more customers. Receivable management process analysis all information about market and helps the business in formulating its credit lending policies. Customers are provided better services by extending credit at convenient rates. Appropriate amount and rates of credit transactions can be easily decided through receivable management process. All credit and payment terms are decided for every customer as per their needs.

□ **Cost of Maintaining Receivables:**

The allowing of credit to customers means giving of funds for the customer's use.

The concern incurs the following costs on maintaining receivables:-

1. Cost of financing receivables.
2. Cost of collection.
3. Bad debts.

□ **Factors influencing the size of Receivables:**

- ❖ Size of credit sales.
 - ❖ Credit policies.
 - ❖ Terms of trade.
 - ❖ Expansion plans.
 - ❖ Relation with profits.
 - ❖ Credit collection efforts.
 - ❖ Habits of customers.
- **Forecasting the Receivables.**
- Credit period allowed.
 - Effect of cost of goods sold.
 - Forecasting expenses.

5.4.3 COSTS & BENEFITS OF RECEIVABLES

There are various costs & benefits attached with a credit policy. These may be enumerated as follows.

COST OF RECEIVABLES:

1. COST OF FINANCING :

The credit sales delays the time of sales realization & therefore the time gap between incurring the cost & the sales realization is extended. This results in blocking of funds for a longer period. The firm on the other hand, has to arrange funds to meet its own obligations towards payment to the supplier, employees etc., and these funds are to be procured at some explicit or implicit cost. This is known as cost of financing the receivables.

2. ADMINISTRATIVE COST:

A firm will also required to incur various costs in order to maintain the record of credit customers both before the credit sales as well as after the credit sale

3. DELINQUENCY COST :

The firm have to incur additional costs known as delinquency costs, if there is delay in the payment by a customer. The firm may have to incur cost on reminders , phone calls , postages, legal notices etc. There is always an opportunity cost of the funds tied up in the receivables due to delay in payment.

4. COST OF DEFAULT BY THE CUSTOMER:

If there is a default by the customer & the receivables becomes partly or wholly, unrealizable , then this amount is known as bad debt, also becomes cost to the firm. This cost does not appear in case of sales.

BENEFITS OF RECEIVABLES

INCREASE IN SALES:

Most of the firms sell goods on credit, either because of trade customs or other conditions. The sales can be further increased by liberalizing the credit terms. This will attract more customers to the firm resulting in higher sales & growth of the firm.

INCREASE IN PROFITS:

Increase in sales help the firm in a)to easily recover the fixed expenses & attaining the break-even level. b)Increase the operating profit of the firm.

EXTRA PROFIT:

Sometimes, the firm makes the credit sales higher than the usual cash selling price. This brings an opportunity to the firm to make extra profit over & above the normal profit.

OTHER BENEFITS OF RECEIVABLES MANAGEMENT

8 BENEFITS OF ACCOUNTS RECEIVABLE MANAGEMENT SOFTWARE

- IMPROVE YOUR CASH POSITION. You have bills you have to pay. ...
- INCREASE CONTROL OVER CASH AND WORKING CAPITAL. ...
- INCREASE ACCOUNTS RECEIVABLE MANAGEMENT EFFICIENCY. ...
- IMPROVE CUSTOMER COMMUNICATION. ...

- IMPROVE CUSTOMER SERVICE AND SATISFACTION. ..
- . • REDUCE ADMINISTRATIVE COSTS. ...
- SHORTEN THE SALES TO PAYMENT CYCLE. ..
- . • MINIMIZE CREDIT RISK.

5.4.4 INVENTORY MANAGEMENT

Meaning of Inventory Management

Inventory Management is a process of ordering, storing, and using inventories. This stock management includes generating the lead on raw materials, components, and finished products, along-side warehousing and processing of such items in your company. The available stock of inventories must be physically counted before it is put on the balance sheet.

Inventory Management is a technique through which stocked goods, inventories, and non-capitalized assets are kept in a proper manner according to their specific shape and placement. An Inventory can be any item that a business holds to receive the goal of resale or repair.

Inventory Management is a process of ordering, storing, and using inventories. This stock management includes generating the lead on raw materials, components, and finished products, along-side warehousing and processing of such items in your company. The available stock of inventories must be physically counted before it is put on the balance sheet.

