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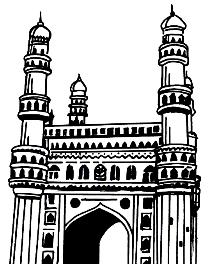

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INTERNATIONAL FINANCE

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UNIT I	**INTRODUCTION :** Globalisation and MNCs Nature and scope of international finance, Globalisatioin and multinational firm, MNCs: the key participant in international financial functions, Factors leading to Fast strides in International financial functions, International trade, Challenges of international finance, Globalization and emerging trends of trade.

1.1 Globalization and MNCs

Q1. Define Globalization. Explain the importance of Globalization in the economy.

Ans :

Meaning

Globalization may be defined as the growing economic interdependence of countries worldwide through increasing volume and variety of cross border transactions in goods and services and of international capital flows and also through the more rapid and widespread diffusion of technology.

Definitions

(i) According to Marin Albrow Globalization is regarded as a process which embodies a transformation of the spatial organization of social relations and transactions.

(ii) According to Anthony Giddens

Globalization can be defined as the intensification of worldwide social relations which link distinct localities in such a way that local happenings are shaped by events occurring many miles away and vice versa.

Importance

Following are the major importance of globalization in the world economy:

1. It ensures free flow of international funds in to the domestic economies around the world.
2. It helps in effective utilization of foreign direct investment that leads to economic development of the nations involved in international trade or business.
3. It encourages the production efficiency in term of goods and services all those possessing comparative advantage.
4. It motivates the companies to prepare goods as per the international standard and quality.
5. It helps in reducing inflation level due to global market competitiveness and increasing volume of import.
6. It ensures exchange of culture, innovative & fresh ideas and technology between countries.
7. Liberalized policies and cut throat global market competition increases the option for consumers.
8. It creates number of opportunities for business firms especially belonging to developing countries.
9. Globalization helps developing nations to boost their international trading activities.

Q2. Explain the impact of Globalization.

Ans : **(Imp.)**

Following are the major adverse impact of globalization:

1. It increases the dominance of MNCs on industrial sectors.
2. Excessive volume of FDI may adversely affect the domestic market of a developing country
3. Big business enterprises may acquire domestic companies or purchase major share of these companies to expand their business.

4. MNCs are taking the advantage from the loopholes of government policies and liberalized approach. It may result in loss of foreign investment in to the country.

5. Entrance of new, modem and improved foreign products leads to replace the traditional domestic products which may affect the local business units.

6. Technology transfer made by MNCs may create number of issues in the host countries.

7. MNCs may introduce the dump and obsolete technologies used in developed countries in developing nations.

Q3. What are the advantages and dis-advantages of Globalization.

Ans : **(Imp.)**

Advantages of Globalization

1. Alteration of Technology

The global alteration of technology is a good sign. Countries can borrow the technology via agreements and implementation for overall development. Communication will be more accessible from any part of the globe by utilizing advanced technology at minimal cost, time, and effort.

2. Better Services and GDP Growth Rate

Globalization always provides better services to people. Through technological progress, services such as water supply, networking, electricity supply, internet, and other services have become easier to deal with. Easy access to the internet is also the advantage of globalization. Globalization also ensures the participation of every country to uplift the world GDP growth.

3. Improvement of Infrastructure

Governments can deliver their services to the people more efficiently owing to the advancement of infrastructure. It is worth mentioning that economic growth and the evolution of infrastructure are harmonious with each other in the development of a country.

4. Affordable Commodities

With access to the latest technology, the countries can provide products to their citizens at affordable prices. Globalization encourages competition in domestic sectors. Companies reduce product prices or follow a discernment pricing strategy.

5. Extensions of Market

Globalization favors the extension of markets. It provides an opening for domestic companies to go global.

Companies can observe saturation in demand for their commodities or services, but through globalization, these companies can satisfy the growing needs of foreign clients.

Disadvantages

1. Rising Inequality

Globalization can raise the problem of inequality everywhere in the world by increasing specialization and trade. By trade boost of the per-capita income, it a cause relative poverty, worldwide.

2. Growing Unemployment rate

Globalization can increase the unemployment rate since it demands higher-skilled work at a lower price. In countries where Companies are relatively incapable of producing highly skilled workers, the unemployment rate can increase in those countries.

3. Imbalanced Trades

The balance of trade refers to the ratio between export and import of commodities and services. Any country can trade with any other country, and globalization causes an imbalance in this ratio. It is also termed 'trade deficits.' Over the years, trade imbalance has increased in developed countries by competition in the market.

4. Environmental Harm

The speed of industrialization is rising as an outcome of globalization. Industrialization advances economic growth, but it also harms the environment. Various chemical industries use harmful fertilizers and solutions or release industrial wastes into nature that causes harm to human life and the environment.

5. Exploits poorer labor markets

Globalization enables businesses to develop jobs and economic possibilities in developing countries by often offering cheaper labor costs. Yet, overall economic growth in such developing countries may be slowed due to globalization or, worse, become stagnant.

Q4. Define Multinational Corporations MNC's. Explain the features of MNC's.

Ans : **(Imp.)**

Meaning

The term multinational is the combination of two words, "Multi" and "National". An organization which carries out business in more than one country is known as a multinational corporation/company. In simple words, an organization which carries out its business activities not only in the country in which it is registered but also in other countries then such an organization is known as multinational corporation.

Definitions

(i) **According to WH Moreland defined** MNCs as "Multinational Corporations or companies are those enterprises whose management, ownership and controls are spread in more than one foreign country".

(ii) **According to David E. Liliental** defined MNCs as, "corporations which have their home in one country but operate and live under the laws and customs of other countries as well".

Features

The features of MNCs are as follows,

1. International Operation

A multinational company functions in more than one country. They have branches, factories and offices in many countries. MNC's sell their products in many countries. For example, Genpact, Wipro etc.

2. Centralized Control

The branches of MNCs are located in various countries but are managed by the head office located in the home country. All branches work under the framework provided by the head office of the company.

3. Oligopolistic Powers

Oligopoly refers to the power in the hands of few companies. MNCs merges with big firms and become the dominating company in the market due to its huge size. They merge with other firms to enhance market share and gain more power.

4. International Management

Multinational companies are managed internationally on the basis of world's best alternatives. The local branches will be managed based on host country. For example, Hindustan unilever is the parent company and originated in United States of America. Hindustan lever in India, managed on the basis of Indian strategies.

5. Various Forms

The functioning of multinational company in host country will be in several forms, i.e., subsidiaries, joint venture, branches, franchise, turn key projects.

Q5. Explain the advantages and dis-advantages of MNC's.

Ans : **(Imp.)**

Advantages

The following are the advantages of MNCs,

1. Technology Gap

MNCs transfer technology to the host country because technology helps to produce good quality products at low prices. Hence, MNCs enable to overcome from the gap between the developing and developed countries.

2. Economic Development

For the economic and industrial growth of the developing countries, foreign capital and advanced technology is necessary and important. MNCs help the developing countries by providing technical, financial and other resources or support in exchange of economic gains.

3. Work Culture

MNC's main objective is to earn profits and increase its market share. Technology upgradation, professional management and product innovation strategies are used to achieve such goals. MNCs have professional, excellent and transparent work culture which makes developing country a developed country.

4. Industrial Growth

MNCs support domestic industries by providing growth opportunities to enter into global market by their wide spread international network.

Disadvantages

The following are the disadvantages of MNCs,

1. Investment

MNCs choose places for investment on the basis of risk factors and profits, rather than on the factors such as national priority, social welfare etc.

2. Technological Problems

The technology used in developed countries is mostly capital intensive. When this technology is adapted by developing countries, it will not be suitable.

3. Self-Centeredness

MNC's main motive is to earn profits. They are very selfish and work for their self-benefit of earning profits, rather than working for host country's development.

4. Foreign Exchange Liquidation

For the working of MNCs, resources are required and due to limited resources in developing countries, MNCs import resources from foreign countries, which results in huge outflow of foreign exchange reserves.

5. Exploitation of Competitors

MNCs take advantage of their marketing strategies for putting down all the competitors and become monopoly in the market.

1.2 Nature and Scope of International Finance

Q6. What do you mean by International Finance?

(OR)

Explain the concept of International Finance.

(OR)

Define the term International Finance.

Ans :

International Finance deals with the management of finances in a global business. It explains how to trade in international markets and how to exchange foreign currency, and earn profit through such activities. In fact, international Finance is an important part of financial economics. It mainly discusses the issues related with monetary interactions of at least two or more countries. International finance is concerned with subjects such as exchange rates of currencies, monetary systems of the world, foreign direct investment (FDI), and other important issues associated with international financial management.

International Finance is a section of financial economics which deals with the macroeconomic relation between two countries and their monetary transactions. The concepts like interest rate, exchange rate, FDI, FPI and currency prevailing in the trade come under this type of finance.

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, euro bond, 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 maximization of the shareholders' wealth.

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

Q7. Briefly explain the nature of International Finance.

Ans : **(Imp.)**

Finance is an art and science of handling and managing monetary resources of the concern efficiently and effectively. Finance is very important part of any business and hence most of the decisions are taken accordingly. International finance records and monitors not only local finance of the nation but it refers to international level or global level. In short, international finance can be said to be focused on financial decisions, allocation decisions and profit distribution or dividend decisions .

Some of the features of international financing management are listed below as international finance management has some certain distinguished features when compared with domestic finance managing they are,

(a) Foreign exchange risks

An understanding of foreign exchange is very important for the investors and managers in today's world of unforeseen changes in exchange rates. This rates is generally ignored and is lesser in domestic economies as it extends to only that particular economy , but when it comes to global level it should be very seriously taken as there is risk of violation foreign exchange rates. It may be regarded as most serious international problem.

(b) Political risks

One of the major risk which an company may encounter in international finance is political risk. It may result in loss. As new acts and laws may be enforced or may change decisions taken by prior person. For example, In 1992, Eron development corporation signed a contract to build India's longest power plant , but it was later cancelled in 1995 by politicians in Maharashtra, who argued that India does not need power plant . The company spent nearly $300 million on that project.

(c) Market imperfections

Market imperfections is in trend nowadays, and this is one of major demerit for the concern. These are various changes in nation's law, taxation , rules and regulations and culture etc.

Q8. Explain the scope of International Finance.

Ans : **(Imp.)**

Traditionally, international finance has been viewed as management of MNCs that engage in some form of international business. 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 internationalization which encompasses unimpeded flows of capital labour and technology across national boundaries.Free trade is always beneficial because it encourages nations to specialize 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.

Q9. Briefly explain the Significance of International Finance.

Ans :

An international finance system maintains peace among the nations. Without a solid finance measure, all nations would work for their self-interest. International finance helps in keeping that issue at bay. Without international finance, chances of conflicts and thereby, a resultant mess, is apparent. International finance helps keep international issues in a disciplined state. International finance organizations, such as IMF, the World Bank, etc., provide a mediators' role in managing international finance disputes. Thus, international finance plays a critical role in international trade and inter-economy exchange of goods and services. The following are the points explaining the importance of international finance:

(i) 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.

(ii) 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.

(iii) 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.

(iv) 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 internalize 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 internationalize its operations. In fact, this company was forced to concentrate on global market and establish manufacturing facilities in foreign countries.

(v) Political stability

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.

(vi) 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.

(vii) 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.

(viii) 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.

(ix) 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.

(x) 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.

(xi) 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.

(xii) Tariffs and import quotas

It was quite common before globalization 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.

(xiii) Calculate exchange rates

International finance is an important tool to find the exchange rates, compare inflation rates, get an idea about investing in international debt securities, ascertain the economic status of other countries and judge the foreign markets. Exchange rates are very important in international finance, as they let us determine the relative values of currencies. International finance helps in calculating these rates.

(xiv) Financial Safety

Various economic factors help in making international investment decisions. Economic factors of economies help in determining whether or not investors money is safe with foreign debt securities. Utilizing IFRS is an important factor for many stages of international finance. Financial statements made by the countries that have adopted IFRS are similar. It helps many countries to follow similar reporting systems. It also helps in saving money by following the rules of reporting on a single accounting standard.

Q10. How International Financial Management is different from Financial Management at Domestic Level.

(OR)

Compare and contrast between inter- national and domestic financial mana- gement.

(OR)

Distiguish between international finance and domestic finance.

(OR)

How international financial management is differ from domestic financial management?

(OR)

Explain the differences between Domestic FM and IFM.

Ans : **(Imp.)**

S.No.	Nature	International Finance	Domestic finance
1.	**Exposure to Foreign Exchange**	Currency exposure impact this transaction.	No impact of currency exposure
2.	**Macro Business Environment**	Exposure to different economic and political environment	Exposure to same economic and political environment.
3.	**Legal and Tax Requirement**	Exposure to different tax laws and regulations.	Exposure to same tax laws and regulations.
4.	**Stakeholder's group**	Stakeholders with different cultures, beliefs, languages etc.	Stakeholders with similar cultures, beliefs, languages etc.
5.	**Foreign exchange derivatives**	Knowledge of forwards, futures, options and swaps is required.	Knowledge of forwards, futures, options and swaps is not required.
6.	**Standards of reporting**	Books of accounts needs to be maintained as per GAAP and As.	No need to maintain separate books.
7.	**Capital Management**	Ample options of financing creates challenges in selection.	Limited options are available, hence no such challenge.

1.3 Globalization and Multinational Firm

Q11. Explain the role of MNC's in Globalization.

Ans : **(Imp.)**

The MNCs plays an important role in Globalization.

1. International Branches

MNCs open their branches and subsidiaries in various countries which results in the growth of globalization.

2. Quality Products

In order to compete at global level, MNCs need to offer quality products in host country as well as in home country. Thus, quality in products provides MNCs higher sales/ turnover, as such they can expand business in other countries. This fuels the process of globalization.

3. Business at Global Level

Going global is not easy task to perform by a MNC. However, MNCs try to establish a good organizational structure through which they can expand their wings by opening branches in different countries. Thus, the intention behind going global should be clear, as such MNC can operate its business throughout the globe.

4. Advertisements and Promotions

MNCs use advertisements and promotional tools to market their products and services. Such type of marketing strategies allow them to get popular in different countries through multi-media. Thus, advertisements and promotions helps to increase globalization.

1.4 MNCs - The Key Participant in International Financial Functions

Q12. Define International Financial Function. Describe the role of MNC's in International Financial Function.

Ans : **(Imp.)**

Meaning

International Financial Function is defined as the financial function of overseas business. It is a process of making financial decisions like acquisition of funds, deployment of resources, expansion of business etc.

Role

The following points highlight the role of MNCs as key participant in financial functions,

1. Promotes Foreign Investment

The external support provided by developed countries to the developing countries is decreasing from past few years. As developed countries are not willing to invest their large portion of GDP as a support for developing countries. In this situation, MNC plays an important role to fill the gap of requirement of foreign capital to enhance foreign investment in India.

2. Transfer of Technology

MNCs also play an active role in transferring modern technology to developing countries which is required to enhance productivity of labourers and to start new productive ventures. Beside new technology, MNCs also transfer skills and technical know how to use new machinery. MNCs play an important role in Indian economy to upgrade technology by spending a large amount of money which will benefit the developing countries.

3. Promoting Exports

MNCs play an important role in promoting exports of country by producing goods at cheaper rates and efficiently. MNCs were allowed to export the product in order to gain foreign exchange for India.

4. Investment in Infrastructure

MNCs has much financial resources and are capable to raise resources both inside and outside India. MNCs can invest in infrastructure which leads to industrial progress and create employment opportunities in Indian economy. Hence, MNCs stimulate economic growth.

1.5 Factors Leading to Fast Strides in International Financial Functions

Q13. Explain the factors responsibility for Fast Strides in International Financial Functions.

Ans : **(Imp.)**

Some of these factors responsible for the fast strides of international finance functions are provided below:

1. Maximum Use of Internet

Internet helps in eliminating the hindrances of time, place and people up to a larger extent. It is being used as an important means of communication all most everywhere. Maximum use of Internet remains one of the important factors responsible for the faster growth in the international finance. It has made the process of international trade easy and convenient. Buyer and Seller can enter in to international business transactions in a very short period using internet through e-Commerce platform. It is further fueled by the banks in the form of digital banking or e banking system. It provides a competitive edge to the users for entering in to international trade activities easily. Banks are also providing financial assistance to the eligible applicants in the form of online loan applications and international traders are taking the advantages of these advanced banking facilities.

2. Highest Use of International Advertising

International advertising is being adopted as a new means of facilitating international trade. There are good numbers of advertising agencies performed at the international circuit and providing their services to their clients. Organizations involved in providing international finance are also taking the help of international advertising. This helps in reaching the global target audience in a very quick period of time. All types of finance products are usually sold in the international market through effective advertisement at international level. It consists of several options such as ads per click (CPC), IPM and CPM. As a result of which, there are billions of transactions are performed each day on the global platform.

3. Limited Restriction on International Trade

Many of the governments of different countries are adopting liberal foreign trade policy which leads in increased volume of international trade. Reduction in restrictions for global trade put the growth rate of such trade up to a higher level ultimately raised the growth potential of international finance along with Forex Market.

