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Chapter 1

FUNDAMENTALS OF INTERNATIONAL FINANCE

1.1 MEANING AND INTRODUCTION OF INTERNATIONAL FINANCE

The international business activity has been in existence for hundreds of years. Adam Smith in his book "Wealth of Nations" wrote that if a foreign country can supply us with a commodity cheaper than ourselves can make it, it is better to buy it, of them with some part of the produce of our own, in which, we have some advantage.

As human societies and economies evolved, production was increasingly for exchange, not for consumption by the producer as in an earlier era; exchange with local communities and villages then within reasons and across countries and finally cross border.

So, the systematic effort to facilitates the free flow of goods and services, across national boundaries, is called international finance. Rapid economic growth in the Western countries joined, in the process, and growth of international trade continues unabated. Despite the difficulties and road blocks, integration of the world economy is moving forward. Fast means of communication have made the world a small village. No single nation can remain aloof today, without having to transact with others. Exchange of goods/services, financial resources, technology development and skilled manpower is the reality of today's international finance. The world trade has in fact grown at a pace much faster than the world output. For several countries, the growth has been described as EXPORT ORIENTED GROWTH, since the share of exports in their GDP is significantly high.

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

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

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

(*b*) It includes international markets (such as international banking, euro currency market, eurobond, international stock exchanges, American Depository Receipts, GDRs, international

institutions *viz.,* IMF, World Bank, Asian Development Bank, Brics Bank, China, WTO, UNCTAD, Letters of Credit, Bill of Lading, factoring and the like, international financial instruments foreign exchange markets, Balance of Payments and International risk management.

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

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

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

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

1.2 IMPORTANCE OF INTERNATIONAL FINANCE

India and other developing countries feel the need for increasing their share in international exchange of goods, services, capital and technology. Some of the important steps taken over during the last 25 years can be summarised as below —

(*i*) establishment of unified market determined exchange-rate.

(*ii*) introduction of current account convertibility and introduction of capital account convertibility in a phased or later period.

(*iii*) reduction in import duties.

(*iv*) liberalisation of portfolio and FDI.

Over a period of time, large size business houses, *i.e.,* Multinational Corporations have production and sales activities spread in many countries.

The process of integration of world economy has witnessed the creation of very dynamic international financial market. A new field of finance *viz.*, financial engineering has come into existence. The market of present day offers a large variety of financial products for investment, speculation and risk management. The financial market with innovative products present vast opportunities as well as unprecedented risks. Now, more and more companies are venturing into international operations in one form or another. Some companies, may be doing only exports, others may be doing both exports and imports while some may be doing exports, imports and investments.

1.3 SCOPE OF INTERNATIONAL FINANCE

Traditionally, international finance has been viewed as management of MNCs that engage in some form of international business. (A business firm is considered an international player according to Fortune Magazine, when its international sales exceed 20% of total). These MNCs continuously devise strategies to improve their cash flows and enhance shareholder wealth. Penetration of foreign market creates opportunities for improving the company's cash flows. The dismantling of barriers to entry encourage companies to pursue international business. Liberal trade is the principal driver of internationalisation which encompasses unimpeded flows of capital labour and technology across national boundaries. Free trade is always beneficial because it encourages

nations to specialise in the products they are best at and import those they are less good at. This results in efficient allocation of resources and maximisation of welfare. Corporates go through different stages in this pursuit, export products or import supplies from foreign manufacturer initially to establishing subsidiaries in foreign countries.

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

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

1.4 GLOBALISATION OF THE WORLD ECONOMY

Global finance has assumed greater relevance in the new economic world order. The phenomenal changes that have occurred drastically after the advent of international institutions, international markets, currency convertibility, the balance of payments position reversed to Northward journey of many economies gave a rigorous boost to international finance.