Inventory accounting is grouped into four separate categories:

- **Raw Materials –**

The raw material is purchased by any company for its production purpose to transform it into a finished good.

- **Work in progress inventory –**

Refers to the process of transformation of raw material into a finished product.

- **Finished goods –**

These are the complete goods that are now ready to be available for sale.

- **Maintenance, repair, operation (MRO) goods –**

Items used for support of the production of finished goods as they will be purchased from the distributor of future resale.

5.4.5 Principle of Inventory Management :

The basic principle of inventory management is to hold costs.

For example: The purchase of the hospital is the direct cost of materials with inclusive taxes.

Next is to control the investment amount for which there should be a balance maintained between purchase cost and carrying cost by procuring the products in optimum quantity, also known as economic order quantity.

Objectives of Inventory Management :

The investment put in inventory is very high, especially for those businesses that deal in manufacturing, wholesale, and retail trade. The amount of investment might be sometimes more than the amount spent on other assets of the company. Almost 90% of the working capital of a business is invested in inventories.

The management should do proper planning on how to purchase, handle, store, and account with an inventory management system. The main aim of an inventory management system is to keep the stock in such a way that it is neither overstock nor under stock. The overstock condition will reduce the other production processes and under stock will lead to stoppage of work.

The objectives of inventory management are operational and financial. In operational, materials and stock should be available in sufficient amount whereas, in financial, the minimum working capital should be locked in.

The objectives of inventory management are as follows:

1. To ensure a continuous supply of materials and stock so that production should not suffer at the time of customer's demand.
2. To avoid both overstocking and under-stocking of inventory.
3. To maintain the availability of materials whenever and wherever required in enough quantity.
4. To maintain minimum working capital as required for operational and sales activities.
5. To optimize various costs indulged with inventories like purchase cost, carrying a cost, storage cost, etc.
6. To keep material cost under control as they contribute to reducing the cost of production.
7. To eliminate duplication in ordering stocks.
8. To minimize loss through deterioration, pilferage, wastages, and damages.
9. To ensure everlasting inventory control so that materials shown in stock ledgers should be physically lying in the warehouse.
10. To ensure the quality of goods at reasonable prices.
11. To facilitate furnishing of data for short and long-term planning with a controlled inventory.
12. To supply the required material continuously.
13. To maintain a systematic record of inventory.

To make stability in price. Cost of Holding Inventory.

Holding costs are those associated with storing inventory that remains unsold. These costs are one component of total inventory costs, along with ordering and shortage costs. A firm's holding costs include the price of goods damaged or spoiled, as well as that of storage space, labour, and insurance.

5.4.6 Benefits of holding Inventory:

There are various benefits of holding inventory: Holding inventory helps in incessant supply of the products leading to a minimum or no loss of sales. Holding inventory reduces the shortage of. If it is possible to hold raw materials on a large volume, the suppliers are pleased to offer discounts. Benefits of Holding Inventory in a firm.

- Holding Inventory avoids loss of sales. ...
- Holding Inventory gains quantity discount. ...
- Holding Inventory reduces order cost. ...
- Achieve efficient production runs by holding inventory. ...
- Holding Inventory reduces risk of production shortages.

Advantages of Holding Inventory

1.Holding Inventory avoids loss of sales:

In case a firm maintains adequate inventory, it can execute the customers' orders without any delay and thus avoid any possibility of losing the patronage of customers and hence sales.

2.Holding Inventory gains quantity discount:

If the firm places a large order of certain materials, the suppliers of the materials will give generous quantity discounts by reducing the price. This quantity discount will reduce the cost of goods of the firm and increase profits earned on sale.

3. Holding Inventory reduces order cost:

By ordering in large numbers, a firm can reduce the cost it incurs. Some of the cost involved when making an order is forms that must be completed, approvals needed to be obtained and the goods arrived must be accepted, inspected and counted. Then an invoice must be issued and payment must be made.

The cost of receiving materials may vary according to the number of orders made. By making bulk orders, the number of orders will reduce and minimize the cost involved.

4. Achieve efficient production runs by holding inventory:

Start up cost is incurred when a firm sets up its labour/man power and machines to produce goods. The cost will then be absorbed when production begins. The cost will come down when the process of production runs longer.