4. Reduce the Risk of International Business

Now days, there are multiple options like hedging, future, options, swaps etc. which are used at in international trade activities. These options help in minimizing the risks associated with such business. Growth in international trade has put in substantial impact on international finance.

Q14. Explain the Factors influencing the development of International Finance.

(OR)

Briefly explain the factors influencing the growth of internal finance.

Ans : **(Imp.)**

(i) Impact of Inflation

If a country's inflation rate increases relative to the countries with which it trades, its current account will be expected to decrease, other things being equal. Consumers and corporations in that country will most likely purchases more goods overseas (due to high local inflations), while the country's exports to other countries will decline.

(ii) Impact of National Income

If a country's income level (national income) increases by a higher percentage than those of other countries, its current account is expected to decrease, other things being equal. As the real income level (adjusted for inflation) rises, so does consumption of goods. A percentage of that increase in consumption will most likely reflect an increased demand for foreign goods.

(iii) Impact of Government Policies

A country's government can have a major effect on its balance of trade due to its policies on subsidizing exporters, restrictions on imports, or lack of enforcement on policy.

(iv) Subsidies for Exporters

Some governments offer subsidies to their domestic firms, so that those firms can produce products at a lower cost than their global competitors. Thus, the demand for the exports produced by those firms is higher as a result of subsidies.

Many firms in China commonly receive free loans or free land from the government. These firms incur a lower cost of operations and are able to price their products lower as a result, which enables them to capture a larger share of the global market.

(v) Restrictions on Imports

If a country's government imposes a tax on imported goods (often referred to as a tariff), the prices of foreign goods to consumers are effectively increased. Tariffs imposed by the U.S. government are on average lower than those imposed by other governments. Some industries, however, are more highly protected by tariffs than others. American apparel products and farm products have historically received more protection against foreign competition through high tariffs on related imports.

In addition to tariffs, a government can reduce its country's imports by enforcing a quota, or a maximum limit that can be imported. Quotas have been commonly applied to a variety of goods imported by the United States and other countries.

(vi) Impact of Exchange Rates

Each country's currency is valued in terms of other currencies through the use of exchange rates, so that currencies can be exchanged to facilitate international transactions.

1.6 International Trade

Q15. Define International Trade. Explain the features of international trade.

Ans :

Meaning

The process of exchanging goods and services among individuals or firms located in two or more countries is known as 'International Trade' or 'Foreign Trade'.

Definitions

(i) According to Wasserman and Haltman, "International trade consist of transaction between residents of different countries".

(ii) According to Anatol Marad, "International trade is a trade between nations".

(iii) According to Robertson, "Foreign trade is an engine of economic growth".

Features

1. Immobility of Factors

The degree of immobility of factors like labour and capital is generally greater between countries than within a country. Immigration laws, citizenship, qualifications, etc. often restrict the international mobility of labour.

2. Heterogeneous Markets

In the international economy, world markets lack homogeneity on account of differences in climate, language, preferences, habit, customs, weights and measures, etc. The behaviour of international buyers in each case would, therefore, be different.

3. Different National Groups

International trade takes place between differently cohered groups. The socio-economic environment differs greatly among different nations.

4. Different Political Units

International trade is a phenomenon which occurs amongst different political units.

5. Different National Policies and Government Intervention

Economic and political policies differ from one country to another. Policies pertaining to trade, commerce, export and import, taxation, etc., also differ widely among countries though they are more or less uniform within the country. Tariff policy, import quota system, subsidies and other controls adopted by governments interfere with the course of normal trade between one country and another.

6. Different Currencies

Another notable feature of international trade is that it involves the use of different types of currencies. So, each country has its own policy in regard to exchange rates and foreign exchange.

Q16. What are the advantages and disadvantages of International Trade?

Ans :

Advantages

The following are the major gains claimed to be emerging from international trade:

1. Optimum Allocation

International specialization and geographical division of labour leads to the optimum allocation of world's resources, making it possible to make the most efficient use of them.

2. Gains of Specialization

Each trading country gains when the total output increases as a result of division of labour and specialization. These gains are in the form of more aggregate production, larger number of varieties and greater diversity of qualities of goods that become available for consumption in each country as a result of international trade.

3. Enhanced Wealth

Increase in the exchangeable value of possessions, means of enjoyment and wealth of each trading country.

4. Welfare Contour

Increase in the world's prosperity and economic welfare of each trading nation.

5. Cultural Values

Cultural exchange and ties among different countries develop when they enter into mutual trading.

6. Better International Politics

International trade relations help in harmonising international political relations.

7. Dealing with Scarcity

A country can easily solve its problem of scarcity of raw materials or food through imports.

8. Advantageous Competition

Competition from foreign goods in the domestic market tends to induce home producers to become more efficient to improve and maintain the quality of their products.

9. Larger size of Market

Because of foreign trade, when a country's size of market expands, domestic producers can operate on a larger scale of production which results in further economies of scale and thus can promote development. Synchronised application of investment to many industries simultaneously become possible. This helps industrialisation of the country along with balanced growth.

Disadvantages

When a country places undue reliance on foreign trade, there is a likelihood of the following disadvantages:

1. Exhaustion of Resources

When a country has larger and continuous exports, her essential raw materials and minerals may get exhausted, unless new resources are tapped or developed (e.g., the near-exhausting oil resources of the oil-producing countries).

2. Blow to Infant Industry

Foreign competition may adversely affect new and developing infant industries at home.

3. Dumping

Dumping tactics resorted to by advanced countries may harm the development of poor countries.

4. Diversification of Savings

A high propensity to import may cause reduction in the domestic savings of a country. This may adversely affect her rate of capital formation and the process of growth.

5. Declining Domestic Employment

Under foreign trade, when a country tends to specialize in a few products, job opportunities available to people are curtailed.

6. Over Interdependence

Foreign trade discourages self-sufficiency and self-reliance in an economy. When countries tend to be interdependent, their economic independence is jeopardized. For instance, for these reasons, there is no free trade in the world. Each country puts some restrictions on its foreign trade under its commercial and political policies.

1.7 Challenges of International Finance

Q17. Explain the various challenges in IFM.

Ans : **(Imp.)**

A firm as a dynamic entity had to continuously adapt itself to changes in its operating environment as well as in its own goals and strategy. The decades of 1980's and 1990's were characterized by unprecedented pace of environmental changes for most Indian firms.

Political uncertainties at home and abroad, economic liberalization at home, greater exposure to international markets, marked increase in the volatility of critical economic and financial variables such as exchange rates and interest rates, increased competition, threats of hostile takeovers are among the factors that have forced many firms to thoroughly rethink their strategic posture.

The start of the 21st century was marked by an even greater acceleration of environmental changes and significant increase in uncertainties facing the firm. As we approach the WTO deadlines pertaining to removal of trade barriers, companies will have to face even greater competition at home and abroad.

Capital account convertibility of the rupee is expected to be put in place anytime. Ceilings on foreign portfolio investment are being revised upwards and barriers to foreign direct investment in India are being steadily lowered. Indian banking sector is being opened up to significant increase in foreign stake.

During 2004 and early 2005, the rupee has shown an upward trend against the US dollar putting a squeeze on margins of exporting industries. On the whole, the process of integration of India in the global economy is expected to accelerate and hence exposure of Indian companies to global financial markets is certainly going to increase significantly during years to come.

The responsibilities of today's finance managers can be understood by examining the principal challenges they are required to cope with.

Five Key Categories of Emerging challenges can be identified

1. Change Based on Environment

To keep up-to-date with significant environmental changes and analyze their implications for the firm. Among the variables to be monitored are exchange rates, interest rates and credit conditions at home and abroad, changes in industrial, tax and foreign trade policies, stock market trends, fiscal and monetary developments, emergence of new financial instruments and products, etc.

2. Interrelationships between relevant environmental variables and corporate responses

To understand and analyze the complex interrelationships between relevant environmental variables and corporate responses own and competitive to the changes in them. Numerous examples can be cited. What would be the impact of a stock market crash on credit conditions in the international financial markets? What opportunities will emerge if infrastructure sectors are opened up to private investment? What are the potential threats from liberalization of foreign investment? How will a default by a major debtor country affect funding prospects in international capital markets? How will a takeover of a major competitor by an outsider affect competition within the industry? If a hitherto publicly owned financial institution is privatised how will its policies change and how will that change affect the firm?

3. Adapt Finance Function of Firms Own Strategic Posture

To be able to adapt the finance function to significant changes in the firm's own strategic posture. A major change in the firm's product-market mix, opening up of a sector or an industry so far prohibited to the firm, increased pace of diversification, a significant change in operating results, and substantial reorientation in a major competitor's strategic stance are some of the factors that will call for a major financial restructuring, exploration of innovative funding strategies, changes in dividend policies. Asset sales to overcome temporary cash shortages and a variety of other responses may be required.

4. To take in stride past failures and mistakes

To take in stride past failures and mistakes to minimize their adverse impact. A wrong takeover decision, a large foreign loan in a currency that has since started appreciating much faster then expected, a floating rate financing obtained when the interest rates were low and have since been rising rapidly, a fix-price supply contract which becomes insufficiently remunerative under current conditions and a host of other errors of judgement which are inevitable in the face of the enormous uncertainties. Ways must be found be contain the damage.

5. To design and implement effective solutions

To design and implement effective solutions to take advantage of the opportunities offered by the markets and advances in financial theory. Among the specific solutions are uses of options, swaps and futures for effective risk management, securitization of assets to increase liquidity, innovative funding techniques, etc.

More generally, the increased complexity and pace of environmental changes calls for greater reliance on financial analysis, forecasting and planning, greater coordination between the treasury management and control functions and extensive use of computers and other advances in information technology.

6. Technology

The level of technological advancement achieved by nation sometimes acts as an impediment in international business. The quality of poor infrastructure in India erratic power supply, poor quality of rail and road transport and missing of world level communication systems forced many world-class organizations, in spite of the huge lucrative Indian market, to set up their plants/ operations in other nations like Thailand and Taiwan.

Similarly, the successful organizations of developing nations find it very difficult to operate in highly developed technical countries such as U.S., Germany and japan.

Q18. Explain the Recent trends in IFM.

Ans :

International trade is increasingly recognized as a vital engine for economic development. IFM has undergone vast changes in international trade and global financial markets. In 2004, the value of world merchandise trade rose by nearly 21%, the highest growth rate in 25 years, amounting to nearly USD 8.9 trillion. Taking account of dollar price changes, real world merchandise trade expanded by 9% in 2004, almost doubling from 5% in 2003. It continues to grow more rapidly than global Gross Domestic Products (GDP).

For example, world trade grew at nearly 6% on average in 1994-2004, while global GDP at market exchange rates grew less than 3% in the same period. In the meantime, a number of new trends in international trade have been observed over recent years.

Mentioned below are among such trends which, in particular, are relevant when preparing the Framework.

1. **Developing countries' trade**

In 2004, the share of developing countries in world merchandise trade stood at 31%, having increased from about 20% in the mid-1980s. This is the highest level since 1950. It is observed that developing countries are increasingly becoming an important destination for the exports of developed countries.

Among those, in particular, some problems have been recognized in identifying tariff classification and assessing the Customs value of second-hand goods such as used cars, computer equipment, machinery and clothing. Also, developing countries contributed more to the 2003 growth of world merchandise trade than developed countries. It was estimated that nearly four-fifths of the real growth in 2003 was attributable to developing countries, including transition economies.

2. **Trade in agricultural and manufactured goods**

Manufactured goods, excluding mining products, recorded above average growth in world merchandise trade during the past two decades (WTO, 2004a; 2005b). As a result, they accounted for around three-quarters of world merchandise trade in 2003.

By contrast, the share of agricultural goods trade remained at around 9% in the three preceding years, which represented approximately 2% below the average level in the 1990s. One of the notable trends is that processed agricultural goods have become more important within trade in agricultural goods over the past decade. They accounted for 48% of global trade in agricultural goods in 2001-2, rising from 42% in 1990-1. This upward trend can be observed across countries and agricultural product groups throughout the 1990-2002 period.

3. **Trade between partners of Regional Trade Agreements (RTAs)**

A surge in trade between RTA partners was achieved mainly by a recent proliferation of RTAs. According to a recent WTO report (2004b), some 220 RTAs were estimated operational as of October 2004, of which 150 had been notified to the GATT/WTO. Nearly all WTO Members belong to at least one RTA, and each belongs to six RTAs on average (World Bank, 2005b). The number of RTAs is likely to continue to increase in coming years, considering the number of RTAs under negotiation.

Consequently, it was estimated that the share of trade between RTA partners of world merchandise trade will grow to 55% by 2005 if all expected RTAs are concluded, rising from 43% at present.

4. **South-South Trade**

Merchandise trade between developing countries, i.e. South-South trade, has significantly increased at an annual average rate of 11% during the past decade, accounting for nearly 13% of world merchandise trade in 2000. Around 40% of exports from developing countries were destined for other developing countries. Intra-regional trade, in particular through RTAs, played a central role in the rise of South-South trade. Also, interregional trade showed signs of growth, albeit on a smaller basis. In addition, intra-Asia trade took a dominant position in this trend, accounting for around 80% of the total South-South trade in 2000, but strong growth in intra-regional trade in Africa and Latin America was also observed.

5. **Global production network**

Global production specialization has advanced, in particular in manufactured goods. Firstly, the share of manufactured goods within world merchandise trade has grown significantly throughout the world. Secondly, the share of parts and components exports of total merchandise exports has greatly increased in all six regions of the world, for example from 6% in 1980 to 15% in 2002 in the East Asia region. Thirdly, exported goods contain a significant portion of imported intermediate inputs.

In the "international segmentation of production", intermediate inputs are exported for more processed intermediate inputs, which are then exported to the next stage in production.

6. Intra-firm trade

Intra-firm trade, i.e. trade within the same company and/or its affiliates, reportedly accounts for around one-third of world merchandise trade, although aggregate data are only available for a few countries. In the case of the US, for example, it accounted for 36.2% of exports and 39.4% of imports in 1999, having remained stable over the 1990s. In Japan, on the other hand, it accounted for 30.8% of exports and 23.6% of imports in 1999, which have significantly increased over the same period.

7. E-commerce

Electronic commerce has become a dominant factor in international trade and business, although traditional methods of trade and business continue to be utilized widely. For example, the use of Information and Communication Technology (ICT) such as Internet communication has made cross-border activities easier and more practical.

1.8 Globalization and Emerging Trends of Trade

Q19. Explain the reasons for the emergence of globalization in present scenario.

Ans : **(Imp.)**

The evolution and development of Inter- national Business in recent time can be traced from the following points,

1. Process of Evolution

The firm passes through various stages of the evolution process and then it expands or is established. Process evolution consists of the following three stages,

(i) Trade

(ii) Assembly or production and

(iii) Integration.

Firms develop and produce creative products to have its impact and demand in foreign markets and if they are successful in creating demand for their products in foreign market which in turn facilitates export orders. This comes under first stage of evolution. Firms usually take the help of middlemen to reach their products to foreign markets. Once the firms are succeeded in creating demand for their products, they can create an export department instead of middlemen. If the trade progresses, then the firms will establish markets in the importing countries that becomes subsidiary. These subsidiaries act as an agent to the firms, regarding collecting information of the customer's preferences and expanding the demand for their products in the foreign market.

2. Early Developments

International trade is very old and it dates back to 16th and the 17th century. For every trade, there are huge losses/profits. Earlier, firms used to operate their business in foreign countries to earn profits and sold foreign products at high prices in the home country. One of the foreign trading companies namely 'East India Company' had its operations in India during 17th century.

There came a drastic change in the international business with the advent of Industrial Revolution in Europe. International firms focused on extracting, processing and transporting raw materials related to industrial plants having its origin in home country and also focused on exporting their produced goods to the countries where its raw materials are produced.

3. Post-War Developments

During 1940's, American industries started progressing which led to rapid industrialization of U.S firms in 1950's. American industries tried to acquire largest share across the world and even their FDI grew from $12 billion to $ 80 billion. In the 1960's, European firms emerged and in 1970's Japanese MNC's progressed, slowly it progressed a lot in the same year. In the 1980's, Japanese made a position in the world by becoming largest producers of automobiles. In the 1970's, only firms operating in developing countries operated globally. The two sets of developing countries are represented by oil exporting countries and newly industrializing countries at that time.

The following are the few famous MNC's of the Eastern Europe. They are,

(a) Zalakeramia Rt. of Hungary dealing with production of clay product.

(b) Pliva d.d of Croatia dealing with pharma- ceuticals

(c) Policor S.A. of Romania producing chemicals.

Short Question & Answers

1. Define Globalization.

Ans :

Meaning

Globalization may be defined as the growing economic interdependence of countries worldwide through increasing volume and variety of cross border transactions in goods and services and of international capital flows and also through the more rapid and widespread diffusion of technology.

Definitions

(i) According to Marin Albrow Globalization is regarded as a process which embodies a transformation of the spatial organization of social relations and transactions.

(ii) According to Anthony Giddens

Globalization can be defined as the intensification of worldwide social relations which link distinct localities in such a way that local happenings are shaped by events occurring many miles away and vice versa.

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2. Define Multinational Corporations MNC's.

Ans :

Meaning

The term multinational is the combination of two words, "Multi" and "National". An organization which carries out business in more than one country is known as a multinational corporation/company. In simple words, an organization which carries out its business activities not only in the country in which it is registered but also in other countries then such an organization is known as multinational corporation.