The modern way of penetrating into the new markets by hitherto restricted markets catapulted the domain of international finance. The massive growth of multinational companies from international company to Global company, to transnational company, gave way to the renewed and necessary significance to international finance. Every country, on the growth path, transverse to financial aspects to a great extent to increase their economic growth and GDP. The main players in the international finance are multinational corporations, who are, more stronger than the national governments. At the end of 2013 the world's largest 500 multinational corporations were situated in different countries as below:

Rank	Country	Companies
Rank 1	U.S.A	132 companies
2	China	89
3	Japan	62
4	U.K.	37
5	France	31
6	Germany	29
7	Netherlands	22
8	Switzerland	14
9	South Korea	14
10	Canada	09
11	Australia	08
12	Italy	08

13	Brazil	08
14	Spain	08
15	India	08
16	Russia	07
17	Taiwan	06

Out of 8 MNCs in India, five are in public sector and the remaining 3 are in the private sector. These MNCs wield their powers, in such a manner that the things may go topsy-turvy or rather the economies are made to bloom and blossom. International finance is the talk of the town or nation or world because finance is the lifeblood of every organisations, the economy and the running of world-trade. International finance encompasses, other than MNCs, the foreign exchange markets, international methods of payments, international financial markets, exchange rates, international risk management and so on. The financial management globally necessitates the international movement of FDI and capital inflows through foreign institutional investors.

The world has entered an era of unprecedented internationalisation and globalisation of economic activity. Each nation is economically related to the nations of the world through a complex network of international traditions and financial relationships in this context; international finance has also become increasingly important as it links world trade and foreign investments. Inflow of foreign investments in the world during 2012 was $ 1351 bn. as against outflows of $ 1391 bn. The largest recipient of foreign invesxtments was USA with $ 168 bn. in 2012 as against largest provider of foreign investments by USA in 2012 with $ 329 bn. As capital markets of the world are becoming more integrated, a solid understanding of international finance has become essential for intelligent corporate decision making. The liberalisation of international trade has internationalise consumption patterns. The production of goods and services has also become globalised on account of the efforts of international firms to source inputs and locate production anywhere in the world, where costs are lower and profits higher. This has given rise to outsourcing which is viewed as exporting jobs from advanced countries to countries, where costs are LOWER. In US globalisation is now seen as a phenomenon that makes rich countries poorer.

Financial markets around the globe are integrated US pension and mutual funds diversify their investment portfolios internationally. The Japanese investors have been investing in US and other financial markets in efforts to re-cycle their trade surpluses. Cross Listing of shares (stock) on foreign stock exchanges has helped trading of shares and provides access to foreign capital as well. Financial globalisation which may give rise to higher capital inflows may not however lead to higher growth since it influences capital labour ratios and not total factor productivity. International companies now force a world where consumption, production and investment decisions are globalised.

These trends especially of globalisation cannot be stopped. The hostility toward globalisation arises from the uneven distribution of benefits and costs across countries.

1.5 GOALS OF INTERNATIONAL FINANCE

There are various goals of international finance. These are:

1. To achieve higher rate of profits: International companies search for foreign markets that hold promise for higher rate of profits. Thus, the objective of profit affects and motivates

the business to expand its operations to foreign countries. For example, Hewlett Packard in US earned 86.2% of its profits from the foreign markets, compared to that of domestic markets, in 2007. Apple earned, US $ 730 million as net profit from the foreign markets and only US $ 620 mn. as net profit, from its domestic market, in 2007.

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

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

4. Limited home market: When the size of the home market is limited due to the smaller size of the population or due to lower purchasing power of the people or both, the companies internalise their operations. For example, most of the Japanese automobile and electronic firms entered the U.S., Europe and even African markets due to the smaller size of the home market. I.T.C. entered the European market due to the lower purchasing power of Indians with regard to high quality cigarettes.

Similarly, the mere six million population of Switzerland, is the reason for Ciba-Geigy to internationalise its operations. In fact, this company was forced to concentrate on global market and establish manufacturing facilities in foreign countries.

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

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

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

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

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

10. Liberalisation and globalisation: Most of the countries in the world, liberalised their economies and opened their countries to the rest of the world.

