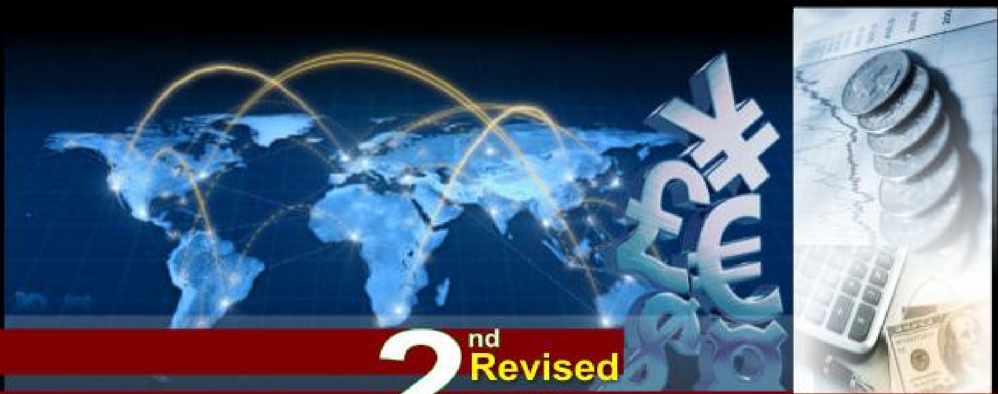

2nd Revised Edition

International Finance

- P.G. GOPALAKRISHNAN
- NANDINI JAGANNARAYAN

Himalaya Publishing House

International Finance

(As Per the Syllabus of BMS VI Sem., Mumbai University)

Dr. P. G. Gopalakrishnan

M.Com., LLM (Gold Medalist), M.Phil., Ph.D.
Principal, S I W S College,
Wadala, Mumbai.

Mrs. Nandini Jagannarayan

M.Sc. Eco., Specialisation (Econometrics),
P.G. Applied Finance (Western Sydney), M.Phil.
Faculty in R.J. College,
Ghatkopar (W), Mumbai.

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Introduction

An earnest attempt is made to present the concepts and the contents of the basics in International Finance. This book is exhaustive in contents and primarily covers the syllabus made out for the students of the University of Mumbai.

International Finance is ever-evolving as the world is now confronted with dynamics of an international meltdown and the need to evolve an international consensus to sustain the growth of the developed and developing nations of the world, be it belonging to the G-7, 8 or 20. Social, political and economic compulsions ordain a broader convergence and international order in banking and finance with renewed thinking for international financial architecture.

The Chapters are designed to be comprehensive, lucid and cater to the understanding of the students in acquiring the input to score well in the examinations and practice the input of knowledge in their real life. The authors sincerely believe that the book would set an appropriate learning mode to the involved students and teachers to seek better insight into the subject.

The Authors thank all those enabled in realising the book in the present form and more specifically of Dr. (Mrs.) Usha Mukundan, Principal, R.J. College, Mumbai and host of well-wishers, friends colleagues and the publishers.

Dr. P.G. Gopalakrishnan

Mrs. Nandini Jagannarayan

Syllabus

Units	Topics	No. of Lectures
I	**Fundamentals of International Finance** • Meaning and scope of International Finance. • Balance of payments as determinant of demand for and supply of currency. • Exchange rate, Determinant of Factors affecting exchange rates. • Current account deficit v/s. Balance of trade and their implications on exchange rate. **Foreign Exchange Arithmetic I** • Exchange rate quotations, Direct and Indirect rates, Cross-currency rates, Vehicle currency. • Percentage spread, calculation of cross rates. • Classification of rates in terms of settlement (cash, tom, spot and forward). • Arbitrage, Speculation and Trading (Spot rate arbitrage calculation).	15
II	**Foreign Exchange Arithmetic II** • Relationship between exchange rates, interest rates, and commodity prices (through international parity conditions namely Purchasing Power Parity, and Fisher Parity). • Use of Covered Interest Parity theory in arbitrage, borrowing and investment decisions. • Calculation of forward rates through use of forward schedules, through use of formula, annualized forward margin, calculation of swap point (calculation for cash/tom rates to be excluded). • Exchange Rate Regimes.	15