When the firm frequently sets up its production line, it will increase its startup cost. Holding an inventory to make sure the production line will never run out of raw materials will ensure longer run in production line, hence lower the startup cost.

5. Holding Inventory reduces risk of production shortages:

An inventory is needed to store large amount of raw materials and unprocessed components. If one single component run out of stock, the-entire production line could be halted.

To avoid the risk of shortage of essential components during a big production process, the firm should maintain inventory management. This will prevent the shortage of vital raw materials and components needed to produce goods. The system will manage and notify any shortage before it is materialized. The inventory management systems are suitable to maintaining large quantities of stocks and always keep firm's inventory on check.

5.5 Credit Policy in Receivable Management:

What is a Credit Policy?

An organization that advances credit and lends to others must consistently ensure that new business aligns with its credit risk tolerance. Similarly, it must effectively collect debts to limit credit losses and safeguard its assets. A credit policy is the complete guidelines and processes for executing this corporate credit strategy.

Credit risk analysis assesses the effectiveness of a company's policy and balances various interests (for example, sales goals and customer demand) to achieve its goals. Policies are uniquely tailored to the organization's specific needs, from small businesses selling to customers on credit, to large financial institutions lending directly to corporations.



5.5.1 Concept of Credit Policy

The discharge of the credit function in a company embraces a number of activities for which the policies have to be clearly laid down. Such a step will ensure consistency in credit decisions and actions. A credit policy thus, establishes guidelines that govern grant or reject credit to a customer, what should be the level of credit granted to a customer etc. A credit policy can be said to have a direct effect on the volume of investment a company desires to make in receivables.

A company falls prey of many factors pertaining to its credit policy. In addition to specific industrial attributes like the trend of industry, pattern of demand, pace of technology changes, factors like financial strength of a company, marketing organization,

growth of its product etc. also influence the credit policy of an enterprise. Certain considerations demand greater attention while formulating the credit policy like a product of lower price should be sold to customer bearing greater credit risk. Credit of smaller amounts results, in greater turnover of credit collection. New customers should be least favoured for large credit sales. The profit margin of a company has direct relationship with the degree of risk. They are said to be inter-woven. Since, every increase in profit margin would be counterbalanced by increase in the element of risk.

Credit policy of every company is at large influenced by two conflicting objectives irrespective of the nature and type of company. They are liquidity and profitability. Liquidity can be directly linked to book debts. Liquidity position of a firm can be easily improved without affecting profitability by reducing the duration of the period for which the credit is granted and further by collecting the realized value of receivables as soon as they fall due. To improve profitability one can resort to lenient credit policy as a booster of sales, but the implications are:

- Changes of extending credit to those with weak credit rating.
- Unduly long credit terms.
- Tendency to expand credit to suit customer's needs; and
- Lack of attention to overdue accounts.

5.5.2 Types of Credit Policy

One way to categorize credit policies is by how loose or stringent a policy is toward advancing credit and managing credit risk, no matter if the goal is credit sales or asset-based lending.

The type of policy is based on firm-level goals and the business environment, so it should adjust dynamically. The ABA report on credit conditions is an example index that measures the general type of credit policy for financial institutions.

Loose credit:

Represents a greater willingness to extend credit to grow the business; a strategy to take on higher credit risk and reap the rewards. Examples include granting credit to below-average credit profiles with worse risk ratings, more limited access to capital, and weaker capacity.

Flexible credit:

Represents a willingness to extend credit depending on circumstances. It's generally a neutral strategy that does not aggressively grow or restrict access to credit for clients. Examples include granting credit to a broader range of average credit profiles with a process for exceptional approval to policy for clients that may fall outside a diverse risk range.

Tight credit:

Generally means less willingness to extend credit to support revenue growth. This is a strategy of restraint often implemented to limit credit losses and/or replenish capital. Examples include only granting credit to above-average credit risks, such as better risk ratings, greater access to capital, and more robust capacity.

No credit:

This is an unwillingness to extend credit, as a company is highly risk-averse or has no business case to support the cost/benefit of extending credit. Examples include "cash only" small-dollar consumable goods or businesses with slim margins and insufficient capital to extend trade credit.