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

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

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

1.6 EMERGING CHALLENGES IN INTERNATIONAL FINANCE

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

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

2. Tariff and non-tariff trade barriers: The progress of the world trade is dependent on FREE TRADE POLICY. Many countries distorted the free trade among themselves and this trade restriction is called trade barrier. The opposite of free trade is trade barrier. These barriers are of two kinds:

— Tariff and

— Non-tariff

By imposing a high tariff (a kind of duty or customs imposed on imports or exports) rates, foreign trade is scuttled. The other reason to restrain the imports is rejecting the goods for the reasons of environmental safety, health hazards, labour standards, subsidy and so on. This is called protectionism or non-tariff barriers World Trade Organisation provides a more powerful organisation, with 159 member countries, its members at the end of 31st March 2014, to solve disputes over trade among the member countries.

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

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

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

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

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

8. Intellectual property rights: The trinity of intellectual properties are patents (for inventions) trade marks (for brand name, image etc.) and copyright (for author, musicians, lyrics, filmmakers). The invention of the new things require world class Research and Development set up by foreign firms. The problem of privacy is haunting several leading companies and brands. India, after a great fight with USA has registered the patent protection for Basmati rice, turmeric and tomato.

In case of pharma products, a large number of patent infringements is happening around the world especially the life savings drugs. This is a vital issue in international business and finance.

9. Cyber crimes: Cyber crime is a crime committed with the use of computer and internet. Today, all around the world e-commerce and e-business, e-governance, are flourishing. The flip side of the e-commerce, is cyber crimestantalising the international finance. The privacy is interrupted, money in some others accounts are withdrawn, manipulated and transferred. The cyber crimes if unabated will pose a great danger to the world business. The WTO has asked all the member-

countries to have in place a proper and comprehensive cyber law in place to check the maladies and anomalies of cyber crimes. We in India, have the first cyber law, styled Information Technology Act, 2000.

The position of cyber crime cases in bank accounts and intrusion in personal life of persons last 5 years was as under:

Cyber Crimes	***Year***				
	2015	***2014***	***2013***	***2012***	***2011***
1. Credit card frauds	157	57	17	07	19
2. Phonographic SMS/MMS	152	52	18	07	13
3. Threatening emails/SMS	08	02	01	02	05
4. Hacking	09	15	03	02	04
5. Nigerian frauds	01	01	01	03	09
6. Sweeping evidences	11	01	00	01	00
7. Others	11254	9494	54	20	25
Total cases	11592	9622	94	42	75

Maharashtra State is number one in cyber crimes. In 2014, in Maharashtra 1879 cases were registered and action was taken against 942 persons. The second state with next higher cyber crimes is Uttar Pradesh where 1737 cases were registered and 1222 persons were arrested. There is reduction in cyber crimes in the Delhi state. In 2014, Delhi had registered cyber crimes of 226 which reduced to 177 in the year 2015. As per reports, cyber crimes are more in the less-illiterated cities and states. There is overall increase of 20% in cyber crimes, every year, in the country.* Recently, in Oct. 2016, about 6.2 million debit cad's data/were hecked in China and U.S.A. and personal data of debit cards were stolen.

10. Transfer Pricing: In any international business there are normally a large number of transfers of goods, services, technology and other resources between the parent company and foreign subsidiaries. The price at which goods, services and others are transferred between affiliates within the company is called transfer price. Transfer price also affects an international company's ability to monitor the performance of individual corporate subsidiaries and to reward or punish managers responsible for their performance. Further, transfer price affects the taxes an international company pays both its home country and to various host countries in which it operates. Transfer price is also used to avoid exchange controls, to increase the international company's share of profits from a joint-venture and to distinguish an affiliate's true profitability.

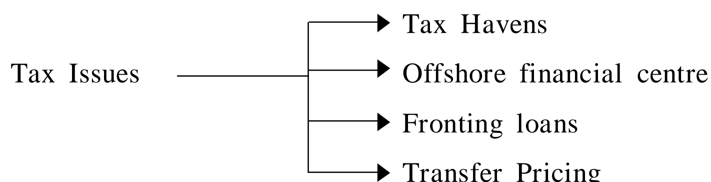
Nevertheless, there are problems associated with Transfer Pricing. Many governments do not like transfer pricing strategy. When transfer prices are used to reduce a firm's tax liabilities or import duties, most governments feel they are being cheated of their legitimate income. Several governments limit the ability of an international business to manipulate transfer prices.