Definitions

(i) According to WH Moreland defined MNCs as "Multinational Corporations or companies are those enterprises whose management, ownership and controls are spread in more than one foreign country".

(ii) According to David E. Liliental defined MNCs as, "corporations which have their home in one country but operate and live under the laws and customs of other countries as well".

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3. Advantages of MNCs.

Ans :

1. Technology Gap

MNCs transfer technology to the host country because technology helps to produce good quality products at low prices. Hence, MNCs enable to overcome from the gap between the developing and developed countries.

2. Economic Development

For the economic and industrial growth of the developing countries, foreign capital and advanced technology is necessary and important. MNCs help the developing countries by providing technical, financial and other resources or support in exchange of economic gains.

3. Work Culture

MNC's main objective is to earn profits and increase its market share. Technology upgradation, professional management and product innovation strategies are used to achieve such goals. MNCs have professional, excellent and transparent work culture which makes developing country a developed country.

4. Industrial Growth

MNCs support domestic industries by providing growth opportunities to enter into global market by their wide spread international network.

4. Disadvantages of MNCs.

Ans :

1. Investment

MNCs choose places for investment on the basis of risk factors and profits, rather than on the factors such as national priority, social welfare etc.

2. Technological Problems

The technology used in developed countries is mostly capital intensive. When this technology is adapted by developing countries, it will not be suitable.

3. Self-Centeredness

MNC's main motive is to earn profits. They are very selfish and work for their self-benefit of earning profits, rather than working for host country's development.

4. Foreign Exchange Liquidation

For the working of MNCs, resources are required and due to limited resources in developing countries, MNCs import resources from foreign countries, which results in huge outflow of foreign exchange reserves.

5. Nature of Inter- national Finance.

Ans :

(a) Foreign exchange risks

An understanding of foreign exchange is very important for the investors and managers in today's world of unforeseen changes in exchange rates. This rates is generally ignored and is lesser in domestic economies as it extends to only that particular economy , but when it comes to global level it should be very seriously taken as there is risk of violation foreign exchange rates. It may be regarded as most serious international problem.

(b) Political risks

One of the major risk which an company may encounter in international finance is political risk. It may result in loss. As new acts and laws may be enforced or may change decisions taken by prior person. For example, In 1992, Eron development corporation signed a contract to build India's longest power plant , but it was later cancelled in 1995 by politicians in Maharashtra, who argued that India does not need power plant . The company spent nearly $300 million on that project.

(c) Market imperfections

Market imperfections is in trend nowadays, and this is one of major demerit for the concern. These are various changes in nation's law, taxation , rules and regulations and culture etc.

6. Define International Financial Function.

Ans :

Meaning

International Financial Function is defined as the financial function of overseas business. It is a process of making financial decisions like acquisition of funds, deployment of resources, expansion of business etc.

Role

The following points highlight the role of MNCs as key participant in financial functions,

1. **Promotes Foreign Investment**

   The external support provided by developed countries to the developing countries is decreasing from past few years. As developed countries are not willing to invest their large portion of GDP as a support for developing countries. In this situation, MNC plays an important role to fill the gap of requirement of foreign capital to enhance foreign investment in India.

2. **Transfer of Technology**

   MNCs also play an active role in transferring modern technology to developing countries which is required to enhance productivity of labourers and to start new productive ventures. Beside new technology, MNCs also transfer skills and technical know how to use new machinery. MNCs play an important role in Indian economy to upgrade technology by spending a large amount of money which will benefit the developing countries.

7. Define International Trade.

Ans :

Meaning

The process of exchanging goods and services among individuals or firms located in two or more countries is known as 'International Trade' or 'Foreign Trade'.

Definitions

(i) **According to Wasserman and Haltman,** "International trade consist of transaction between residents of different countries".

(ii) **According to Anatol Marad,** "International trade is a trade between nations".

(iii) **According to Robertson,** "Foreign trade is an engine of economic growth".

8. Dis- advantages of International Trade

Ans :

When a country places undue reliance on foreign trade, there is a likelihood of the following disadvantages:

1. **Exhaustion of Resources**

   When a country has larger and continuous exports, her essential raw materials and minerals may get exhausted, unless new resources are tapped or developed (e.g., the near-exhausting oil resources of the oil-producing countries).

2. Blow to Infant Industry

Foreign competition may adversely affect new and developing infant industries at home.

3. Dumping

Dumping tactics resorted to by advanced countries may harm the development of poor countries.

4. Diversification of Savings

A high propensity to import may cause reduction in the domestic savings of a country. This may adversely affect her rate of capital formation and the process of growth.

5. Declining Domestic Employment

Under foreign trade, when a country tends to specialize in a few products, job opportunities available to people are curtailed.

6. Over Interdependence

Foreign trade discourages self-sufficiency and self-reliance in an economy. When countries tend to be interdependent, their economic independence is jeopardized. For instance, for these reasons, there is no free trade in the world. Each country puts some restrictions on its foreign trade under its commercial and political policies.

9. Importance of globalization.

Ans :

1. It ensures free flow of international funds in to the domestic economies around the world.
2. It helps in effective utilization of foreign direct investment that leads to economic development of the nations involved in international trade or business.
3. It encourages the production efficiency in term of goods and services all those possessing comparative advantage.
4. It motivates the companies to prepare goods as per the international standard and quality.
5. It helps in reducing inflation level due to global market competitiveness and increasing volume of import.
6. It ensures exchange of culture, innovative & fresh ideas and technology between countries.
7. Liberalized policies and cut throat global market competition increases the option for consumers.
8. It creates number of opportunities for business firms especially belonging to developing countries.

10. Disadvantages of Globalization.

Ans :

1. Rising Inequality

Globalization can raise the problem of inequality everywhere in the world by increasing specialization and trade. By trade boost of the per-capita income, it a cause relative poverty, worldwide.

2. Growing Unemployment rate

Globalization can increase the unemployment rate since it demands higher-skilled work at a lower price. In countries where Companies are relatively incapable of producing highly skilled workers, the unemployment rate can increase in those countries.

3. Imbalanced Trades

The balance of trade refers to the ratio between export and import of commodities and services. Any country can trade with any other country, and globalization causes an imbalance in this ratio. It is also termed 'trade deficits.' Over the years, trade imbalance has increased in developed countries by competition in the market.

4. Environmental Harm

The speed of industrialization is rising as an outcome of globalization. Industrialization advances economic growth, but it also harms the environment. Various chemical industries use harmful fertilizers and solutions or release industrial wastes into nature that causes harm to human life and the environment.

Choose the Correct Answers

1. What is the amalgamation and rapid unification between countries identified as? [a]
   (a) Globalization (b) Liberalization
   (c) Socialization (d) Privatization
2. Globalization has improved the living structure of which of the following? [b]
   (a) All the people (b) People living in developing countries
   (c) People living in developed countries (d) None of the above
3. Which Indian industries have been hit by globalization? [c]
   (a) Cement (b) Jute
   (c) Toy making (d) Information technology (IT)
4. Which of these organizations emphasises on the liberalization of foreign investment and foreign trade? [c]
   (a) International Monetary Fund (b) World Health Organization
   (c) World Trade Organization (d) International Labour Organisation
5. Tax on imports is considered as an example of [b]
   (a) Collateral (b) Trade barriers
   (c) Foreign trade (d) Terms of trade
6. Which of the following is the main reason behind the investments of MNCs? [d]
   (a) To benefit foreign countries
   (b) To provide financial support to the country's government
   (c) For the welfare of underprivileged people
   (d) To increase the assets and earn profits
7. Which of these institutes supports investments and foreign trade in India? [b]
   (a) International Monetary Fund (IMF) (b) World Trade Organisation (WTO)
   (c) World Bank (d) International Labour Organisation (ILO)
8. When did the government remove the barriers for investment in India? [b]
   (a) 1990 (b) 1991
   (c) 1992 (d) 1993
9. The evolution of IF includes the growth of ________. [d]
   (a) Gold standard and Bretton woods standard
   (b) Floating exchange rates
   (c) European Monetary System (EMS)
   (d) All the above
10. ________ are the decisions taken by the international firms to maximize the values of firm. [d]
    (a) Investment (b) Financing
    (c) Money Management (d) All the above

Fill in the Blanks

1. ________ is regarded as a process which embodies a transformation of the spatial organization of social relations and transactions.
2. ________ policies and cut throat global market competition increases the option for consumers.
3. An organization which carries out business in more than one country is known as a ________
4. ________ deals with the management of finances in a global business.
5. ________ is an art and science of handling and managing monetary resources of the concern efficiently and effectively.
6. International Financial Function is defined as the ________ function of overseas business.
7. The process of exchanging goods and services among individuals or firms located in two or more countries is known as ________ .
8. Foreign trade is an engine of ________ growth.
9. ________ trade is increasingly recognized as a vital engine for economic development.
10. GDP Stands for ________.

ANSWERS

1. Globalization
2. Liberalized
3. Multinational corporation.
4. International Finance
5. Finance
6. Financial
7. International Trade
8. Economic
9. International
10. Gross domestic Products

UNIT II

RISK AND EXPOSURE :

Nature of Exposure of Risk, Defining Exposure and Risk Classification of Foreign Exchange Exposure and risk, Risk Management and Wealth Maximization, Classification of foreign Exchange Exposure and risk, Measuring Exposure and Risk

2.1 Defining Exposure and Risk

Q1. Define Exposure and Risk.

Ans :

1. Exposure

Definitions

(i) According to Aven, exposure is defined as "the system is subject to the risk source or hazard/threat". In the context of business, exposure can be defined as the "sensitivity of the real value of the firm's assets, liabilities or operating income due to unforeseen and uncontrolled changes in the risk factors"

(ii) In otherwords, It refers to the degree of sensitivity of the value of a financial item or financial product like asset, liability or cash flows.

In the context of international business and finance, foreign exchange exposure can be defined as that part of a firm's volume of business, which may get affected by movements in exchange rates.

2. Risk

(i) According tot he Dictionary, risk refers to the possibility that something unpleasant or dangerous might happen. "Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for.

(ii) According to Life Insurance Corporation (LIC) of India, risk is "a condition where there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for, there is no requirement that the possibility be measurable, only that it must exits".

(iii) According to S.E. Herrinton, risk is "at its most general level, risk is used to describe any situation where there is uncertainty about what outcome will occur, life is obviously risky"

(iv) According to Frank Knight, "risk is measurable uncertainty".

(v) According to Lrving Fisher, "risk may be defined as combination of hazards measured by probability".

(vi) According to A.M. Wille, risk is an objectified uncertainly regarding the occurrence of an undesirable event".

2.2 Nature of Exposure of Risk

Q2. Explain the Nature of Exposure of Risk.

Ans :

- International Trade involves international economic and commercial transactions in the form of goods and services.
- It requires huge flow of international funds between participating countries. All these trade activities performed at international circuit involves high level of risks.
- These risks may be caused due to several factors such as shipping, transit, and credit policy of parties involved, transportation in airways along with the transportation modalities. It is not confined to that of trading of merchandise goods only but applicable in different forms of services.
- There are number of service industries such as international travel and tourism, transportations, banking and insurance remained a part of international business.

- These segments are not free from the effect of international risk exposure from accidents, war between countries, changes in foreign trade policies of participating countries and export-import policies & procedures etc.
- There are also possibilities of happening of some contingencies like loss of goods, inferior quality, deterioration and destruction of goods.
- Risks associated with currency and foreign exchange has a substantial impact on international trading activities.
- It is evident from the incidents of loss of currency during physical transfer or loss of credit instruments in transit.
- There are different forms of risks connected with foreign exchange transactions available in the currency market.
- It is pertinent to note here that some of these risks like changes in interest rate, forex rates and time value of money mostly caused due to inflation in the economic conditions of the nations involved in global trade.
- Risks are also involved in case of Foreign Direct Investment and Portfolio Investment in the form of moderate or high volume nature.
- It is reflected in case of fluctuations in currency rates of debt availed or used by international business firms as a part of their financing proposition.

2.3 Risk Management

Q3. What is Risk Management ?

Ans :

Risk management is a process that identifies loss exposures faced by an organization and selects the most appropriate techniques for treating such exposures. Because the term "risk" is ambiguous and has different meanings, many risk managers use the term "loss exposure" to identify potential losses. A loss exposure is any situation or circumstance in which a loss is possible, regardless of whether a loss occurs.

Risk management is an integrated process of delineating specific areas or risk, developing a comprehensive plan, integrating the plan, and conducting ongoing evaluation.

Risk management is a process of thinking systematically about all possible risks, problems or disasters before they happen and setting up procedures that will avoid the risk, or minimize its impact, or cope with its impact. It is basically setting up a process where you can identify the risk and set up a strategy to control or deal with it.

Q4. Explain the various objectives of Risk Management.

Ans : **(Imp.)**

Risk management should not be confused with insurance management. Risk management is broader concept and includes all techniques for treating loss exposures, in addition to insurance. These objectives can be classified follows :

(A) Preloss Objective : Following are the objectives before the loss.

(i) Reduction in worry and fear : The risk management should be able to reduce anxiety and fear in the mind of the likely exposed unit and should be able to enhance value without constraints on operating activities,

(ii) Economy : This means that the firm should prepare for potential losses in the most economical way. This preparation involves an analysis of the cost safety programs, insurance premium paid and the costs assonated with the deferent techniques for handling losses.

(iii) Meeting legal obligations : The next objective is to meet any legal obligations. Risk managers must see that all these obligations are met or not.

For example: Government Regulation may require a firm to install safely devices to protect workers from harm, to dispose hazardous waste materials property etc.

(B) Post Loss Objective : Following are the objective of risk management after a loss occurs.

(i) Survival : The most important post loss objective is survival of the firm. If a loss occurs, the firm cannot be totally shut down. The firm should be able to resume the operations or at least partial operations within some reasonable time period so that the firm will survive in the market.

(ii) Continued operation : Even if a loss occurs, the firms mainly service provider should be able to continue their operations,. For example, public utility firms such as airlines, banks, bakeries and dories must continued to operate even after a loss. Otherwise business will be lost to competitors.

(iii) Stability of earning : The next post loss objective is stability in earning. If the firm continues to operate, then there will be a stability in the earning of the firm. The firm will have to face substantial additional expenses to achieve this goal. The firm can shift their operation to another location.

(iv) Continued Growth : After the stability is earning the company can show a continuous growth. It can develop new products and enter into new markets. They can acquire or merge with another company. The risk manager must consider the effect that a loss will have on the firm's ability to grow.

(v) Optimizing Social Effects : The objective of social responsibility of risk management is to minimize the effects that a loss will have on other person and on socially. A severe loss can adversely affect employees, suppliers, creditors and the community in general.

For example, a severe loss that shut down a plant in a small town for an extended period can cause considerable economic distress in the town.

Q5. Explain Need of Risk Management.

Ans :

1. The need for risk management has been evolved with the globalization as the main focus of risk management revolves around the profit margins.

2. If the margins are very low, then there is a need to manage the risk. Therefore, CEOs of all the companies and banks/financial institutions who have failed desperately have started focussing on risk management.

3. The basic purpose of risk management is to obtain sufficient returns through effective risk management, helps the organizations to maximize their wealth. Especially, it is very essential for the banks and financial institutions to focus, since its influence is spread on worldwide and thus could give rise to disputes between the institutions.

4. Risk is an unavoidable factor especially in business. In financial institutions, it seems like business and risk are two sides of the same coin. Hence, it is very essential to hold business and risk together.

5. Institutions need to be structured in a systematic order because the limited liability corporations have engaged in dividing the management and ownership.

6. The management comprises of top level people like executive directors and functional managers who control and safeguard the stakeholder of the company.

7. In every financial organization, there is a need to manage risk because the products and number of transactions which have been traded have started to increase day-by-day. Due to the participation of derivatives, individuals in every organization need to trade at various levels by thoroughly analyzing the risk to achieve adequate profits.

Q6. Explain the methods of handling risks.

(OR)

Explain the various methods of risk management.

Ans : **(Imp.)**

The following are the various methods of risk management :

1. Risk Control
   A) Avoidance
   B) Loss Control
2. Risk Financing
   A) Retention
   B) Noninsurance Transfers
   C) Insurance

1. Risk Control : Risk control is the best method of managing risk and usually the least expensive. Risk control involves avoiding the risk entirely or mitigating the risk by lowering the probability and magnitude of losses. Many risks cannot be avoided, but almost all risks can be mitigated through the use of loss control. Nonetheless, even losses from mitigated risks can be expensive, so both people and businesses usually transfer some of that risk to 3rd parties.

(a) Risk Avoidance : Risk avoidance is the elimination of risk. You can avoid the risk of a loss in the stock market by not buying or shorting stocks; the risk of a venereal disease can be avoided by not having sex, or the risk of divorce, by not marrying; the risk of having car trouble, by not having a car. Many manufacturers avoid legal risk by not manufacturing particular products.