Components of a Credit Policy:

Rigorously applying the Cs of credit along with tight administration practices throughout the sales and collection cycle is what usually forms the components of a sound credit policy. As a firm grows and gains the capacity to serve a broader range of clients, it assesses and evolves its policy.

Credit application process:

Describes the evaluation and approval of credit. Due diligence may include reviewing the client's financial picture against specific metrics, past performance with credit, and collateral (if any) pledged to support the request. Amendment, renewal, and refinancing of existing credit also play a pivotal role in this process.

Credit types, limits, and terms:

Cover the types of credit, the amount available, and their repayment terms. For simple trade credit, it may be "2/10 net 30", which provides a discount for prompt payment, with full payment due after a grace period of 30 days. More complex examples, such as forms of AR financing or asset-based financing, carry conditional terms linked to specific company performance.

Collection:

Administers credit post-advance. The collection process may involve an internal team and systems, or it may require external means (such as collection agencies and other legal remedies). These all serve to recover the credit in full and in the manner agreed upon. A useful measure is the average collection period.

Monitoring and control:

Assess the effectiveness of the credit policy and cover the entire gamut of credit decisions and performance of the credit portfolio. Examples include the growth in credit sales, days sales outstanding, delinquencies, and provisions for credit losses. The process gauges and controls the achievement of its credit strategy or provides evidence to adjust the policy if conditions warrant.

Risk management:

Includes tools and processes to support crafting the credit policy and mitigating portfolio risk. Portfolio-wide risk mitigation techniques include an internal risk rating system, customer concentration limits, and industry diversification.

Other examples are layers of approval when tailoring to complex terms of advance and repayment, sourcing insurance (such as trade credit insurance), letters of credit, and other product.

5.5.3 Setting a Credit Policy

To establish a credit policy, a company must establish credit terms, credit standards and a collection policy.

1. Credit Terms:

Credit terms refer to the stipulations recognized by the firms for making credit sale of the goods to its buyers. In other words, credit terms literally mean the terms of payments of the receivables. A firm is required to consider various aspects of credit customers, approval of credit period, acceptance of sales discounts, provisions regarding the instruments of security for credit to be accepted are a few considerations which need due care and attention like the selection of credit customers can be made on the basis of firms, capacity to absorb the bad debt losses during a given period of time.

However, a firm may opt for determining the credit terms in accordance with the established practices in the light of its needs. The amount of funds tied up in the receivables is directly related to the limits of credit granted to customers. These limits should never be ascertained on the basis of the subjects own requirements, they should be based upon the debt paying power of customers and his ledger record of the orders and payments. There are two important components of credit terms which are detailed below:

2. Credit period:

The credit period lays its multi-faced effect on many aspects the volume of investment in receivables; its indirect influence can be seen on the net worth of the company. A long period credit term may boost sales but it's also increase investment in receivables and lowers the quality of trade credit.

While determining a credit period a company is bound to take into consideration various factors like buyer's rate of stock turnover, competitors approach, the nature of commodity, margin of profit and availability of funds etc. The period of credit differs from industry to industry.

In practice, the firms of same industry grant varied credit period to different individuals. as most of such firms decide upon the period of credit to be allowed to a

customer on the basis of his financial position in addition to the nature of commodity, quality involved in transaction, the difference in the economic status of customer that may considerably influence the credit period. The general way of expressing credit period of a firm is to coin it in terms of net date that is, if a firm's credit terms are "Net 30", it means that the customer is expected to repay his credit obligation within 30 days. Generally, a free credit period granted, to pay for the goods purchased on accounts tends to be tailored in relation to the period required for the business and in turn, to resale the goods and to collect payments for them.

A firm may tighten its credit period if it confronts fault cases too often and fears occurrence of bad debt losses. On the other side, it may lengthen the credit period for enhancing operating profit through sales expansion. Anyhow, the net operating profit would increase only if the cost of extending credit period will be less than the incremental operating profit.

But the increase in sales alone with extended credit period would increase the investment in receivables too because of the following two reasons: (i) Incremental sales result into incremental receivables, and (ii) The average collection period will get extended, as the customers will be granted more time to repay credit obligation.