11. International Taxation: Taxes have a significant impact on areas, as diverse as making foreign investment decisions, managing exchange risks, planning capital structures, determining financing costs and managing inter affiliate funds flows. For the international business with

* Nav Bharat Daily Newspaper Mumbai, dt. 5-9-2016.

activities in many countries, the various treaties have important implications for how the international company should structure its internal payments system among the foreign subsidiaries and the parent company.

A typical company uses several strategies to manage the tax issues. They are tax havens, offshore financial centres, transfer prices, fronting loans and the income revital form.



(i) Tax Havens: Some companies use tax havens to minimise their tax burden. Tax Havens are countries that impose little or no corporate taxes, *viz.*, Cayman Islands, the Bahamas, Bernuda and Vanuatu. International companies avoid or defer income taxes by establishing a wholly owned, non-operating subsidiary in the tax haven.

(ii) Offshore financial centre: International business may also use the advantages presented by an offshore financial centre, which offers ample opportunities for more effective international tax planning. For example, Malaysia established the international off-shore financial centre at Labuan, a small island located in East Malaysia. Labuan operates as a FREE PORT, where no sales tax, excise, import or export duties are imposed to promote off-shore business activity.

(iii) Transfer Pricing: China introduced the income tax law for enterprises with foreign investments and foreign enterprises. It taxes companies' on transfer pricing.

(iv) Fronting Loan: It is also called back-to-back loan or link financing. It is a loan between parent and its subsidiary company channelled through a financial intermediary, usually a large international bank. In a arrangement, the parent company deposits funds with a bank in country 'x' that in turn lends the money to a subsidiary in century 'y'. Companies use fronting loans for two reasons.

— first, back to back loans can circumvent host country restriction on the remittance of funds, from a subsidiary to the parent company. But it is less likely to restrict a subsidiary ability to repay a loan to a large international bank.

— second, fronting loan strategy saves tax of subsidiary, located in host country.

12. Economic and Currency Crisis: The Asian crisis, Malaysian crisis, Pacific-Rim country crisis are in relation to economic crisis wherein they have experienced. RECESSION and ADVERSE, BALANCE OF PAYMENTS position. The same countries alongwith Japan experienced currency crisis in that the value of currencies were either depreciated or devalued and further they were exposed to shortage of foreign exchange reserves.

13. Interest Rates Charging: The rate of interest charged by World Bank on its loans disbursed is 7.5 per cent p.a. and Asian Development Bank's concessional interest rate is 4 per cent p.a. The equity cost of capital is less when compared to debt funds in the global capital market. The increasing interest rate raises cost of capital and profitability of the company is

lessened interest rate is a parameter in global finance which plays a dominant role in production and operational risks of global corporates.

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

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

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

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

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

19. International Cash Management: One major task of an international financial manager relates to the management of cash. This task is more complicated for international companies. For example, Cathay Pacific uses over 30 currencies in its operations. While managing cash, the international financial manager needs to address three issues —

minimising cash balances.

minimising currency conversion costs, and

minimising foreign exchange risks.

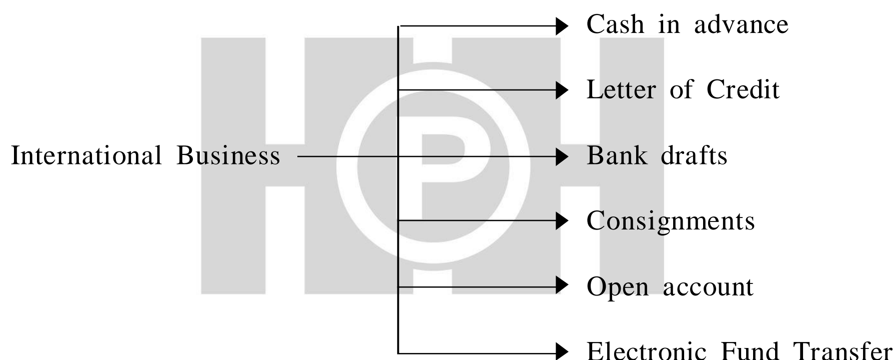
(i) Minimising cash balances: A company needs to hold cash to facilitate everyday transactions and to cover the company against unexpected demand for cash. It is unwise to hold cash idle and it is equally risky to run out of cash. International companies generally makes use of centralised treasury to minimise its company wide cash holding. It is also called as cross-border pooling.