(b) Loss control : Loss Control can either be effected through loss prevention, by reducing the probability of risk, or loss reduction, by minimizing the loss. Loss prevention requires identifying the factors that increase the likelihood of a loss, then either eliminating the factors or minimizing their effect. For instance, speeding and driving drunk greatly increase auto accidents. Not driving after drinking alcohol is a method of loss prevention that reduces the probability of an accident. Driving slower is an example of both loss prevention and loss reduction, since it both reduces the probability of an accident and, if an accident does occur, it reduces the magnitude of the losses, since accidents at slower speeds generally cause less damage. Salvage operations may also reduce the cost of the loss.

2. Risk Financing : Risk financing focuses on methods for paying for losses, which is necessary because not all losses can be prevented. Risk financing is accomplished by retaining the risk, and for some risks, some or most of the cost of potential losses is transferred to 3rd parties, usually insurance companies. Although insurance is a major means of lowering the cost of losses, all people and businesses retain risk to some extent, even for insured losses, because most forms of insurance have deductibles, and some have copayments.

(a) Risk Retention : Risk Retention is handling the unavoidable or unavoided risk internally, either because insurance cannot be purchased or it is too expensive for the risk, or because it is much more cost-effective to handle the risk internally. Usually, retained risks occur with greater frequency, but have a lower severity. An insurance deductible is a common example of risk retention to save money, since a deductible is a limited risk that can save money on insurance premiums for larger risks. Businesses actively retain many risks.

Passive risk retention is retaining risk because the risk is unknown or because the risk taker either does not know the risk or considers it a lesser risk than it actually is. For instance, smoking cigarettes can be considered a form of passive risk retention, since many people smoke without knowing the many risks of disease, and, of the risks they do know, they don't think it will happen to them. Another example is speeding. Many people think they can handle speed, and that, therefore, there is no risk.

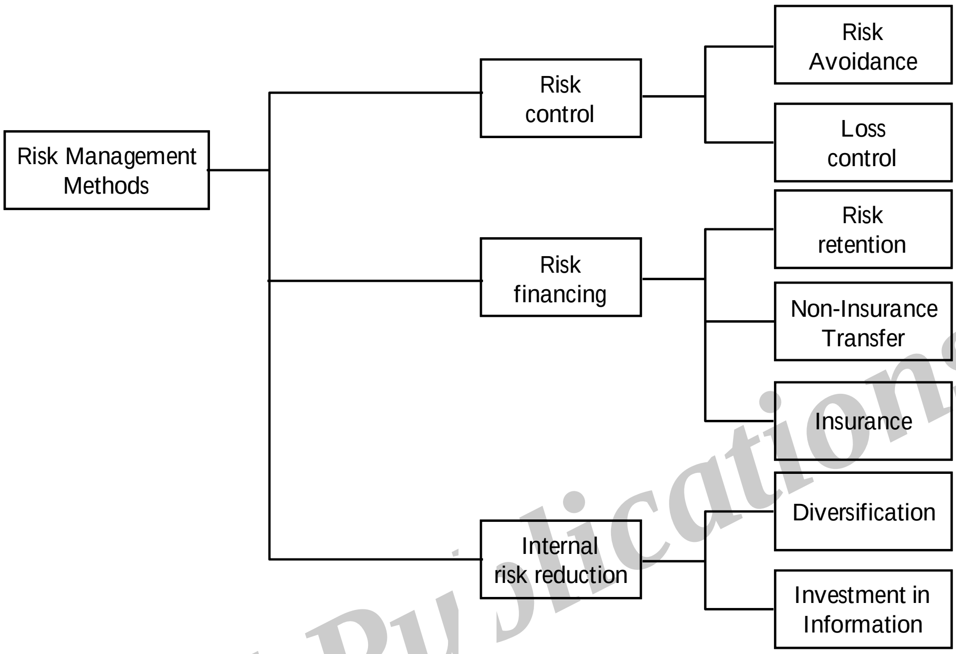


Fig.: Risk Management Methods

(b) Non-Insurance Transfer : Risk can also be managed by noninsurance transfers of risk. The 3 major forms of noninsurance risk transfer are by contract, hedging, and, for business risks, by incorporating. A common way to transfer risk by contract is by purchasing the warranty extension that many retailers sell for the items that they sell.

(c) Insurance is another major method that most people, businesses, and other organizations can use to transfer pure risks, by paying a premium to an insurance company in exchange for a payment of a possible large loss. By using the law of large numbers, an insurance company can estimate fairly reliably the amount of loss for a given number of customers within a specific time.

An insurance company can pay for losses because it pools and invests the premiums of many subscribers to pay the few who will have significant losses. Not every pure risk is insurable by private insurance companies.

3. Internal Risk Reduction

Risk can be reduced internally through two major forms,

(i) Diversification: Risk can be reduced internally by diversifying or spreading the different business activities. Here, it follows a policy "Do not put all the eggs in one basket".

(ii) Investment in Information: Gathering the information about their related business ensures the businessman to have a clear idea about their performance of business when compared with market.

Q7. Outline the Process of Risk Management.

(OR)

Explain the process of Risk management.

Ans : **(Imp.)**

Risk management is the process of identification, analysis and control of those risks. Risk management involves like following steps.

1. **Defining the Objective of Risk Management :** The First step in the risk management is to define the objective. Risk management is widely used by corporations, small employers, farmers, government bodies and even by individuals. Different risky situations result in deferent kind of losses. Loss from accident is significantly differ from loss from firm when risk managers deal with there risks, they must have certain objectives, produce and post loss.

2. **Identifying Potential Losses :** The next step is to identify the potential loss exposures. Risk managers must have the knowledge about the firm, the market in which it operates, the legal, social, economical and political environment in which it operates the firm's financial background and also the business mechanism. Then the risk may cause a major loss for the organization. Property loss, liability loss, business income lose, death or disability, retirement or unemployment, robbery and etc. are some of the major loss exposures using some sources of flowcharts, financial statements, on-site physical inspection and interaction with exports.

3. **Evaluating the Potential Losses :** Next step as to evaluate and measure the impact of the losses. This step involves an estimation of the potential frequency and security of losses. Loss frequency refers to the probable number of losses that may occur during some given time period. Loss servile refers to the probable size of the losses.

Defining the Objective of Risk Management
↓
Identifying Potential Losses
↓
Evaluating the Potential Losses
↓
Selecting Appropriate Techniques for Losses
↓
Implementing and Reviewing the Programme

Fig.: Process of Risk Management

Once the frequency and security of each type of loss exposures are estimated, various loss exposures can be ranked according to their relative importance. Because a loss exposure with high potential is much more important than an exposure with small loss potential. Also the estimation of frequency and security of loss will help the risk manager to select most appropriate each exposure.

4. **Selecting Appropriate Techniques for Losses :** The next step in the risk management process is to select the most appropriate technique for treating loss exposures. These techniques can be broadly classified as risk control and risk financing.

   (a) Risk Control : Risk control is a technique in which no monetary compensation is involved. Loss controls are those actions which reduce the expected cost of losses by reducing the frequency and severity of losses major risk control techniques involve the following:-

   (i) Avoidance

   (ii) Loss prevention

   (iii) Loss reduction

   (b) Risk Financing : Risk financing refers to the manner in which the risk control measures that have been implemented shall be financed. It refers to techniques that provide for the funding of losses offer they occur. Major risk-financing techniques include the following:

(i) Risk retention

(ii) Non-insurance transfers

(iii) Commercial insurance

5. **Implementing and Reviewing the Programme :** To have an effective risk management programme, a risk management policy statement is necessary. This statement outlines the risk management objectives of the firm as well as the company policy with respect to the treatment of loss exposures. In addition to this, a risk treatment manual can be developed. This manual describes the details of the program. It is a very useful tool for training new employees of the firm. This manual also includes important information's such as procedures to follow in an emergency. The risk manager should have cooperation with other financial departments like marketing, production, finance, hr, etc..

Finally, the risk management programme must be periodically reviewed and evaluated to determine whether the objectives are being attained. Risk management costs, safety programs must be carefully monitored. Loss records must be periodically examined to detect any changes in frequency and severityz.

2.3.1 Risk Management and Wealth Maximization

Q8. Explain the relationship between Risk Management and Wealth Maximization.

Ans :

Risk management is a process that identifies loss exposures faced by an organization and selects the most appropriate techniques for treating such exposures. Because the term "risk" is ambiguous and has different meanings, many risk managers use the term "loss exposure" to identify potential losses. A loss exposure is any situation or circumstance in which a loss is possible, regardless of whether a loss occurs.

Risk management is an integrated process of delineating specific areas or risk, developing a comprehensive plan, integrating the plan, and conducting ongoing evaluation.

On the other hand, wealth maximization refers to maximizing the wealth of shareholders. Since return of a financial asset depends upon the risk factors, risk management plays an important role in mimizing the risk associated with the return.

While deploying firm's financial resources, the treasurer must aim at maximizing the expected return and ensure that associate risk does not exceed the level acceptable to the management. In operational terms, the manager must focus on maximizing the return while minimizing the probability of financial loss. When resources are raised, the criteria should be to minimize the cost of funds subject to some ceiling on risk.

2.4 Classification of Foreign Exchange Exposure and Risk

Q9. Explain the various types of Foreign Exchange Exposure.

(OR)

What types of Exchange Exposures is a multinational enterprises subjec-ted to?

(OR)

Briefly the techniques available to manage the exposure and reduce the foreign exchange risk.

Ans : **(Imp.)**

Broadly there are three categories of foreign exchange exposure the firms with global operations are likely to face. They are discussed as follows.

1. **Transaction Exposure**

The transaction exposure that is concerned with the impact of changes in exchange rate on present cash flows. Transaction exposure emerges mainly on account of export and import of commodities on open account, borrowing and lending in a foreign currency and intra firm flows in an international company.

Example

Suppose an Indian firm exports goods to the USA and the bill is invoiced in US dollars. It has to receive payments within two months, but within this period, the US dollar depreciates. This will cause a reduction in earnings in rupee terms. If the US dollar appreciates, it will make the export earning bigger in rupee terms. Change in cash flow occurs in both the cases. In one case, there is loss; in the other, there is gain. Similarly, when an Indian importer imports goods from the USA and if the US dollar appreciates before payment is made in US dollars, it will have to pay more rupees. If the US dollar depreciates, on the other hand, less rupees will have to be paid.

In this case too, the cash flow changes. This type of change in cash flow is known as transaction exposure.

In other words,

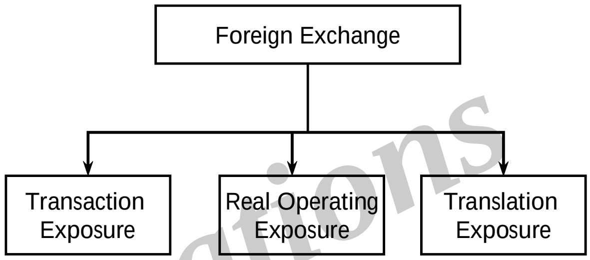
Transaction exposure (gains or loss) = rupee worth of accounts receivable (payable) when actual settlement is made minus rupee worth of accounts receivable (payable) when the trade transaction was initiated.

- The transaction exposure on account of trade is divided into three parts.
- The first part, known as quotation exposure is created when the exporter quotes a price in foreign currency and exists till the importer places an order with the exporter at that price.
- The second part is backlog exposure that exists between the placement of order by the importer and the shipping and billing by the seller. The third part is the billing exposure and exists between the billing of the shipment and the settlement of the trade payments.

2. Real Operating Exposure

Real operating exposure arises when changes in exchange rate, together with rates of inflation, alter the amount and risk element of a company's future revenue and cost stream. The word, "real" denotes the concept of real exchange rate which means nominal exchange rate adjusted for inflation. The word, "operating" is used because we are concerned with the operating cash flow a change in which causes change in the value of the firm.

The measurement of real operating exposure is not very easy, in so far as the measurement of inflation rate differential in the years to come is not easy, especially when the countries are experiencing a highly volatile rate of inflation. However, if inflation rate differential is forecast correctly, real operating exposure can be estimated for a simple example. If the rupee depreciates by 10 per cent, Indian exports will turn competitive and i imports will become costlier, and this will impact the cash flows. If, however, the inflation differential in India also goes up by 10 per cent, the ultimate result may manifest in zero real operating exposure.



The impact of inflation and changes in exchange rate on the future cash flow may vary under different market conditions. As far as revenue is concerned, the impact may vary if the firm produces:

(i) For the export market,

(ii) For the domestic market but competition from import is present, and

(iii) For the domestic market and there is no competition from abroad.

Similarly, the impact of inflation and exchange rate changes on the cost structure shall be different if the firm

(i) Imports inputs,

(ii) Procures inputs from domestic sources, but competition from foreign supplier is present, and

(iii) Gets inputs from domestic sources and there is no competition from foreign suppliers.

3. Translation Exposure

Translation exposure, which is also known as accounting exposure, emerges on account of consolidation of financial statements of different units of a multinational firm. The parent company is normally interested in maximising its overall profitability and to make it possible to ascertain overall profitability, it consolidates the financial statements of its subsidiaries with its own. The other objective of consolidation of financial statements is to evaluate the comparative performance of different subsidiaries.

The objective of consolidation, it is done through translating the items of the financial statements of subsidiaries denominated in different currencies into the domestic currency of the parent company. When the currency of any of the host countries changes its value, its translated value in the domestic currency of the parent company changes as does the picture of the consolidated statement.

The extent of this change represents the magnitude of translation exposure. If the subsidiary maintains its account in the reporting currency i.e. the domestic currency of the parent company as is sometimes done by the extended departments of a firm abroad, the translation exposure does not emerge. Normally though, the subsidiaries maintain their accounts in a functional currency that is normally the currency of the host country, and there is every possibility for the translation exposure to emerge in the wake of exchange rate changes.

2.4.1 Measuring Exposure and Risk

2.4.1.1 Transaction Exposure

Q10. What is Transaction Exposure? How to manage Transaction Exposure.

(OR)

Briefly explain about various techniques of handling Transaction Exposure.

(OR)

Discuss the methods of managing transaction exposure.

(OR)

Briefly explain the technique available to manage the transaction exposure to reduce foreign exchange risk.

Ans : **(Imp.)**

Meaning

The transaction exposure that is concerned with the impact of changes in exchange rate on present cash flows. Transaction exposure emerges mainly on account of export and import of commodities on open account, borrowing and lending in a foreign currency and intra- firm flows in an international company.

1. Forward Market Hedge

In a Forward Market Hedge, a company that is long in a foreign currency will sell the foreign currency forward, whereas a company that is short in a foreign currency will buy the currency forward. In this way, the company can fix the dollar value of future foreign currency cash flow.

If funds to fulfill the forward contract are available on hand or are due to be received by the business, the hedge is considered "covered," "perfect or "square" because no residual foreign exchange risk exists. Funds on hand or to be received are matched by funds to be paid.

In situations where funds to fulfill the contract are not available but have to be purchased in the spot market at some future date, such a hedge is considered to be "open" or "uncovered". It involves considerable risk as the hedger purchases foreign exchange at an uncertain future spot rate in order to fulfill the forward contract.

In a forward market hedge, a net liability (asset) position is covered by an asset (liability) in the forward market. To illustrate the mechanism of the forward market hedge, consider the case of an Indian firm which has a liability of $100,000 payable in 60 days to an American supplier on account of credit purchases.

The firm may employ the following steps to cover its liability position :

Step 1 : Enter into a forward contract to purchase $100,000 in 60 days from a foreign exchange, dealer. The 60-day forward contract rate is, say, Rs. 41.90 per dollar.

Step 2 : On the sixtieth day the dealer Rs. 4,190,000 ($100,000 × Rs. 41.90).

By using such a mechanism, the Indian firm can eliminate the exchange risk in dollars because of its assets position in the forward dollars. To cover a net asset position in the foreign currency a reverse process has to be followed. To illustrate this process, consider an Indian firm which is expecting a payment of $100,000 due in 60 days, on account of credit sale, from an American customer. The firm can take the following steps to cover its asset position :

Step 1 : Enter into a forward contract with a foreign exchange dealer to sell $100,000 in 60 days. The 60-day forward rate is, say. Rs. 41.85.

Step 2 : On the sixth collect $100,000 from the American customer, deliver the same to the dealer and collect Rs. 4,185,000.

The forward market hedge is a relatively simple and- convenient arrangement. It merely involves getting a forward quotation from a foreign exchange dealer and advising him to do the needful. Of course, the dealer will charge a commission for performing the transaction.

2. Money Market

A money market hedge involves simultaneous borrowing and lending activities in two different currencies to lock in the domestic currency value of a future foreign currency value of future foreign currency cash flow. By doing this, the firm knows its total cost in advance in the form of principal and interest it needs to repay in the domestic markets.

For example, a firm has a dollar payable after three months. It can borrow in the domestic currency now, convert it at the spot rate into dollars, invest these dollars in the money market and use the proceeds to pay the payable after three months.

Option market hedge in the circumstances, the firm is uncertain when hedge foreign currency cash flow or out flow will materialized. An options-market hedge involves the purchasing a call option or put option to cover exchange risk.

i) A call option allows MNCs to cover currency risks for accounts payables.

ii) A put option allows MNCs to cover currency risks for accounts receivable!

iii) An options market hedge protects MNCs from adverse exchange rate movements, but also allows MNCs to benefit from favorable exchange rate movements.