	• Gold Standard – Features. • Bretton Woods System – Background and Features, reasons for its failure, Smittsonian agreement, SDRs. • Flexible exchange rate system – Features, Managed float, Central Bank intervention. • Merits and Demerits of Fixed and Flexible Exchange rate systems.	
III	**International Foreign Exchange Markets** • Characteristics. • Dealing room operations. **Eurocurrency Market** • Orign and reasons for the growth of Eurocurrency (offshore) markets, their characteristics and components. • A brief understanding of the Eurocurrency deposit, loans, bonds and notes market. • Concept of offshore banking as a form of globalization of the Eurocurrency concept, its introduction in India, and tax havens. **International Equity Markets** • Concept of Depository Receipt. • Global Depository Receipt – characteristics, mechanism of issue, participants involved. • American Depository Receipt – types and characteristics. • Foreign Currency Convertible Bonds and Foreign Currency Exchangeable Bonds. • Foreign Direct Investment and Foreign Portfolio Investment. • Participatory notes.	**15**
IV	**Foreign Exchange Management in India** • Retail and wholesale components of the Indian Foreign Exchange Market. • Capital Account Convertibility.	**15**

	• Reserve Management. • Role of FEDAI in the Indian Foreign Exchange Market. **Risk Management and Derivatives** • Risk versus exposure. • Transaction, Translation and Economic risk faced by Corporate entities. • Transaction, position, pre-settlement, Settlement risk faced by commercial banks. • Internal and external hedging. • Foreign currency derivatives as instruments of risk management, i.e., forward contracts, swaps, futures and options. • Overview of Non-deliverable forward market (NDF market). **International Institutions** • Contribution of bank for international settlements in risk management system. • European central bank.	

Contents

Detailed Contents

1 Introduction to International Finance

Objectives:

To understand the basics of international finance

Structure:

- ❖ Meaning and Scope of International Finance
- ❖ Features of International Finance
- ❖ Benefits Derived from International Finance
- ❖ Review Questions

MEANING AND SCOPE OF INTERNATIONAL FINANCE

International Finance is the branch of economics that studies the dynamics of exchange rates, foreign investment, and how these affect international trade.

International Finance, in short is an offshoot of economics, encompasses a detailed understanding of exchange rates and foreign investment and their impact on international trade. Analysis of international projects, overseas investments, cross-border capital flows, trade deficits, currency swaps and global financial markets are some of its key areas of study. Individual investors usually focus on that part of international finance that deals with global futures and options and the forex market.

Three conceptually distinct but interrelated parts are identifiable in international finance:

- ❖ **International Financial Economics:** Concerned with causes and effects of financial flows among nations – application of macroeconomic theory and policy to the global economy.
- ❖ **International Financial Management:** Concerned with how individual economic units, especially MNCs, cope with the complex financial environment of international business. Focuses on issues most relevant for making sound business decision in a global economy.
- ❖ **International Financial Markets:** Concerned with international financial/investment instruments, foreign exchange markets, international banking, international securities markets, financial derivatives, etc.

DISTINGUISHING FEATURES OF INTERNATIONAL FINANCE

Arbitrage

- Purchase of securities or commodities in one market for immediate resale in another to profit from a price discrepancy.
- **Tax Arbitrage:** Shifting of gains or losses from one tax jurisdiction to another in order to profit from differences in tax rates.
- **Risk Arbitrage:** The process which ensures that, in equilibrium, risk-adjusted returns on different securities are equal, unless market imperfections hinder the adjustment process.

INTERNATIONAL FINANCE

Benefits

Some of the benefits of international finance are:

- Access to capital markets across the world enables a country to borrow during tough times and lend during good times.
- It promotes domestic investment and growth through capital import.
- Worldwide cash flows can exert a corrective force against bad government policies.
- It prevents excessive domestic regulation through global financial institutions.
- International finance leads to healthy competition and, hence, a more effective banking system.
- It provides information on the vital areas of investments and leads to effective capital allocation.

International Finance promotes the integration of economies, facilitating the easy flow of capital. The free transfer of funds would eventually result in more equality among countries that are a part of the global financial system.

REVIEW QUESTIONS

Q.1. What do you mean by 'International Finance'?

Q.2. What are the benefits of International Finance?

Q.3. Explain the features and scope of International Finance.