(ii) Minimising currency conversion costs: It is also called as Transaction Costs. Minimising this cost is a tough task, for the international financial manager. The international corporate's foreign subsidiaries continuously buy and sell parts and finished goods between each other. Cumulative bank charges for transferring funds and converting currencies can be quite high. It is usually 0.3% of the total value of the transaction.

(iii) Minimising foreign exchange risks: Foreign exchange risks can be minimised through currency swamp lead strategy, lag strategy, dispersal locations of subsidiaries, flexible sourcing, reducing transaction and translation exposures and the like.

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

21. Methods of Payment: Every shipment abroad requires some kind of financing while in transit. The exporter also needs funds to buy or manufacture its good. Similarly the importer has to carry these goods in inventory until they are sold. There are 6 methods of payments in international market. Such methods are



(i) Cash in advance: Exporter affords the greater protection because payment is received either before shipment or upon the arrivals of goods. This enables the exporter to less of owned funds.

(ii) Letter of Credit: LC offers the exporter the greatest level of safety. On the bank promising, the importer promises to pay the seller the amount of transaction at an agreed fees. The LC becomes a financial contract between the issuing bank and a designated beneficiary.

(iii) Draft or Bill of Exchange: It is an instrument written by an exporter on the importer directing the latter to pay a certain sum on a specified date, for having goods shipped to the importer. The exporter submits the bill to its bankers, who collects the stated amounts from the importer's bank and remits the proceeds to the seller or to the bearer of the bill of exchange.

(iv) Consignment of goods: Goods sent on consignment are duly shipped to the importer, but they are not sold. The exporter (consignor) retains the title to the goods until the importer (consignee) has sold them to a third party. Foreign Exchange Management Act (FEMA) 1999, requires that an exporter shall not without the permission of RBI,

allow the sale of goods on consignment at a value less than the amount declared by it, at the time of export.

(v) Open account selling: Under it, shipping of goods is done first and billing the importer is done later. Sales on open account, are made only to a foreign affiliate or to a customer with which the exporter has a long history of favourable business dealings. However, open account sales are greatly expanded due to the major increase in international trade, the improvement in credit information about importers and the greater familiarity with exporting in general. The benefits of open account sales include greater flexibility, lower costs, fewer bank charges than with other methods of payment.

(vi) EFT: With the enormous use of internet, e-banking, e-business and e-commerce, the international trade has gained momentum. With the electronic funds transfer system banks have made it possible to transfer funds of individuals, international corporates, different nations, from one place to another easily and speedily.

22. Foreign Exchange Markets: It is the market where foreign currencies are bought and sold against each other. Foreign Exchange (FEX) market is an organised one and banks are the important players. Bulk of trade is accounted for small number of currencies, *viz.* US Dollar, Euro, Japanese Yens, Pound Sterling, Swiss Francs, Canadian Dollar and Australian Dollar. It is an over the counter market. This means that there is no single physical or electronic market place. The market itself is actually a worldwide network of interbank traders consisting of authorised dealers, *i.e.,* banks, connected by telephonic lines and computers. The currency appreciation and depreciation of a particular currency will affect international corporates business considerably. In advanced countries, the capital account convertibility as in existence conversely in Indian, capital account convertibility of currency is restricted for the fear of foreign capital exodus. Though the Tarapore Committee recommended capital account convertibility in the phased manner, but could not happen.

Some Basic Concepts

In an increasingly globalised world economy there is an ever-growing exchange of goods, services and capital between different countries. The result of the exchange is captured by balance of payments statistics. The International Monetary Fund has published a manual for compiling and reporting of cross border transactions in the form of both "flows" and "stocks", to facilitate uniformity of methodology used by different countries, arid inter-country comparisons. The following definitions are copied from the latest (sixth) edition of the IMP's Balance of Payments and International Investment Position Manual:

(i) Balance of payments: The balance of payments is a statistical statement that summarises transactions between residents and non-residents during a period. It consists of the goods and services account, the primary income account, the secondary income account, the capital account, and the financial account.

(ii) Current account: The current account shows flows of goods, services, primary income, and secondary income between residents and non-residents.