3. Options Market Hedge

In many circumstances, the firm is uncer-tain whether the hedged foreign currency cash inflow or outflow will materialise. Currency options obviate this problem.

There are two kinds of options.

A put option gives the buyer the right, but not the obligation, to sell a specified number of foreign currency units to the option seller at a fixed price up to the option's expiration date.

Alternatively, a call option is the right, but not the obligation, to buy a foreign currency at a specified price, upto the expiration date.

A call option is valuable, for example, when a firm has offered to buy a foreign asset, such as another firm, at a fixed foreign currency price but is uncertain whether its bid will be accepted.

The general rules to follow when choosing between currency options and forward contracts for hedging purposes are summarised as follows:

i. When the quantity of a foreign currency cash outflow is known, buy the currency forward, when the quantity is unknown, buy a call option on the currency.

ii. When the quantity of a foreign currency cash inflow is known, sell the currency forward, when the quantity is unknown, buy a put option on the currency.

iii. When the quantity of foreign currency cash flow is partially known and partially uncertain, use a forward contract to hedge the known portion and an option to hedge the maximum value of the uncertain remainder.

4. Exposure Netting

When a firm has a portfolio of currency positions, i.e., both receivables and payments in different currencies, it is unnecessary to hedge every position if the adverse effects of exchange rate movements in some cases are likely to be offset by the favourable movements in other cases.

Exposure netting involves offsetting exposures in one currency with exposures in the same or another currency, where exchange rates are expected to move in such a way that losses (gains) on the first exposed position should be offset by gains (losses) on the second currency exposure. This portfolio approach to hedging recognizes that the total variability or risk of a currency exposure portfolio should be less than the sum of the individual variabilities of each currency exposure considered in isolation. The assumption underlying exposure netting is that the net gain or loss on the entire currency exposure portfolio is what matters, rather than the gain or loss on any individual monetary unit.

In practice, exposure netting involves one of three possibilities :

i) A firm can offset a long position in a currency with a short position in the same currency.

ii) If the exchange rate movements of two currencies are positively correlated (for example, the Swiss franc and Deutsche mark), then the firm can offset a long position in one currency with a short position in the other.

iii) If the currency movements are negatively correlated, then short (or long) positions can be used to offset each other.

Q11. Explain the accounting treatment of transaction exposure.

(OR)

Some of the foreign exchange transac-tions are treated at current rates while others at historical rates. Elaborate.

Ans :

1. Assets and liabilities are recorded at the rate on the date of purchase of the asset or incurred liability.

2. Items settled during the current accounting period are recorded at the rate which is prevailing on the date of settlement which results into the exchange gains/losses. The treatment for these gains/ losses depends on the nature of the items i.e., whether it is a gain/loss.

   If it loss, it is shown in income immediately. If it is gain, it is shown in current and future income.

3. The items which are not settled during the accounting period are recorded at the historical rate or closing rate in the balance sheet.

4. The exchange loss arising out of providing depreciation on the adjusted purchased at home but financed out of foreign currency is adjusted to the cost of the asset and the assert is recorded at that adjusted value.

PROBLEMS

1. Akira Corporation, a US based company has transaction exposure on £ 1000000 payable to a British supplier in 60 days. The 60 day forward rate, the current spot rate, and details relevant to an option contract are given below. Advise the company on whether to let the transaction exposure go unhedged, and if not, which hedging device to choose.

Current spot rate = \$ 1.7550/E

60 day forward rate = \$ 1.7545/£

Strike price of call option = \$ 1.7542/E

Call premium = \$ 0.0001/E

Expected spot rate 60. days from now = \$ 1.7544/E.

Sol :

Given that,

£ 10,00,000 payable to British supplier in 60 days.

60 days forward rate = \$ 1.7545/£

Current spot rate = \$ 1.7550/£

Strike price of call option = \$ 1.7542/£

Call premium = \$ 0.0001/£

Expected spot rate = \$ 1,7544/£

$$\% \text{ Premium} = \frac{\text{Forward rate} - \text{Expected spot rate}}{\text{Spot rate}} \times \frac{12}{n} \times 100$$

$$= \frac{1.7545 - 1.7544}{1.7544} \times \frac{12}{2} \times 100 = 0.03419\% \text{ p.a}$$

Premium payable = Purchase cost x Current Spot rate x % Premium

= 10,00,000 × 1.7550 × 0.03419 = 60003.45

If spot rate for 60 days is \$ 1.7544

In this case the exporter will not excuse his option.

Since, strike price is 1.7542 which is less than spot rate.

Net amount receivable = 10,00,000 x 1.7542 + 60003.45 = 1,814,203.45.

2. An Indian importer purchased a machine at 1 million dollar. The exchange rate at the time of contract is ` 45,000/\$. The machine takes about 30 days to reach the Indian Seashore from the place of its export. In the next 30 days rupee is likely to depreciate to ` 46.50/\$. Calculate the transactions exposure of the importer.

Sol :

Cost of machine = \$ 10,00,000

Post-devaluation payment = 46,50,000 (10,00,000 × 46.50)

Pre-devaluation payment = 45,00,000 (10,00,000 × 45)

Potential loss = 15000

∴ The importer is facing a transaction exposure of Rs. 150,000.

3. Find out the transaction gain or loss on the basis of the following data pertaining to India's foreign trade.

Particulars	US $ (in millions)	Japanese Yen (in millions)	British (In millions)
Imports	1250	650	800
Exports	1100	625	850
Pre-charge Exchange Rate	Rs. 45/$	Re. 0.40/¥	Rs. 70/£
Pre-charge Exchange Rate	Rs. 47/$	Re. 0.41/¥	Rs. 68/£

Sol : **(Dec.-16)**

Transaction Gain (or) Loss

With US $: Exports – Imports = 1100 – 1250 = 150 (A)

Pre exchange rate = 150 × 45 = 6750 $

Post exchange rate = 150 × 47 = 7050 $

Transaction loss = 300 $

In Japanese yen : The net gain/loss will be:

(650 – 625) = 25 $\rightarrow$ Net outflow

Pre exchange rate = 25 × 0.40 = 10

Post exchange rate = 25 × 0.41 = 10.25

Transaction loss = 0.25 £

British £

Net inflow = 850 – 800 = 50

Pre-exchange rate = 70 × 50 = 3500 £

Post exchange rate = 70 × 68 = 4760 £

Transaction gain = 1260 £

2.4.1.2 Operating Exposure

Q12. Define Operating Exposure. What are the determinants of Operating Exposure.

Ans : **(Imp.)**

Meaning

Real operating exposure arises when changes in exchange rate, together with rates of inflation, alter the amount and risk element of a company's future revenue and cost stream. The word, "real" denotes the concept of real exchange rate which means nominal exchange rate adjusted for inflation. The word, "operating" is used because we are concerned with the operating cash flow a change in which causes change in the value of the firm.

The measurement of real operating exposure is not very easy, in so far as the measurement of inflation rate differential in the years to come is not easy, especially when the countries are experiencing a highly volatile rate of inflation. However, if inflation rate differential is forecast correctly, real operating exposure can be estimated

Determinants

It is not possible to ascertain the operating exposure with the help of the accounting statements of the firm. There are two determinants through which operating exposure of the firm can be identified i.e.,

- The structure of the markets and
- The ability of firm to reduce the effect of exchange rate changes.

Usually, firm whose cost or price is sensitive to exchange rate changes involves greater degree of operating exposure. The firm does not have higher, operating exposure in case, if both cost and price are sensitive or insensitive to exchange rate changes. Along with market structure, the ability of firm to stabilize cash flows with respect to exchange rate changes also helps in determining the operating exposure.

In other words, flexibility of the firm with respect to production locations, sourcing and financial hedging strategy is an essential determinant of its operating exposure to exchange risk. The firms facing exchange rate changes may make use of any one of the following pricing strategies as follows,

- The cost shock is completely transferred to the selling prices.
- The cost shock is absorbed completely so that selling prices are not changed or remains the same.
- Combination of the above two strategies.

Q13. How to measure Economic exposure?

Ans :

Currency risk or uncertainty highlights the random changes that takes place in exchange rates but it is not the same as currency exposure which evaluates "what is at risk". In some situations, the firm does not face any exposure at all, even though exchange rates keep on changing randomly. When asset of the company is sensitive to the exchange rate changes then the company would be exposed to greater currency risk and if in case the asset is insensitive to the exchange rate changes then it implies that the company needs to hedge against the exchange risk.

Exposure to currency risk can be calculated accurately by the sensitivities of,

1. The expected home currency values of the firm's assets in future.
2. The operating cash flows of the firm to random changes in exchange rates.

For instance, let us take an example of asset exposure wherein dollar inflation is assumed to be non- random. From US's point of view firm which owns an asset in Britain, the exposure would be calculated by the coefficient (C) in regressing the dollar value (V) of the British asset on the dollar/ pound exchange rate (E_x).

$$\boxed{V = a + C \times E_x + e}$$

Where,

a = Regression constant

e = Random error term with mean zero.

$$\boxed{E(e) = 0,\ V = E_x\ P * d}$$

Where,

P^1 = Local currency price of the asset.

From the above equation, it is clear that the regression coefficient (C) helps in calculating the sensitivity of the dollar value of the asset (V) to exchange rate (is). The dollar value of an asset is independent only when regression coefficient is zero i.e., C = 0 which results no exposure.

Depending on the above analysis, exposure can be referred as regression coefficient. The exposure coefficient (C) can be statistically represented as,

$$\boxed{C = \frac{Cov(V,\ E_x)}{Var(E_x)}}$$

Where,

$Cov(V, E_x)$ = Covariance between dollar value of the asset and the exchange. rate.

$Var(E_x)$ = Variance of exchange rate

Depending on the regression equation, the variability of the dollar value of the asset Var(V) is divided into separate parts i.e., exchange rate-related and residual.

$$\boxed{Var(V) = C^2 Var(E_x) + Var(e)}$$

C^2 $Var(E_x)$ represents the portion of the variability of the dollar value of the asset which is effected by random changes in the exchange rate. Whereas, Var(e) indicates the residual part of the dollar value variability which is not effected by the exchange rate changes. The uncertainty relating to future dollar value of the asset is associated with exchange rate uncertainty. The variability of the dollar value of the asset can be eliminated by hedging exchange exposure.

Q14. State the instruments for minimizing operating risk.

Ans :

The following are the instruments that could be used for managing operating risk,

1. Low Cost Production Sites

The low cost production site can be a major instrument for minimizing operating risk. At times when the home currency is expected to be strong the companies may plan to shift their production units to those foreign countries where the operating cost is low, so as to keep their production cost low. The companies select only those foreign countries which have undervalued currency or low cost factors of production.

2. Flexible Sourcing Policy

The firms can even use a flexible sourcing policy for minimizing the operating risk. With the help of such a flexible sourcing policy, the firm is able to continue the production in the home country itself by sourcing the factors of production from countries where the cost prices were found to be low.

3. Market Diversification

This is also one of the major instrument for minimizing the intensity of operating risk. Here, the firm can minimize the exchange rate risk of one country by diversifying its sales to another country. This enables the firm to stabilize its operating cash flow, since the exchange rates fluctuate on a regular basis. Example, Sony electronics are selling LCD TV's in Switzerland and United kingdom. The sales in Switzerland suffer a setback due to the appreciation of dollar against Swiss francs but increased sale sin UK as a result of depreciation of dollar against pond minimizes the operating risk.

4. Research and Development efforts and Product Differentiation

The continuous R & D efforts enable the firm to face tough competition and minimizes the operating risk. Continuous and successful R & D efforts leads to improved productivity or the introduction of a new and distinct product. Such products prove to be effective in facing the competition and keep the firms in the business.

5. Financial Hedging

This tools minimizes operating risk by stabilizing the cash flows of a firm. The financial hedging enables firms to lend or borrow foreign currencies for long period of time or the firms can be hedged against the operating risk by using the currency forward or options contract. The financial contracts prove to be very much helpful to the firms as the real changes in exchange rate directly affects the firm's position.

PROBLEMS

4. A US parent company has a single wholly owned subsidiary in France. It has monetary assets of 100 million FFr and monetary liability of 50 million FFr. The exchange rate declines from 4 FFr/ $ to 5 FFr/$. Calculate net exposure and potential exchange loss.

Sol :

Calculation of Net Exposure

		FFr
	Monetary assets	100 million
(-)	Monetary liability	50 million
	Net exposure	50 million
	Pre devaluation value of 50 million worth assets [50 ÷ 4]	$ 12.5 million
(-)	Post devaluation value [50 ÷ 5]	$10 million
	Potential loss	$ 2.5 million

5. A French subsidiary of a US firm is expected to earn an operating profit of 35 million FFr after taxes and its depreciation change is estimated at 5 million FFr. The exchange rate is expected to decrease from 4 FFr/S at present to FFr 5/$. Calculate operating exposure and potential gain and loss.

Sol :

		FFr
	PAT (Profit after Tax)	35 million
	(+) depreciation	5 million
	Operating Exposure	40 million
	Pre-devaluation value = $10.00 (40 ÷ 4)	
(-)	Post-devaluation value = $ 8.00 (40 ÷ 5)	
	Potential loss	= $ 2.00

2.4.1.3 Translation Exposure

Q15. What is Accounting Exposure?

(OR)

Describe various accounting principles of Translation Exposure.

(OR)

Explain the various methods of Translation Exposure measure.

Ans : **(Imp.)**

Translation exposure, which is also known as accounting exposure, emerges on account of consolidation of financial statements of different units of a multinational firm. The parent company is normally interested in maximising its overall profitability and to make it possible to ascertain overall profitability, it consolidates the financial statements of its subsidiaries with its own. The other objective of consolidation of financial statements is to evaluate the comparative performance of different subsidiaries.

The objective of consolidation, it is done through translating the items of the financial statements of subsidiaries denominated in different currencies into the domestic currency of the parent company. When the currency of any of the host countries changes its value, its translated value in the domestic currency of the parent company changes as does the picture of the consolidated statement.

Accounting Treatment of Translation Exposure

There are two basic methods for translation of foreign subsidiary financial statements. They are,

1. Current rate method
2. Temporal method

1. Current Rate Method

In this method, current exchange rate is used to treat the items. The items are as follows,

a) **Assets and Liabilities:** Current exchange rates must be considered while recording assets and liabilities.

b) **Income Statement Items:** Costs and depreciation charged on tangible fixed assets should be translated using the exchange rate on the date of purchase of the asset.

c) **Dividends:** Dividends are translated by using the exchange rate prevailing at the time of payment.

d) **Equity Items:** Stocks are paid in capital accounts must be recorded at their historical rates while calculating net income (consolidated), adjusted gains/ loss must be shown as a separate equity reserve account which is termed as "cumulative translation adjustment".

2. Temporal Method

Under this method, specific assets and liabilities are translated at the rate of exchange prevailing with the timing of the creation of the item. This method assumes that some of individual line item assets are restated/shown regularly to reflect market value. The category of line items includes,

a) Monetary Assets and Liabilities

Monetary items such as cash, accounts receivables, long-term receivables, monetary liabilities and long- term debt are translated at current exchange rate.

b) Non-monetary Items

Non-monetary items (i.e., non-monetary assets and liabilities) are translated at the exchange rate that was prevailing at the time of valuation in past (historical rates).

c) Income Statement Items

Income statement items are translated at the average exchange rate for the period. But exceptionally some items as depreciation and cost of goods sold are translated at their historical rate as they are directly associated with non-monetary assets or liabilities.

d) Distribution of Dividends

Dividends paid are translated at the exchange rate on the date of payment.

e) Equity Items

Common stock and paid in capital accounts are translated at historical rates. Whereas the earnings retained by the firm at the end of the year is actually the collection of retained earnings of beginning year plus or minus income or loss occurring for that year.

Retained earnings (X years) = Retained earnings of beginning period + Income (X years)

(or)

= Retained earnings beginning period - Loss (X years)

Under this method, gains/losses resulting from translation adjustments are carried directly to current consolidated income, not to equity reserves.

If the transaction was settled in the accounting period in which it has occurred, the exchange rate is shown as an income or expense in the parent firm's profit and loss account in the period during which it occurs.

Q16. What are the differences between Transaction Exposure and Translation Exposure?

(OR)

Compare and contrast Transaction Exposure and Translation Exposure.

(OR)

Distinguish between Transaction Exposure and Translation Exposure.

Ans : **(Imp.)**

Sl. No.	Transaction Exposure	Sl. No.	Translation Exposure
1.	The transaction exposure refers to the alterations which are being made in the existing cash flow of an organisation due to changes in the exchange rate.	1.	The translation exposure refers to the mismatch between the translated value of assets and liabilities that has taken place due to the changes in exchange rate.
2.	It usually takes place due to import and export of commodities on open account, lending and borrowing in foreign currency and flows of intrafirms in foreign firm.	2.	It usually takes place due to the consolidation of financial statements of various units of an MNC.
3.	If there is a commitment to pay foreign currency or possibility to receive foreign currency at a future date, then any movement in the exchange rate will effect the domestic value of the transaction.	3.	The extent to which financial statements are exposed to exchange rate fluctuation is known as translation exposure. But this exposure does not affect the profit and loss account, as it affects the balance sheets.
4.	Transaction exposures includes the fluctuations in the exchange rate on present cash flows.	4.	Translation exposure includes the consolidation of financial statement by the parent firm in order to assess the profitability and performance of the firms.
5.	It includes current cash flows	5.	It does not include any cash flow.
6.	The losses that occurs due to transaction exposure, helps in reducing the taxable income in the same year when it is obtained.	6.	The losses that takes place due to translation exposure are usually not the cash losses and hence they are not being deducted from the taxable income.
7.	Its main objective is to measure the alterations in the value of outstanding financial obligation that are incurred before the exchange rates changes.	7.	Its main objective is to prepare the consolidated statements which are of great use to the firm as well as to its management.
8.	Transaction risk exposure are related with the way the asset and liability value appears in the financial accounts.	8.	The translation risk and exposure is concerned with the assets and liabilities values at the time of its liquidation.