3.Cash Discount Terms:

The cash discount is granted by the firm to its debtors, in order to induce them to make the payment earlier than the expiry of credit period allowed to them. Granting discount means reduction in prices entitled to the debtors so as to encourage them for early payment before the time stipulated to the i.e. the credit period. Grant of cash discount beneficial to the debtor is profitable to the creditor as well. A customer of the firm i.e. debtor would be realized from his obligation to pay Soon that too at discounted prices.

On the other hand, it increases the turnover rate of working capital and enables the creditor firm to operate a greater volume of working capital. It also prevents debtors from using trade credit as a source of working capital. Cash discount is expressed is a percentage of sales.

A cash discount term is accompanied by (a) the rate of cash discount, (b) the cash discount period, and (c) the net credit period. For instance, a credit term may be given as "1/10 Net 30" that mean a debtor is granted 1 percent discount if settles his accounts with the creditor before the tenth day starting from a day after the date of invoice.

But in case the debtor does not opt for discount he is bound to terminate his obligation within the credit period of thirty days. Change in cash discount can either have positive or negative implication and at times both. Any increase in cash discount would directly increase the volume of credits sale. As the cash discount reduces the price of commodity for sale. So, the demand for the product ultimately increase leading to more sales.

On the other hand, cash discount lures the debtors for prompt payment so that they can relish the discount facility available to them. This in turn reduces the average collection period and bad debt expenses thereby, bringing about a decline in the level of investment in receivables. Ultimately the profits would increase. Increase in discount rate can negatively affect the profit margin per unit of sale due to reduction of prices.

A situation exactly reverse of the one stated above will occur in case of decline in cash discount. Yet, the management of business enterprises should always take note of the point that cash discount, as a percentage of invoice prices, must not be high as to have an uneconomic bearing on the financial position of the concern.

It should be seen in this connection that terms of sales include net credit period so that cash discount may continue to retain its significance and might be prevented from being treated by the buyers just like quantity discount. To make cash discount an effective tool of credit control, a business enterprise should also see that is allowed to only those customers who make payments at due date. And finally, the credit terms of an enterprise on the receipt of securities while granting credit to its customers. Credit sales may be got secured by being furnished with instruments such as trade acceptance, promissory notes or bank guarantees.

2.Credit Standards:

Credit standards refers to the minimum criteria adopted by a firm for the purpose of short listing its customers for extension of credit during a period of time. The nature of

credit standard followed by a firm can be directly linked to changes in sales and receivables. A liberal credit standard always tends to push up the sales by luring customers into dealings. The firm, as a consequence would have to expand receivables investment along with sustaining costs of administering credit and bad debt losses.

As a more liberal extension of credit may cause certain customers to be less conscientious in paying their bills on time. Contrary, to these strict credit standards would mean extending credit to financially sound customers only. This saves the firm from bad debt losses and the firm has to spend lesser by a way of administrative credit cost. But, this reduces investment in receivables besides depressing sales. In this way profit sacrificed by the firm on account of losing sales amounts more than the cost saved by the firm.

Prudently, a firm should opt for lowering its credit standard only up to that level where profitability arising through expansion in sales exceeds the various costs associated with it. That way, optimum credit standards can be determined and maintained by inducing trade-off between incremental returns and incremental costs.

4.Collection Policy

Collection policy refers to the procedures adopted by a firm (creditor) collect the amount of from its debtors when such amount becomes due after the expiry of credit period. The requirements of collection policy arise on account of the defaulters i.e. the customers not making the payments of receivables in time. As a few turn out to be slow payers and some other non-payers. A collection policy shall be formulated with a whole and sole aim of accelerating collection from bad debt losses by ensuring prompt and regular collections. Regular collection on one hand indicates collection efficiency through control of bad debts and collection costs as well as by inducing velocity to working capital turnover.

On the other hand it keeps debtors alert in respect of prompt payments of their dues. A credit policy is needed to be framed in context of various considerations like short-term operations, determinations of level of authority, control procedures etc. Credit policy of an enterprise shall be reviewed and evaluated periodically and if necessary amendments shall be made to suit the changing requirements of the business. It should

be designed in such a way that it co-ordinates activities of concerns departments to achieve the overall objective of the business enterprises. Finally, poor implementation of good credit policy will not produce optimal results.