(iii) Capital account: The capital account shows credit and debit entries for non-produced non-financial assets and capital transfers between residents and non-residents. It records acquisitions and disposals of non-produced non-financial assets, such as land sold to

embassies and sales of leases and licenses, as well as capital transfers, that is, the provision of resources for capital purposes by one party without anything of economic value being supplied as a direct return to that party. (In other words, as per the revised definition of capital account, it principally comprise with non-commercial capital transactions.)

(iv) Financial account: The financial account shows net acquisition and disposal of financial assets and liabilities.... Financial accounts transactions appear in the balance of payments and, because of their effect on the stock of assets and liabilities, also in the integrated lIP statement.

(v) The International Investment Position: The international investment position (IIP) is a statistical statement that shows at a point in time the value and composition of:

(*a*) Financial assets of residents of an economy that are claims on non-residents and gold bullion held as reserve assets, and

(*b*) Liabilities of residents of an economy to non-residents.

The difference between an economy's external financial assets and liabilities is the economy's net IIP, which may be positive or negative.

One point worth noting: while the first three heads under balance of payments report "flows", the lIP reports the "stock" of external assets and liabilities.

The Manual prescribes detailed rules for compilation of the data, and is available on the net. It also defines domestic and foreign currency as follows: "Domestic currency is that which is legal tender in the economy and issued by the monetary authority for that economy; that is, either that of an individual economy or, in a currency union, that of the common currency area to which the economy belongs. All other currencies are foreign currencies".

Most countries publish BoP and IIP data under different heads, broadly in alignment with the format in the IMF Manual.

India's Foreign Exchange Management Act, 1999, defines capital and current account transactions somewhat differently, as follows:

(*e*) "capital account transaction" means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in sub-section (3) of section 6;

(*j*) "current account transaction" means a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction includes:

(*i*) payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities in the ordinary course of business,

(*ii*) payments due as interest on loans and as net income from investments,

(*iii*) remittances for living expenses of parents, spouse and children residing abroad, and

(*iv*) expenses in connection with foreign travel, education and medical care of parents, spouse and children."

Trade in goods is often referred to as "merchandise trade" and the services and other income as "invisibles". Invisibles comprise current international payments for items other than merchandise exports or imports. Some of the more important items under the head "invisibles" comprise travel, transportation, interest and dividend payments, remittances, etc. In India, export of IT and other services has become an increasingly important part of invisibles.

Transfers on financial account include external borrowings or repayments of external borrowings, external investments or disinvestments (both portfolio and direct), both inward and outward, etc.

When the central bank does not intervene in the foreign exchange market (*e.g.,* under a floating rate regime), the balances on current and capital accounts would neutralise each other leaving the country's reserves unchanged, but the flows may alter the exchange rate. When the central bank does intervene by buying or selling foreign currency in the market, under any of the managed exchange rate regimes (see paragraph 1.3.1), the reserves will go up (through buying foreign currency) or down (though selling foreign currency from the reserves). The change in reserves will balance the difference between current and capital account transactions. It will be readily appreciated that a central bank will buy foreign currency in the market to stem the domestic currency appreciation (and sell if its desires to reduce its depreciation) as part of its overall macro-economic policy.

Such intervention by the central bank also has its impact on the domestic money market: buying foreign currency will increase liquidity, and vice versa. This impact is often mitigated/ neutralised ("sterilised") by the central bank through "open market operations" — *i.e.,* sale (or purchase) of government securities from (for) its portfolio.

As far as the euro zone is concerned the intra-zonal flows between member countries, positive and negative, are reflected in the balances of the national central banks with the European Central Bank: Germany, which has a huge surplus within the euro zone, is currently a large creditor to the ECB, as reflected in the balance sheet of the Deutsche Bundesbank; contrarily, the deficit countries' central banks have large debit balances with the ECB.

The current account deficit or surplus of a country can also be looked at in another way. In national accounting terms, the current account is a mirror image of the difference between domestic savings and domestic investments. If domestic savings exceed domestic investments, a surplus on current account will result. On the other hand, if domestic savings are insufficient to finance domestic investments, this will be reflected in a deficit on current account and would need to be financed either through a drawdown of reserves or by inflows of external capital.