Q17. Discuss Accounting standards for translation exposure in India.

Ans :

The accounting standard 11 is applicable for translating the financial statements of foreign operations. The currency in which a firm presents its financial statements is not mentioned by this statement but usually the firm utilizes the currency of the country where it is being located. In case if a different currency is being used, the criteria for utilizing that currency is required by the statement and in case of any alterations in the reporting currency, its disclosure is needed.

The statement includes the use of the following terms along with their meanings,

1. **Closing Rate:** It is the exchange rate at the balance sheet date.
2. **Average Rate:** It refers to the mean of the exchange rates in force during a particular time period.
3. **Exchange Rate:** It is the ratio for the exchange of two currencies.
4. **Foreign Currency:** It refers to a currency except the reporting currency of a firm.
5. **Exchange Difference:** It is the variation (difference) that results out from reporting the similar number of units of foreign currency at various exchange rates in the reporting currency.
6. **Fair Value:** It refers to the amount for which an asset can be exchanged or a liability can be settled down between agreed parties in the arms length transaction.
7. **Foreign Exchange Contract:** It means an agreement which is used for exchanging various currencies at a forward rate.
8. **Foreign Operation:** It refers to a subsidiary, joint venture, associate or branch of the reporting firm whose activities are based in a country apart from the reporting country enterprise.
9. **Forward Rate:** The forward rate is the particular exchange rate for exchanging the two different currencies at a pre-determined future date.
10. **Monetary Items:** It refers to the money that is held and the assets and liabilities which are to be received or paid in fixed amount of money.
11. **Integral Foreign Operation:** It is a foreign operation. The activities of this foreign operation acts as an integral part of the reporting firm.
12. **Non-integral Foreign Operations:** The activities of this foreign operation is not an integral foreign operations.
13. **Net Investment:** It is referred to the share of reporting enterprise in a non-integral foreign operation.
14. **Reporting Currency:** It refers to the currency that is utilized in the presentation of financial statements.

PROBLEMS

6. An Indian subsidiary of a UK multinational firm has a translation exposure of ` 10 million. The rates are as follows,

Spot : Rs. 55.0000/£

One-year forward: Rs. 56.3200/£

A 4 percent depreciation of the rupee is expected. How can the exchange risk be hedged?

Sol :

i) Given that,

Translation exposure = 10 million

Spot rate = Rs. 55.0000/£

Add @ 4% depreciation of rupee value = Rs. 2.2/£

Rs. 57.2/£

The expected spot rate = Rs. 57.2/£ after 1 year.

Number of contracts at an expected spot rate,

$\Rightarrow \dfrac{1,00,00,000}{57.2}$

$\Rightarrow$ 1,74,825.17

Number of contracts after 1 year,

$\Rightarrow \dfrac{1,00,00,000}{56.3200}$

= 1,77,557

= 1,74,825.17

= Rs. 2,732 (gain)

Total gain of an investor = 2732 × 55

= 1,50,260

Total number of contracts that can be gained by an investor.

The expected spot forward rate	= Rs. 57.2/£
Less: One year forward rate	= Rs. 56.3200/£
	Rs. 0.88/£

ii) Since, the investor have a profit margin of Rs. 0.88/£. The exchange risk can be hedged by multiplying Rs. 0.88 with Rs. 10 millions = Rs. 88,00,000.

7. Total translation exposure of a company is ` 1.5 million. The exposure is in French francs. Interest rates are 8 and 11% for the franc and the rupee respectively. How is hedging to be done? Sport rate is ` 6 per FFr. The rupee is likely to depreciate by 6%.

Sol :

Since, only the interest rate data is available, the hedging operation is to be done in the money market. The following steps are involved,

1. Borrow Rs. 1.5 million at 11 percent and convert them into French francs at spot rate to obtain,

$$\frac{\text{Rs. 1.5 million}}{6} = 0.25 \text{ million FFr}$$

2. Place FFr 0.25 million in the money market for a year at 8 percent. This would give FFr 0.27 million after a year.

3. The sum thus obtained is converted into rupees. If the anticipated depreciation of 6 percent does take place, the rate would settle at Rs. 6.36/FFr. So, the amount in rupees at the end of the year would be Rs. (0.27 million x 6.36) = Rs. 1.7172 million.

4. Refund the rupee loan with interest, the refund amount works out to Rs.(1.5 million × 1.11) = Rs. 1.665 million.

Thus, the hedging operation would result into a net gain of Rs. 52,500 (Rs.1.172 million – Rs. 1.665 million). The gain in french france would be FFr 8.208.

Short Question and Answers

1. Define Exposure

Ans :

(i) According to Aven, exposure is defined as "the system is subject to the risk source or hazard/threat". In the context of business, exposure can be defined as the "sensitivity of the real value of the firm's assets, liabilities or operating income due to unforeseen and uncontrolled changes in the risk factors"

(ii) In otherwords, it refers to the degree of sensitivity of the value of a financial item or financial product like asset, liability or cash flows.

In the context of international business and finance, foreign exchange exposure can be defined as that part of a firm's volume of business, which may get affected by movements in exchange rates.

2. Risk Management

Ans :

Risk management is a process that identifies loss exposures faced by an organization and selects the most appropriate techniques for treating such exposures. Because the term "risk" is ambiguous and has different meanings, many risk managers use the term "loss exposure" to identify potential losses. A loss exposure is any situation or circumstance in which a loss is possible, regardless of whether a loss occurs.

Risk management is an integrated process of delineating specific areas or risk, developing a comprehensive plan, integrating the plan, and conducting ongoing evaluation.

3. Need of Risk Management.

Ans :

1. The need for risk management has been evolved with the globalization as the main focus of risk management revolves around the profit margins.
2. If the margins are very low, then there is a need to manage the risk. Therefore, CEOs of all the companies and banks/financial institutions who have failed desperately have started focussing on risk management.
3. The basic purpose of risk management is to obtain sufficient returns through effective risk management, helps the organizations to maximize their wealth. Especially, it is very essential for the banks and financial institutions to focus, since its influence is spread on worldwide and thus could give rise to disputes between the institutions.
4. Risk is an unavoidable factor especially in business. In financial institutions, it seems like business and risk are two sides of the same coin. Hence, it is very essential to hold business and risk together.
5. Institutions need to be structured in a systematic order because the limited liability corporations have engaged in dividing the management and ownership.
6. The management comprises of top level people like executive directors and functional managers who control and safeguard the stakeholder of the company.

4. Risk Financing

Ans :

Risk financing focuses on methods for paying for losses, which is necessary because not all losses can be prevented. Risk financing is accomplished by retaining the risk, and for some risks, some or most of the cost of potential losses is transferred to 3rd parties, usually insurance companies. Although insurance is a major means of lowering the cost of losses, all people and businesses retain risk to some extent, even for insured losses, because most forms of insurance have deductibles, and some have copayments.

5. Risk Control

Ans :

Risk control is the best method of managing risk and usually the least expensive. Risk control involves avoiding the risk entirely or mitigating the risk by lowering the probability and magnitude of losses. Many risks cannot be avoided, but almost all risks can be mitigated through the use of loss control. Nonetheless, even losses from mitigated risks can be expensive, so both people and businesses usually transfer some of that risk to 3rd parties.

6. Transaction Exposure

Ans :

The transaction exposure that is concerned with the impact of changes in exchange rate on present cash flows. Transaction exposure emerges mainly on account of export and import of commodities on open account, borrowing and lending in a foreign currency and intra firm flows in an international company.

Example

Suppose an Indian firm exports goods to the USA and the bill is invoiced in US dollars. It has to receive payments within two months, but within this period, the US dollar depreciates. This will cause a reduction in earnings in rupee terms. If the US dollar appreciates, it will make the export earning bigger in rupee terms. Change in cash flow occurs in both the cases. In one case, there is loss; in the other, there is gain. Similarly, when an Indian importer imports goods from the USA and if the US dollar appreciates before payment is made in US dollars, it will have to pay more rupees. If the US dollar depreciates, on the other hand, less rupees will have to be paid.

7. Real Operating Exposure

Ans :

Real operating exposure arises when changes in exchange rate, together with rates of inflation, alter the amount and risk element of a company's future revenue and cost stream. The word, "real" denotes the concept of real exchange rate which means nominal exchange rate adjusted for inflation. The word, "operating" is used because we are concerned with the operating cash flow a change in which causes change in the value of the firm.

8. Translation Exposure

Ans :

Translation exposure, which is also known as accounting exposure, emerges on account of consolidation of financial statements of different units of a multinational firm. The parent company is normally interested in maximising its overall profitability and to make it possible to ascertain overall profitability, it consolidates the financial statements of its subsidiaries with its own. The other objective of consolidation of financial statements is to evaluate the comparative performance of different subsidiaries.

The objective of consolidation, it is done through translating the items of the financial statements of subsidiaries denominated in different currencies into the domestic currency of the parent company. When the currency of any of the host countries changes its value, its translated value in the domestic currency of the parent company changes as does the picture of the consolidated statement.

9. Transaction Exposure Vs. Translation Exposure.

Ans :

Sl. No.	Transaction Exposure	Sl. No.	Translation Exposure
1.	The transaction exposure refers to the alterations which are being made in the existing cash flow of an organisation due to changes in the exchange rate.	1.	The translation exposure refers to the mismatch between the translated value of assets and liabilities that has taken place due to the changes in exchange rate.
2.	It usually takes place due to import and export of commodities on open account, lending and borrowing in foreign currency and flows of intrafirms in foreign firm.	2.	It usually takes place due to the consolidation of financial statements of various units of an MNC.
3.	If there is a commitment to pay foreign currency or possibility to receive foreign currency at a future date, then any movement in the exchange rate will effect the domestic value of the transaction.	3.	The extent to which financial statements are exposed to exchange rate fluctuation is known as translation exposure. But this exposure does not affect the profit and loss account, as it affects the balance sheets.

10. Current Rate Method

Ans :

In this method, current exchange rate is used to treat the items. The items are as follows,

a) **Assets and Liabilities:** Current exchange rates must be considered while recording assets and liabilities.

b) **Income Statement Items:** Costs and depreciation charged on tangible fixed assets should be translated using the exchange rate on the date of purchase of the asset.

c) **Dividends:** Dividends are translated by using the exchange rate prevailing at the time of payment.

d) **Equity Items:** Stocks are paid in capital accounts must be recorded at their historical rates while calculating net income (consolidated), adjusted gains/loss must be shown as a separate equity reserve account which is termed as “cumulative translation adjustment”.

Choose the Correct Answer

1. Which of the following is true of foreign exchange markets? [c]
   (a) The futures market is mainly used by hedgers while the forward market is mainly used for speculating.
   (b) The futures market and the forward market are mainly used for hedging.
   (c) The futures market is mainly used by speculators while the forward market is mainly used for hedging.
   (d) The futures market and the forward market are mainly used for speculating.
2. A speculator in foreign exchange is a person who [a]
   (a) Buys foreign currency, hoping to profit by selling it a a higher exchange rate at some later date
   (b) Earns illegal profit by manipulation foreign exchange
   (c) Causes differences in exchange rates in different geographic markets
   (d) None of the above
3. A floating exchange rate [d]
   (a) Is determined by the national governments involved
   (b) Remains extremely stable over long periods of time
   (c) Is determined by the actions of central banks
   (d) Is allowed to vary according to market forces
4. A simultaneous purchase and sale of foreign exchange for two different dates is called [b]
   (a) Currency devalue (b) Currency swap
   (c) Currency valuation (d) Currency exchange
5. The market value of a share is responsible for. [a]
   (a) The investment market (b) The government
   (c) Shareholders (d) The respective companies
6. Trade between two countries can be useful if cost ratios of goods are: [d]
   (a) Undetermined (b) Decreasing
   (c) Equal (d) Different
7. The term Euro Currency market refers to [b]
   (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

8. Govt. policy about exports and imports is called: [a]

   (a) Commercial policy (b) Fiscal policy

   (c) Monetary policy (d) Finance policy

9. The are used as reference for identifying risks in a specific organization at a particular situation. [c]

   (a) SWOT analysis (b) Risk analysis

   (c) Risk check list (d) Risk prompt list

10. __________ is a method used of translation exposure. [c]

   (a) Commercial policy (b) Fiscal policy

   (c) Monetary policy (d) Finance policy

Fill in the Blanks

1. ______ is measurable uncertainty.
2. ______ is a process that identifies loss exposures faced by an organization and selects the most appropriate techniques for treating such exposures.
3. ______ is the best method of managing risk and usually the least expensive.
4. ______ can either be effected through loss prevention, by reducing the probability of risk, or loss reduction, by minimizing the loss.
5. ______ focuses on methods for paying for losses, which is necessary because not all losses can be prevented.
6. The ______ exposure that is concerned with the impact of changes in exchange rate on present cash flows.
7. ______ exposure arises when changes in exchange rate, together with rates of inflation, alter the amount and risk element of a company's future revenue and cost stream.
8. ______ exposure, which is also known as accounting exposure, emerges on account of consolidation of financial statements of different units of a multinational firm.
9. A ______ hedge involves simulta-neous borrowing and lending activities in two different currencies to lock in the domestic currency value of a future foreign currency value of future foreign currency cash flow.
10. Translation exposure, which is also known as ______ exposure

ANSWERS

1. Risk
2. Risk management
3. Risk control
4. Loss Control
5. Risk financing
6. Transaction
7. Real operating
8. Translation
9. Money market
10. Accounting

UNIT III

BALANCE OF PAYMENTS :

Features of BOP, components of BOP the global economy, balance of payments, economy of a country, exchange rates and BOP exchange of national currencies, basics of foreign exchange markets, Interpretation of exchange rates theories, currency convertibility and the strength of the rupee Financial or speculative, Price risk and exchange rate financial instruments like derivatives

3.1 Balance of Payments

Q1. What is Balance of Payments?

(OR)

Define Balance of Payments.

Ans :

Introduction

The balance of payments (BOP) is a statistical statement that systematically summarizes, for a specific period (typically a year or quarter), the economic transactions of an economy with the rest of the world. It covers

(a) All the goods, services, factor income and current transfers an economy receives from or provides to the rest of the world; and

(b) Capital transfers and changes in an economy's external financial claims and liabilities.

Definitions

(i) According to Kindleberger Balance of payments 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".

(ii) According to Prof Benham "Balance of payments of a country is a record of the monetary transactions over a period with the rest of the world".

In any country, balance of payments influences the level of exchange rate which is dependent on the exchange rate regime

3.1.1 Features of BOP

Q2. Explain the features of Balance of Payments.

(OR)

State the distinct features of Balance of Payments.

Ans : **(Imp.)**

Main features of balance of payments are as under :

1. **Systematic Record :** It is a systematic record of receipts and payments of a country with other countries.

2. **Fixed Period of Time :** It is a statement of account pertaining to a given period of time, usually, one year

3. **Comprehensiveness :** It includes all the three items i.e., visible, invisible and capital transfers.

4. **Double Entry System :** Receipts and payments are recorded on the basis of double entry system.

5. **Self-balanced :** From the point of view of accounting, double entry system keeps automatically debit and credit sides of the accounts in balance.

6. **Adjustment of Differences :** Whenever there is difference in actual total receipts and payments, need is felt for necessary adjustment.

7. **All Items-Government and Non-Government:** Balance of payments includes receipts and payments of all items government and non-government.

Q3. Explain the significance of Balance of Payments.

Ans : **(Imp.)**

1. BOP helps to forecast the future market potential of a country particularly for a small period of time.
2. If BOP is found to have deficit then such countries are not able to import the large quantity of goods which they used to practice if they were having BOP surplus.
3. The BOP helps to know the pressure on the foreign exchange rate of a country, firm's trading potential, or an enquiry of whether the country is making the foreign exchange gains or foreign exchange losses.
4. If any changes occur in BOP then it would predict the removal of foreign exchange controls.
5. Any alterations or modifications in the BOP of a country indicates the removal of control over payment of dividends, interest, license fees, royalty fees or any other cash payments to foreign firms or investors.
6. BOP data indicates the high risk associated with the foreign exchange of certain countries.

3.1.2 Components of BOP the Global Economy - Economy of a Country

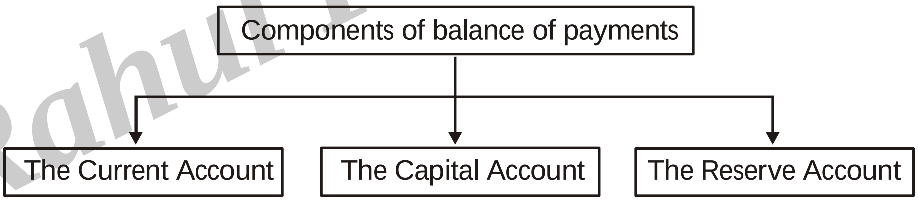
Q4. Describe the components of Balance of Payments.