To conclude, the credit policy of a company should be developed in accord with the strategic, marketing, financial and organizational context of the business and be designed to contribute to the achievement of corporate objectives. The corporate strategy can include trade credit management not just in terms of its contribution to collection and cash flow but as a means of generating sales and profits, and of investing in customers by building relationships. The management of trade credit can help build stable and long-term relationships with customers, generate information about the customer and their requirements and facilitate different customer strategies in terms of credit granting, credit terms and customer service. The objective is to generate growing but profitable sales.

A credit policy thus, establishes guidelines that govern grant or reject credit to a customer, what should be the level of credit granted to a customer etc. A credit policy can be said to have a direct effect on the volume of investment a company desires to make in receivables.

5.5.4 Techniques of the Inventory Management System

Many businesses select one inventory management technique, and some prefer a unique blend of techniques, that best suits their particular needs. However, what implements an integrated inventory management software to your business is Asset Infinity.

Nevertheless, the technique your business chooses to employ, if it does not have the ability to track, trace and account your inventory in real-time, anyhow it will run into trouble. There are several inventory management techniques that you can use to manage, track, and analyze your production and sales system.

The three most common Inventory Management techniques are:

1. Just-in-Time (JIT) Delivery –

Just-in-Time technique is a strategy to increase efficiency and decrease waste by receiving goods in the quantity as needed for the production process, thereby decreasing inventory costs.

JIT delivery leads to reductions in costs and improves efficiency and profit margins in the following ways:

- Decreased inventory levels
- Reduced labour costs
- Fewer factory spaces
- Stock reduction
- Increased productivity
- Improved quality
- Reduced throughput times

2.ABC Inventory Analysis –

ABC Analysis allows you to characterize your product according to their requirement. A few of the product require more attention than others. In this add your product to each category as per their requirement list.

- Category A — This includes the product of high quality with a low frequency of sales.
- Category B — This includes the product of moderate quality with a moderate frequency of sales.
- Category C — This includes the product of low quality with a high frequency of sales.

3.Drop-Shipping –

Drop shipping technique is a retail fulfilment method where a store does not keep the finished products to sell in its stock. Instead, when a store had to sell a product, it

purchases the item from the third party, and it is shipped directly to the customer. As a result, the merchant never sees or handles the product.

5.6 Unit-Summary

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.

A proper Inventory Management System must be used to manage stocks. All inventory management has to do is to keep accurate records of items that are ready for shipment. Inventory management is also important for keeping costs down while meeting regulation. Supply and demand are a delicate balance, and inventory management promises to ensure that the balance is undisturbed.

Economic Order Quantity Economic Order Quantity is an inventory management tool, which shows quantity to be ordered each time that inventory cost. Normally, the ordering cost and carrying cost are equal at the point of economic order quantity. Thus, the economic order quantity is the quantity that minimizes the total inventory cost.

Several Indian investors save money in financial securities to secure their futures. You can multiply money well by investing in financial instruments like bonds, [mutual funds](#), deposits, cash, and cash equivalents. Financial instruments are a promising channel to invest in and raise funds.

5.7 Check your progress

1.The concept of financial market efficiency implies...

- a) All opportunities for easy arbitrage profit have been exhausted.
- b) Short-run interest rates will be lower than long-run interest rates, holding the risk quality of assets constant.
- c) The existence of speculative asset price bubbles when interest rates approach zero.
- d) The nominal rate of interest is positive.

2.The inverse relationship between interest rates and bond prices is due to the following fact:

- a) Market makers require a bid-ask spread to offer their services at all.
- b) That maturity premiums increase with the term of a bond.
- c) A bond price represents the present discounted value of the payments agreed upon at the time when the bond was issued.
- d) Capital markets are not efficient for long-maturity loans.

3.Eurobonds are Admired because

- a) They are less risky than Traditional Bonds
- b) European companies are considered very stable
- c) of Government regulation
- d) Of absence of Government regulation

4.Theory states that the exchange rate between currencies of two countries should be equal to the ratio of the countries price levels.

- a) Interest Rate parity
- b) Purchasing Power Parity
- c) International Fisher Effect
- d) None of the above

5.The implication for macroeconomics that assets are durable is that...