As stated above the net result of the current and capital account transactions should, in theory, be equal to changes in the country's reserves of foreign exchange. As the Manual clarifies, however, "although the balance of payments accounts are, in principle, balanced, imbalances result in practice from imperfections in source data and compilation. This imbalance, a usual feature of balance of payments data, is labelled net errors and omissions and should be identified separately in published data".

Reinvestments of undistributed profits earned by enterprises with foreign direct investments are reported as FDI inflows. To balance the books, a corresponding amount is added to dividend outflows. (Reinvestments are generally reported only in annual statistics.)

In India, the Reserve Bank had appointed a Working Group on Balance of Payments Manual for India, following the publication of the 6th edition of the IMF's Manual. The Group's report

was published in 2010. Indian BoP statistics are broadly in alignment with the IMF Manual. The RBI publishes Balance of Payments and International Investment Position data, once a quarter. The IMP has also published a Guide for Compilers and Users of External Debt Statistics. In India, debt statistics are published by the RBI for the first two quarters of a fiscal year; and by the Ministry of Finance for the remaining two.

The latest data under all three heads are as follows, and inclusive of the individual elements under each head.

Table 1

India's Overall Balance of Payments ($ mn)

Items	*2010-11*	*2011-12*	*2012-13*
(A) Current Account (a + b)	–48,053	–78,155	–88,163
(*a*) Trade Balance (i – ii)	–127,322	–189,759	–195,656
(*i*) Exports	256,159	309,774	306,581
(*ii*) Imports	383,401	499,533	502,237
(*b*) Invisibles (iii + iv + v)	79,269	111,604	107,493
(*iii*) Services	44,081	64,090	64,915
(*iv*) Transfers	53,140	63,494	64,034
(*v*) Income	–17,952	–15,988	–21,455
(B) Capital Account (c + d + e + f + g)	63,740	67,756	9,300
(*c*) Foreign Investment (vi + vii)	42,127	39,231	46,711
(*vi*) Foreign Direct Investment	11,834	22,061	19,819
(*vii*) Foreign Portfolio Investment	30,293	17,170	26,891
(*d*) Loans	29,135	19,307	31,124
(*viii*) External assistance, net	4,941	2,296	982
(*viii*) Commercial borrowings, net: of which	24,194	17,012	30,142
Medium & Long-term	12,160	10,344	8,485
Short Term	12,034	6,668	21,657
(*e*) Banking Capital, of which:	4,962	16,226	16,570
NRI deposits, net	3,238	11,918	14,842
(*f*) Rupee debt service	–68	–79	–58
(*g*) Other capital	–12,416	–6,929	–5,047
(C) Errors & Omissions	–2,636	–2,432	2,689
(D) Overall balance (A + B + C)	13051	–12,831	3,826
(E) Monetary Movements (F + G)	–13,051	12,831	–3,826
(F) IMF, Net	0	0	0
(G) Reserves and Monetary Gold (Increase Decrease +)	–13,051	12,831	–3,826

Table 2
India's External Debt
(As at end-March)

(US $ million)