(OR)

Explain the components of Balance of Payments.

Ans : **(Imp.)**

The structure of BOP has three main accounting components. They are :



1. The Current Account

The current account records at exports and imports of merchandise and invisibles. Merchandise includes agricultural commodities and industrial components and products. Invisibles include (a) services, (b) income flows, and (c) unilateral transfers.

Exports of services include spending by foreign tourists in the country and overseas earnings of residents, including firms. This encompasses earnings on various services (like banking, insurance, consulting, and accounting) and earning of royalties, transportation, and communication. Imports of services include resident tourists' spending abroad, payments made to foreign firms for their services, and royalties on foreign books and movies.

Other items under the current account include profits remitted by foreign branches of Indian firms, interest received on foreign investments, interest paid on foreign borrowing, and funds received from foreign governments for the maintenance of their embassies and consulates. In other words, earnings in the form of interest, dividends, and rent, also known as factor income, received by the residents of a country and the income payments (e.g., interest, dividends, rents, etc.) made by the residents of the country to foreigners form part of the current account of the BOP.

Also part of the current account are official transfers like contributions to international institutions, gifts or aid to foreigners, and private transfers like cash remittances by nationals residing abroad (such as non-resident Indians sending money to their relatives in India). As these transfers of funds do not involve any specific services rendered by the residents of the country, they are referred to as unilateral transfers. In the case of unilateral transfers, there is a flow of goods, services, or funds in only one direction, as against the merchandise or services trade in which goods or services flow in one direction and payments flow in the opposite direction.

Thus, all commercial transactions (exports and imports of goods and services), private remittances, and transfers of goods and services from the government of the home country to foreign governments (such as the sale of military goods to foreign governments and payment of pensions to persons abroad) constitute the current account of a country.

All exports of goods and services are credited to the current account and all imports of goods and services are debited to the current account. The interests, dividends, and other incomes received on assets held abroad are credited to the current account, while the interests, dividends, and other payments made on foreign assets held in the country are debited to the current account.

The remittances received from abroad are credited to the current account and the remittances made to other countries are debited to the current account. That is, the receipt of funds in the form of gifts and grants under unilateral transfers gives rise to a demand for the home currency, just as the export of goods and services does. Such trans-actions are recorded as credit entries in the BOP.

Similarly, unilateral transfers to foreigners (gifts and aid to foreigners) increase the supply of the home currency in the foreign exchange market, just as the import of goods and services does, so, such transactions are recorded as debit entries in the BOP. Thus, all credit entries represent transactions involving receipts from foreigners and all debit entries represent transactions involving payments to foreigners. In order to satisfy the principle of double-entry bookkeeping, it is necessary to treat unilateral transfers as goodwill being purchased or imported by the donor from the recipient of the grant, gift (or) aid.

2. The Capital Account

The capital account of BOP reflects the capital inflows and outflows of the country. The purchases of real assets (physical assets like lands, buildings, and equipment) located abroad and financial securities (e.g., stocks and bonds) issued by foreign governments or foreign companies are called capital transactions. The difference between such purchases made by the residents of one country (say, India) in all other countries, and such purchases by residents of all other countries in India, is called the balance on capital account.

The capital account includes foreign equity investments, loans, and other foreign investments. Foreign equity investments may take the form of either portfolio investments or direct investments. Portfolio investments are cross-border transactions associated with changes in ownership of financial assets and liabilities. Direct investment occurs when there are cross-border outflows and inflows of equity capital. Such ownership of a foreign operating business gives a measure of control to the investors.

An example of direct investment is an Indian firm promoting business in a foreign country. When a foreign institutional investor buys the equity stock of an Indian company, it is an instance of portfolio investment. Note that portfolio investment involves the buying of foreign financial assets (e.g., shares and bonds) without any change in the control of the concerned company, whereas foreign direct investments may result in the transfer of control of the company.

3. The Reserve Account

The official reserve account of the BOP measures a country's official reserves, which are in the form of liquid assets like the central bank's holding of gold. These reserves also include foreign exchange in the form of balances with foreign banks and the IMF, and the government's holding of SDRs. While an increase in the holdings of foreign currency reserves by the country's central bank (e.g., Reserve Bank of India) is debited to the official reserve account, a decrease in the holdings of foreign currency reserves by the country's central bank is credited to the reserve account.

The following are the functions of foreign exchange reserves :

- The official reserve account is used to maintain the exchange value of the home currency in the foreign exchange market at a desired level. The monetary authority of a country may intervene in the foreign exchange market through the official reserve account, by buying or selling the home currency, and thus maintaining the exchange value at the desired level. A country holds reserves so that it will have the power to defend its home currency in the foreign exchange market.
- The surplus or deficit on current account and capital account are reflected in changes in official reserves. A drop in reserves occurs when the country sells off its reserve assets like gold to acquire foreign exchange to finance a deficit in its BOP. A balance of payments surplus (surplus in current account and capital account put together) may lead to the acquisition of reserve assets from foreign agencies. Such adjustments can be made in the official reserve account in order to maintain BOP equilibrium.

Q5. Discuss about fundamentals of Balance of Payment.

Ans :

The Fundamentals of Balance of Payment (BOP) is that "BOP must always balance". If the BOP is not balanced it means some aspects are not counted or some aspects are counted incorrectly. Balance of Payment (BOP) must be in equilibrium. The factors which cause imbalance in country's currency are supply and demand. The entire BOP belonging to a single country is always balanced and the subaccount of the BOP like merchandise trade balance are unbalanced.

The three essential elements of the actual process of measuring international economic activity arc as follows,

1. Identifying international economic transaction
2. Understanding the flow of goods, services, assets and money which create debits and credits to the overall BOP
3. Understanding the book-keeping procedures for BOP accounting

1. Identifying International Economic Transactions

Identifying international transaction is not difficult. The international transactions include export of merchandise goods, like trucks, machinery, computers, telecommunication equipments etc. Imports pertaining to French wine, Japanese Cameras and German automobiles comes under international transactions. The purchase of a glass figure in Venice, Italy by an Indian tourist is considered as an Indian merchandise import. The expenditure incurred by Indian tourists for services are entered in India's balance of payments as imports of travel services in the current account. Under International Financial transactions, if foreign resident purchases an Indian GDR then it is recorded in the capital/financial account of the Indian BOP.

2. The BOP as a Flow Statement

The Balance of Payment (BOP) is not a balance sheet but it is a cash flow statement. BOP records all international transactions from time to time in a year and also identify the flow of purchases and payments between a country and all other countries. It records all international transactions but does not add up the value of all assets and liabilities as balance sheet does on specific date.

The business transactions which dominates the BOP are of two types,

(a) Exchange of Real Assets

The exchange of real assets wherein goods and services are exchanged totally for money. Exchange of goods include automobiles, computers, watches, textiles etc and services include banking services, consulting services, travel services etc.

(b) Exchange of Financial Assets

It includes the exchange of financial claims like stocks, bonds, loans, purchases or sales of companies for other financial claims or money.

3. BOP Accounting

The measurement related to international transactions within or outside the country is a difficult task. The reasons behind these problems are mistakes, errors and statistical discrepancies and not following the principle of double-entry book-keeping. Current and capital/financial account entries are recorded separately. All these factors leads to discrepancies for both debits and credits. The firm should follow the principle of double-entry book-keeping for recording all the transactions and to avoid discrepancies between debits and credits.

Performa of BOPs are Presented by RBI

Transactions	Credit	Debit	Net Amount
A. Current Account			
1. Merchandise			
– Export			
– Import			
2. Invisibles			
(a) Services			
Travel			
Transportation			
Insurance			
Miscellaneous			
(b) Transfer Receipts / Payment			
Official			
Private			
(c) Investment income			
Total Current A/c [1+2]			XXXX
B. Capital Account			
1. Foreign Investment (a + b)			
(a) In India direct Portfolio			
(b) Abroad			
2. Loans			
(a) External Assistance			
By India			
To India			
(b) Commercial Borrowings [Medium - term and long term]			
By India			
To India			
(c) Short-term Capital flow			
To India			
3. Banking Capital flow			
(a) Commercial Banks			
Assets			

Liabilities			
Non resident deposits			
4. Rupee Debt service			
5. Other capital			
Total Capital a/c (1+2+3+4+5)			XXXX
C. Official Reserves			
IMF			
Foreign Exchange Reserves			
Total Official Financing			XXXX

Q6. What are the limitions of BOP?

Ans :

- BOP is an important source of information on economic and financial situation of a country. The analysis of different accounts in a BOP Statement, inter-se, enables one to understand or foresee the circumstantial or structural equilibria.
- Sources of information used to prepare a BOP Statement are varied, namely, central bank, institutions linked with external trade such as Export-Import (EXIM) Bank, and customs authorities, etc.
- A perfect coherence among these sources may not be possible.
- Thus, the account Errors and Omissions serves to bring about an equilibrium between economic operations and their monetary counterparts.
- BOP Statement is established in terms of transactions. That is, it takes into account transactions rather than settlements. But the dates of effective settlements may be far distant in time from the dates of delivery owing to advances accorded, commercial credits, delay in payments or non-payments, etc.
- BOP is expressed in national currency. But often the operations have been done in other currencies. This causes the problem of exchange gain or loss, which is ignored. Some countries like Japan prepare the BOP Statement in two currencies, Yen and US dollar.

Q7. List out the recent trends of BOP in India.

Ans : **(Imp.)**

During post-independence period India's balance of payments was unfavourable i.e., there was deficit in balance of payments, but at the time of second world war it was favourable. Deficit in balance-of-payments in each plan is illustrated in the tabular form.

1. Pre-Planning Period

Pre-planning period lies from the year 1947 to 1951. The deficit in balance of payment on current account during the pre-planning period was `240 crore. In the year 1949 the rupee value was devalued but there was no improvement in the circumstances.

2. First Plan (1951 - 56)

The duration of the first year plan was from 1951 to 1956, the deficit in balance of payments on current account was ` 42 crore only.

3. Second Plan (1956-1961)

The duration of the 2nd five year plan was 1956 to 1961. During this plan there was an increase in the deficit of balance of payments. It was ` 1,725 crore due to heavy imports of machines, raw materials and food grains.

4. Third Plan (1961-65)

The duration of this plan was from 1961-1965. Again in this period there was an increase and deficit in balance of payments due to Indo-China and Indo-Pak war, huge imports of military equipments and food grains, this resulted in the shortage of food grains. The deficit was increased to ` 951 crore.

5. Three-Annual Plans (1966-1969)

There was further rise in the deficit of balance of payments on current accounts i.e., it increased from ` 1951 to ` 2,015 crores due to shortage of food in the nation. This period also witnessed heavy imports of food grains and also heavy interest payment on foreign loans.

6. Fourth Plan (1969-74)

The duration of this plan was from 1969 to 1974. During this period the balance of payments was favourable which was about ` 100 crore. It was for the first time after independence that the BOP were favourable due to many reasons like increase in exports, decrease in imports, rise in receipts from invisible items and so on.

7. Fifth Plan (1974-74)

The duration of this plan was from 1974 to 1978. The balance of payments was increased to 3,082 crore. Several factors accounted for this increase like the minimization in the deficit balance of payments with an increase in exports and restrictions on imports, restriction on smuggling, greater number of tourist visiting India and remittances from Indians residing abroad. All these factors together contributed towards making the BOP favourable.

8. Sixth Plan (1980-85)

The duration of this plan was from 1980-1985. During this plan, their was again unfavourable/ deficit is balance of payment and the deficit was ` 11,384 crore.

India's Balance of Payments [Current Account]

Plan	Balance of Payments on Current Account [Rs. in crore]
First plan [I plan]	(-) 42
Second plan [II plan]	(-) 1,725
Third plan	(-) 1,951
Three annual plans	(-) 2, 015
Fourth plan	(+) 100 [Favourable]
Fifth plan	(+) 3,082 [Favourable]
Sixth plan	(-) 11,384

Seventh plan	(-) 38,313
Eighth plan	(-) 59, 832
Ninth plan	(-) 62,715
Tenth plan [2002-03]	+19,987 [Favourable]
[2003 - 04]	+47,952 [Favourable]
[2004 - 05]	(-) 12,174
[2005 - 06]	(-) 43,737
[2006 - 07]	(-) 45,343

(Source: Statistical Outline of India, 2007-08 and economic survey 2007-08)

9. Seventh Plan (1985-90)

The duration of this plan was from 1985-1990. Gulf war took place during this period, which greatly effected the Indian balance of trade and balance of payments. The price of the petrol fares were increased and there was decline in the invisible receipts from abroad. Thus, deficit in balance of payments on current accounts was accounted nearly ` 38, 313 crore.

10. Eighth Plan (1992-1997)

The duration of this period was from 1992 to 1997. The actual commencement of eighth plan was in the year 1990, but it was started in the year 1992. The deficit in balance of payments, on current accounts however decreased in these two years. Therefore, there was a fall in the level of foreign exchange reserves upto Rs.4,388 crore and current account deficit was around ` 17,366 crore.

During eighth plan the balance-of-payment were unfavorable, as there was an increase in the import of capital goods and crude oil prices were increased greatly, thus current account deficit was upto Rs.59.832 crore.

11. Ninth Plan [1997-2002]

The duration of this plan was from 1997 to 2002. The first four years of this plan recorded a deficit of Rs.69,434 crore, but in the last year of this plan i.e., 2001-02 a surplus of Rs.6,719 crore was gained. Thus, there was considerable decrease in the current account deficit i.e., it reduced from Rs.69,434 to 62,715 crore by the end of this plan i.e., (69,434 - 6,719 = 62, 715).

12. Tenth Plan (2002-07)

The duration of this plan was from 2002 to 2007. The first year of this plan recorded a surplus of Rs.19,987 crore. In the year 2003-04 there was a surplus in current account balance of payments of Rs.47,952 crore. By the end of this plan current account deficit was declined considerably to Rs.45,343 crore.

Trends in Overall Balance-of-Payments

India's balance-of-payments consists of balance-of-payments on current account and capital account. Several attempts have been made in order to attract the foreign investment with the help of economic reforms of 1991 which has been successful with an increase in capital receipts. The status of India's overall balance-of-payments has been represented in the tabular form.

Overall Position of India's Balance - of - Payments [` In Crore]

Year	Balance-of-Payment on Current Account	Balance-of-Payment on Capital Account	Total Balance-of-Payment [Capital + Current Account]
1990 - 91	(–) 17,366	(+) 12,895	(–) 4,471
2000 - 01	(–) 11,431	(+) 39, 093	(+) 27,662
2003 - 04	(+) 47,952	(+) 96,042	(+) 1, 43,994
2004 - 05	(–) 12, 174	(+) 1, 28, 081	(+) 1, 15, 907
2005 - 06	(–) 43, 737	(+) 1,09,633	(+) 65,896
2006 - 07	(–) 45, 343	(+) 2,08,977	(+) 1, 63,634

Since, many years balance-of-payments on capital account is positive which is being acting as a support in the overall balance of payments and this is further accessing in increasing the forex reserves of India by April 4th 2008 the status of India's forex reserves was U.S $ 311.9 billion.

3.1.3 Exchange Rates and BOP

Q8. Explain the effect of BOP on different exchange rates.

Ans : **(Imp.)**

The effect of BOP on different exchange rate countries is discussed below,

1. Effect of BOP on Fixed Exchange Rate Countries

For countries following fixed exchange rate system has the responsibility to see that balance of payment balance has become zero. Specifically, sum of current account and capital account must be zero. If not, it means that there exists a situation of surplus or deficit demand for domestic currency world wide.

If the sum of capital and current account is less than zero then, it means that there is an excess supply of domestic currency. In order to overcome this situation, government has to buy domestic currency and if the sum is greater than zero then, it means that there is a surplus demand for domestic currency all over the world. In order to overcome this situation, government interfere into foreign exchange market and sell domestic currency for exchange reserves or gold. Thus, BOP becomes zero.

2. Effect of BOP on Floating Exchange Rate Countries

Under floating exchange rate system, government does not interfere to fluctuate its exchange rates. Instead of that, the situation where the sum of capital and current account is not zero will influence exchange rate to fluctuate in such a way so that BOP reaches near zero.

Consider an example, a country with a deficit BOP balance which lead to excess supply of domestic currency in world markets. This will result in excess supply of goods in the market. Thus, imbalance market will start lowering the price. As a result, domestic currency devaluate and BOP will move to zero.

PROBLEMS

1. Record the effect of following transaction and the balance of payment statement

(i) An Indian company exports tables worth ` 40,000 to USA on an agreement of collecting its payment after 3 months.

(ii) A tourist spends ` 10,000 in Germany, he is an Indian resident.

(iii) ` 3,00,000 is given by the Indian government as a aid program for the flood victims of neighbouring country.

(iv) Foreign balance in an Indian bank account is increased to make a payment of foreign stock worth ` 1000 being purchased by an Indian resident.