- a) Expectations of the value of assets in future periods are essential for understanding the value of assets in the present period.
- b) One economic actor's asset is another's liability.
- c) Flows of assets are traded in large, well-organized international markets.
- d) Lower risk premiums are necessary with increasing asset durability.

6.Diversification cannot completely eliminate risk in an investor's portfolio because...

- a) Of risk aversion
- b) Of the bid-ask spread.
- c) There is no one willing to take an unnecessary risk.
- d) Existing risks are almost never perfectly negatively correlated with each other.

7.The Zurich stock exchange has a total market value of (in % of GDP)

- a) 20%
- b) 50%
- c) 100%
- d) 200%

8.What does the no-profit condition say?

- a) In the short-run there are no profits through assets.
- b) In the long-run there are no profits through assets.
- c) Profit opportunities are dissipated quickly through participants
- d) Profit opportunities are dissipated quickly through laws.

9.The longer the maturity of the loan, the...

- a) Lower are the interest rates
- b) Lower are the fees of the asset
- c) Higher are the fees of the asset
- d) Higher are the interest rates

10.People who do not wish to invest in assets where higher expected returns are unpredictable are...

- a) Risk seeking
- b) Risk averse
- c) Loss averse
- d) Gain seeking

11. India's foreign exchange rate system is _____

- a) Fixed target of band
- b) Free float
- c) Mixed System
- d) Managed float

12.The global financial crisis started in

- a). Great Britain
- b) USA
- c) UAE
- d) China

13. Exchange rate overshooting often occurs because?

- a) Domestic prices adjust slowly to shifts in demand
- b) Military spending during military conflicts
- c) Elasticities are smaller in the short run than the long run
- d) None of the Above

14. International finance mainly discusses the issues related with monetary interactions of at least _____.

- a) One country
- b) Two or more countries
- c) Five countries
- d) Two countries

15. When was the first Eurobond issued?

- a) 1983
- b) 1991
- c) 1973
- d) 1963

5.8 GLOSSARY

Exchange Rate Mechanism (ERM)	The particular system by which the central banks agree to intervention levels, or u
European Option	An option that can be exercised only on the option's expiration date.
Exchange Rate Overshooting	Occurs when exchange rate changes are in excess of some given standard of volatility.
Euro note	A short-term fully negotiable bearer promissory note usually issued at a discount to face value of one-, three-,

	or six-month maturity.
Euro credits .	Intermediate-term loans of Eurocurrencies made by banking syndicates to corporate and government borrowers
Eurobond	A bond underwritten by an international syndicate of banks and marketed internationally in countries other than the country of the currency in which it is denominated. The issue is thus not subject to national restrictions.
Debt-Equity Swap	Process whereby creditors exchange bank debt for an equity interest in assets owned by the debtors. This activity has been extensively conducted by banks holding debt of less developed countries.
Cross-currency Warrants	Bonds with warrants exercisable into bonds denominated in a currency other than that of the host bond.
Certificates of Deposit (CDs)	Negotiable instruments issued by a bank and payable to the bearer. CDs pay a stated amount of interest and mature on a stated date, but may be bought and sold daily in a secondary market.

5.9 Self-Assessment Questions

I) Answer short questions

1. Define international financial markets?
2. What are euro bonds?
3. Write a short note on short term services in international financial transactions.
4. Explain the objectives of receivables management.
5. What is credit policy? Explain its types.

ii) Answer the essay questions.

1. Analyze the functions of financial markets and financial instruments.
2. Discuss the role of interest rates and their usage in securities valuation.

3. Explain Characteristics of an efficient market.
4. Analyze the functions of various financial institutions in the economy, the financial industry, and for individual investors.
5. Explain the role and functions of non-depository financial institutions in detail.
6. Explain Organized Market and Over-the-Counter Market comparatively in detail
7. Compare the functions of different investment vehicles, distinguishing between the bond, stock, mutual fund, mortgage, and foreign exchange markets.
8. Explain the connection between the ethical responsibility of the banking industry and the management of financial institutions.
9. Explain the influence of improvements in information technology on financial markets.
10. Explain the role and functions of non-depository financial institutions in detail.

5.9 Reference:

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