Items	*2011*	*2012*	*2013*
I. Multilateral	48,475	50,453	51,642
A. Government borrowing	42,579	43,686	43,539
(*i*) Concessional	26,992	27,221	26,442
(*ii*) Ncn-concessional	15,587	16,465	17,096
B. Non-Government borrowing	5,896	6,767	8,103
(*i*) Concessional	—	—	0
(*ii*) Non-concessional	5,896	6,767	8,103
II. Bilateral	25,712	26,888	25,065
A. Government borrowing	17,988	17,986	16,259
(*i*) Concessional	17,988	17,986	16,259
(*ii*) Non-concessional	—	—	0
B. Non-Government borrowing	7,724	8,902	8,807
(*i*) Concessional	918	1,501	1,497
(*ii*) Non-concessional	6,806	7,401	7,310
III. International Monetary Fund	6,308	6,163	5,964
IV. Trade Credit	18,614	19,067	17,705
(*i*) Buyers' credit	16,412	16,870	15,531
(*ii*) Suppliers' credit,	638	633	760
(*iii*) Export credit component of bilateral credit	1,564	1,564	1,414
(*iv*) Export credit for defence purposes	–	–	0
V. Commercial Borrowings	88,479	104,786	120,893
(*i*) Commercial bank loans	58,613	73,248	82,613
(*ii*) Securitised borrowings (including FCCBs) $	29,134	31,033	37,960
(*iii*) Loans/securitised borrowings, etc	732	505	321
(*iv*) Self-Liquidating Loans	–	–	0
VI. NRI & FC(B&O) Deposits	51,682	58,608	70,823
(*i*) FCNR(B)	15,597	14,968	15,188
(*ii*) NR(E)RA	26,378	31,408	45,924
(*iii*) NRO	9,707	12,232	9,710
VII. Rupee Debt *	1,601	1,354	1,258
(*i*) Defence	1,437	1,216	1,133
(*ii*) Civilian +	164	138	125
VIII. Total Long-term Debt (1 to VII)	240,871	267,319	293,351
IX. Short-term Debt	64,990	78,179	96,697
(*i*) Trade Related Credits	58,463	65,130	86,787
(*ii*) FII Investment in Govt. T-Bills & other instruments	5,424	9,395	5,455
(*iii*) Investment in Treasury Bills by foreign central banks and international institutions etc.	50	64	82

(*iv*) External Debt Liabilities of Central Bank and Commercial Banks	1,053	3,590	4,373
X. GROSS TOTAL	305,861	345,498	39,048
Concessional Debt	47,499	48,062	45,456
As percentage of Total Debt	15.5	13.9	11.7
Short Term Debt	64,990	78,179	96,697
As percentage of Total Debt	21.2	22.6	24.8
Debt Indicators:			
1. Debt Stock — GDP Ratio (in per cent)	17.5	19.7	21.2
2. Debt Service Ratio (per cent) (for fiscal year) (including debt-servicing on non-civilian credits)	4.4	6	5.9

Table 3

International Investment Position

External Assets and Liabilities

(As at end March)
US $ million

Item	*2011*	*2012*	*2013*
Net International Investment Position	–207,021	–249,462	–307,323
Assets	441,912	437,225	447,768
Direct investment	101,485	112,376	119,510
Portfolio investment	1,566	1,472	1,390
Equity and investment fund shares	1,501	1,455	1,307
Debt securities	65	17	83
Other investment	34,044	28,979	34,822
Currency and deposits	12,438	11,144	13,058
Loans	6,927	5,982	4,917
Trade credit and advances	4,827	–39	3,921
Other accounts receivable	9,851	11,893	12,926
Reserve Assets	304,818	294,397	292,046
Liabilities	648,933	686,687	755,091
Direct investment	214,299	222,206	233,678
Equity and investment fund shares	207,496	213,109	223,143
Debt instruments	6,803	9,097	10,535
Portfolio investment	167,339	165,820	182,957
Equity and investment fund shares	132,731	125,327	139,460
Debt securities	34,608	40,493	43,497
Other Investment	267,295	298,661	338,456
Currency and deposits	51,837	58,778	71,004
Loans	144,742	160,221	165,893
Trade credit and advances	60,665	67,327	88,961
Other accounts payable — other	10,051	12,335	12,597

In India, merchandise trade data are also published monthly by the Commerce Ministry on "Customs Cleared" basis. In such data, it is customary to report imports on CIF and exports on FOB basis for calculating the trade balance. Commerce Ministry data differ from the RBI's BoP data because the former are on customs clearance basis, the latter on payments basis; therefore, the former do not capture merchandise not passing through customs (imports of aircraft, ships and defence equipment for example), the latter do.

1.7 MODEL QUESTIONS

Q. 01 Define International Finance and its various parameters.

Q. 02. Discuss the importance of MNCs in international finance.

Q. 03. Explain the various goals of international finance.

Q. 04. Are there emerging challenges before international finance? It yes, discuss in detail.

Q. 05. Explain about the overall Balance of Payment position of India. Further define the terms of current account, capital account and balance of payments.

Q. 06. Explain the net international investment position of assets and liabilities at the end of 2012-13 or year after that. And also discuss the types of foreign investments.