(v) Short-term bills of Indian worth the 500 are purchased by a foreign investor and its payment is made by his Indian bank account.

Sol.

	Particulars	**Debit(`)**	**Credit(`)**
1.	Outflow of short term capital merchandise exports	4000	40,000
2.	Tourism services outflow of short-term capital	10,000	10,000
3.	Unilateral transfer outflow of short-term capital	3,00,000	3,00,000
4.	Inflow of long term capital (foreign stock)	1,000	
	Outflow of short-term capital		1,000
5.	Outflow of short-term capital	500	
	in flow of short-term capital		500

The balance of payment of India is as follows,

Particulars	**Debit(`)**	**Credit(`)**
Merchandise		40,000
Services	10,000	
Unilateral transfer	3,000,000	
Short-term capital		
[10000 + 300000 + 500 - (40000 + 500)]		2,71,000
Long-term capital	1,000	
	3,11,000	3,11,000

2. How are the following transactions entered in the U.S. balance of payment?

(a) A U.S. firm exports $100 worth of goods to the UK payable in 3 months.

(b) After 3 months the English importer pays by drawing down her dollar deposits in a New York bank.

(c) What is left of transactions?

(d) If they occur in the same calender year? If they do not ?

Sol.

	Particulars	Debit(–) (in $)	Credit(–) (in $)
(a)	Private capital (Increase in U.S.		
	outflow asset abroad)	100	–
	Merchandise in current	–	100
(b)	Capital outflow	100	–
	Capital inflow (Decrease in U.S.		
	assets abroad)	–	100

(c) If transactions (a) and (b) occur in the same calender year : debt of (a) is balanced by credit of (b) If transaction (a) occurs in October. November or December, transaction (a) would be included in the U.S., BOP of that year while transaction (b) in BOP for next year.

3. Record the following transactions and prepare the balance of payment statement.

(a) A U.S. firm exports $500 worth of goods to be paid in 3-months.

(b) A U.S. resident visits London he spends $200 on hotel meals and so on.

(c) U.S. government gives a U.S. bank balance of $100 to the government of a developing nation as part of the U.S. aid programme.

(d) A U.S. resident purchases a foreign stock for $400 and pay for it by increasing the foreign bank balance in the U.S.

(e) A foreign investor purchases $300 of U.S. treasury bills and pays by drawing down his bank balances in the U.S. by an equal amount.

Sol.

	Particulars	Debit(–) (in $)	Credit(–) (in $)
(a)	Short-term capital outflow	500	–
	Merchandise exports	–	500
(b)	Travel services purchased		
	from foreigners	200	–
	Short-term capital inflow	–	200
(c)	Unilateral transfer mode	100	–
	Short-term capital inflow	–	100
(d)	Long-term capital outflow	400	–
	Short-term capital inflow	–	400
(e)	Short-term capital outflow		300

(The reduction in foreign bank balance in the U.S. short-term capital inflow)

Short-term Capital Inflow

(The purchase of U.S. treasury bills by a foreigner)

If e assume that these five transactions are all the international transactions of United States during the year, the U.S. balance of payments is as follows,

Particulars	Debit(–) (in $)	Credit(–) (in $)
Merchandise	500	
Services	200	–
Unilateral transfers	100	–
Long-term capital	400	–
Short-term capital, net	–	200
Total	700	700

The net short-term capital credit balance of $200 is obtained together the five short-term capital entries (– $ 500, $260, $100, $400, $300, –$300) examined separately. Total debits equal total credit because of double entry book keeping.

3.2 Exchange of National Currencies - Basics of Foreign Exchange Markets

Q9. What is Foreign Exchange Market (Forex Market)? Explain the characteristics of Foreign Exchange Market.

Ans : **(Imp.)**

Meaning

The foreign exchange market is the market where the currency of one country is exchanged for that of another country and where the rate of exchange is determined. The genesis of Foreign Exchange (FE) market can be traced to the need for foreign currencies arising from:

- international trade
- foreign investment and
- lending to and borrowing from foreigners.

In order to maintain an equilibrium in the FE market, demand for foreign currency (or the supply of home currency) should equal supply of foreign currency (or the demand for home currency). In operational terms, the demand for and supply of home currency should be equal. In the event of a disequilibrium situation, the monetary authority of the concerned country normally inter-vanes/steps in to bring out the desired balance by:

- variation in the exchange rate or
- changes in official reserves or
- both

Features

The following are the features of foreign exchange market are :

1. Over the Counter Market

It does not denote a particular place or floor where dealers assemble and transact foreign currencies. Rather, it is a network of banks, brokers and dealers spread across the various financial centres of the world. The market relies more on communication network and that is why transactions are based normally on spoken and followed by written communication.

2. Dealing Room

All the professionals who deal in currencies, options, futures and swaps assemble in a dealing room. This is a forum where all transactions related to foreign exchange are carried out. It facilitates instant access to the entire information and communication.

Major agencies which participate in the market communicate between themselves through a network of telephones, faxes and other means of communications supplied by Routers, Telerate, Bloom rang etc. "Dealing 2000", "Electronic Booking System (EBS)", "MINEX" act are popular these days.

3. Round-the-Clock Market

The world wide forex market is a 24-hour market. It is open virtually 24 hours a day, at least one of the financial markets of the world. When New York market closes at 3.00 PM. The Los Angeles market remains open as the corresponding time there is 12.00 PM.

When the Los Angeles market closes, it is the opening time at Sidney and Tokyo. When Tokyo closes, the Hong Kong market is still open as it would be only 2.00 PM there. At the time of the Hong Kong market closing, the Singapore market can be accessed, as it being only 1.00 PM.

Before the closing of Singapore market, the Bahrain market opens. The closing time of the Bahrain market finds both Frankfurt and Zurich markets open, it being only 12.00 PM. there. London market being one hour behind these two, it remains open even after these two markets close down. Again, before the London market closes down, it is the opening time at New York market.

4. Largest Financial Market

The foreign exchange market is by far the largest financial market in the world. A recent estimate placed the average foreign exchange trading volume at $1300 billion in 2000, daily increased from over $650 million in 1990. The average daily foreign exchange trading transactions are increasing at a growing rate with the advent of globalization of the activities around the world.

5. Volume of Transactions

Over the years, there has been a sizable growth in foreign exchange operations. This increase may be attributed to every active participation of financial institutions and corporates as they go about trying to manage this exchange rate risk. About five percent of volume traded on market represents the needs of international trade and tourism.

The figure is higher at 10 to 15 percent, pertaining to movement of capital like investment funds. The bulk share of foreign exchange operations comes from commercial banks. More and more exchange operations are concentrated in certain banks such as Citibank, Morgan, Uniondes Banques, Suisses, Barclays and Midlands etc.

6. High Volatility

Foreign exchange market is one of the most volatile markets in the world. Exchange rates fluctuate once in every four seconds. This volatility is due to the influence of demand and supply forces in the market and has attracted speculators and arbitrators to take part in the forex market.

Q10. Explain the functions of foreign exchange market.

Ans :

(i) It helps in transfer of purchasing power due to international trade and capital transactions include those parties living in countries with different national currencies.

(ii) It facilitates parties to deal in a foreign currency.

(iii) The foreign exchange market is a source of credit for maintaining inventory.

(iv) The foreign exchange market helps in providing "hedging" facilities related to transferring of foreign exchange risk to other person who can handle risk.

(v) It provides specialized instruments like banker's acceptances, letter of credit and are available to finance foreign trade.

Q11. Explain the advantages and disadvantages of foreign exchange market.

Ans : **(Imp.)**

Advantages

- The forex market is extremely liquid, hence its rapidly growing popularity. Currencies may be converted when bought or sold without causing too much movement in the price and keeping losses to a minimum.
- As there is no central bank, trading can take place anywhere in the world and operates on a 24-hour basis apart from weekends.
- An investor needs only small amounts of capital compared with other investments. Forex trading is outstanding in this regard.
- It is an unregulated market, meaning that there is no trade commission overseeing transactions and there are no restrictions on trade.
- In common with futures, forex is traded using a "good faith deposit" rather than a loan. The interest rate spread is an attractive advantage.

Disadvantages

- The major risk is that one counterparty fails to deliver the currency involved in a very large transaction. In theory at least, such a failure could bring ruin to the forex market as a whole.
- Investors need a lot of capital to make good profits because the profit margins on small-scale trades are very low.

Q12. Who are the Major Participants in foreign exchange market?

(OR)

Write a note on various participants in foriegn exchange market.

Ans : **(Imp.)**

The main players in forex market are as follows,

(a) Customers

The customers who are engaged in foreign trade participate in foreign exchange market by availing the services of the agencies undertaking foreign exchange operations. It includes individuals, tourists, importers, exporters, investment managers and corporate treasurers who exchange domestic currency for foreign currency and vice versa.

(b) Commercial Banks

They are most active players in the forex market. Major commercial banks dealing with international transactions offer services for conversion of one currency into another. They have a wide network of branches/ correspondent banks all over the world enabling them to undertake international transactions in an efficient and effective manner.

All the major commercial banks that have been authorized to deal in foreign exchange collectively constitute what is known as "Inter-Bank Market". On account of exchange control regulations, the commercial banks have to conduct their foreign exchange operations as per the local regulatory framework.

(c) Central Banks

The central banks in most of the countries have been charged with the responsibility of maintaining the external value of the currency of the country.

The Central bank has to ensure orderliness in the movement of exchange rates. This is achieved by central bank's intervention in the foreign market.

When the market rate of the currency reaches the upper lines called as "upper intervention point", the central bank of that country must increase the sale of its own currency in exchange for other currencies.

Similarly, the central bank must sell foreign currencies and buy its own currency when the market rate reaches the lower lines called "Lower Intervention Point".

(d) Exchange Brokers

Forex brokers plays a very important role in the foreign exchange markets. However, the extent to which services of forex brokers are utilized depends on the tradition and practice prevailing at a particular forex market centre.

In London, New York and Paris inter-bank transactions are put through forex brokers. Similarly, in India dealing is done in inter-bank market through forex brokers. The forex brokers are not allowed to deal on their own account all over the world as in India.

(e) Speculators

Central banks, commercial banks, corporates and individuals who undertake activity of buying and selling of foreign currencies for booking short-term profits by taking advantage of exchange rate movements are known as speculators. They play a very important and active role in the foreign exchange markets. In fact, a major junk of foreign exchange dealings in the market is due to speculative activities.

(f) Commercial companies

An important part of this market comes from the financial activities of companies seeking foreign exchange to pay for goods or services. Commercial companies often trade fairly small amounts compared to those of banks or speculators, and their trades often have little short term impact on market rates. Nevertheless, trade flows are an important factor in the long-term direction of a currency's exchange rate. Some multinational companies can have an unpredictable impact when very large positions are covered due to exposures that are not widely known by other market participants.

(g) Foreign Fixing

Forex fixing is the daily monetary exchange rate fixed by the national bank of each country. The idea is that central banks use the fixing time and exchange rate to evaluate behavior of their currency. Fixing exchange rates reflects the real value of equilibrium in the forex market. Banks, dealers and online foreign exchange traders use fixing rates as a trend indicator.

Again, the participants may be grouped also according to their motive and behaviour in their foreign exchange transactions as follows:

- Non-banking entities which simply exchange currencies to honour their obligations or to get the desired currency.
- Non-banking entities such as traders that use the foreign exchange market for the purpose of hedging their foreign exchange exposure on account of changes in the exchange rate.
- Banks which exchange currencies on behalf of their customers. In such cases, their profit is limited to the amount of spread between the bid and the ask rates.
- Arbitrageurs who change currencies because of varying rates of exchange in different markets. The varying rates are the source of their profit.
- Speculators who buy or sell currencies when they expect movement in the exchange rate in a particular direction. They make their profit from movement of exchange rate in the desired direction.

Q13. Explain the structure of foreign exchange market.

Ans :

The following figure depicts the structure of foreign exchange markets,

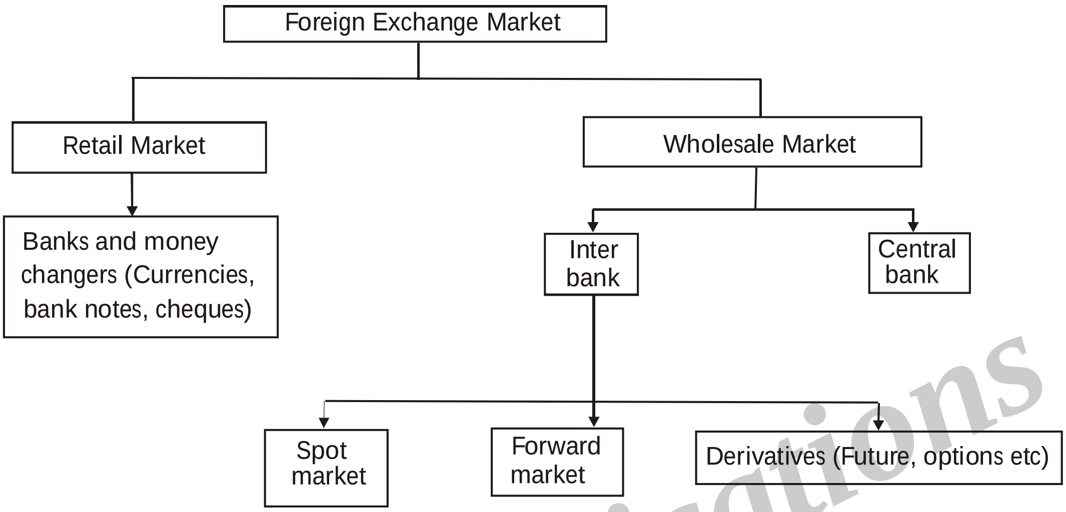


Figure: Structure of Foreign Exchange Market

1. Retail Market

The transactions in the retail market are exchange of currency, bank draft, bank notes, ordinary and er's cheques etc.

2. Wholesale Markets

In case of wholesale market, regional offices and head offices of major commercial banks are the markets. Wholesale market is broadly classified into inter-bank and central bank.

(a) Inter-bank

In inter-bank market, banks trade in currencies. Banks transfer deposits from sellers to buyers accounts. Compared to bank notes market, inter-bank market is much wider. Inter-bank market is sub divided into spot market, forward market and derivatives.

(i) Spot Market

Spot market includes transactions involving sale and purchase of currencies for immediate delivery at a rate existing on the day of transaction which is known as spot rate.

(ii) Forward Market

In forward market, the transactions are settled on a future date as specified in the contract. The rate of exchange for the transaction is agreed up on the very day the deal is finalized and is known as forward rate.

(iii) Derivatives

A derivative is a financial contract or an instrument value. Derivatives are subdivided into,

➢ **Future Market**

It is localized exchange where derivatives instruments called future are traded with currency as its underlying financial instrument.

➢ **Option Market**

In this market, option is traded which gives choice to a foreign exchange market operator to buy or sell a foreign currency on or up to a date at a specified rate.

➢ **Swap Market**

In this market, the instrument called as "swaps" are traded.

(b) Central Banks

The central banks in most of the countries have been charged with the responsibility of maintaining the external value of the currency of the country.

The central banks normally enter the market to smoothen the fluctuations in the exchange rate or to maintain fixed exchange rates.

3.3 Interpretation of Exchange Rates Theories

Q14. Define Exchange Rate. What are the different factors influencing Exchange Rates.

Ans : **(Imp.)**

Meaning

The exchange rate refers to the price of currency in one country in terms of currency of another country. Exchange rates are affected by changes in product prices and interest rates. They are essential for business organizations, governments and individuals.

In case of goods or services, the price of currency is affected by the demand for and supply of the currency. Hence, any change in supply and demand forces leads to changes in exchange rate. Equilibrium exchange rate is indicated at a point where demand and supply intersect.

Factors Influencing Exchange Rates

The various factors that affect the exchange rates are as follows,

1. Terms and the Amount of Trade

The terms of trade and the amount of trade have an influence on the exchange rates. This can be explained with the help of the following diagram.

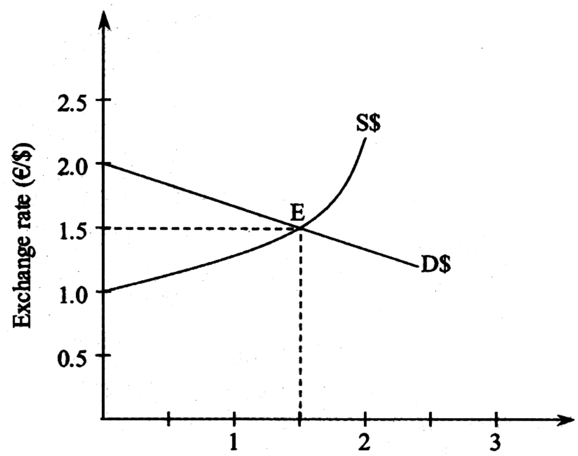


Fig.: Supply of and Demand for Euros (Billions/Year)

In the above diagram the demand and supply curve helps in determining the exchange rate equal to the value of exports and imports. The point E at which the demand and supply are equal is the equilibrium exchange rate. In the above case the equilibrium exchange rate is 1.5/$. An exogenous increase in the value of exports shifts the demand curve for dollars. The sloping of the demand curve towards right leads to increase in the value of dollar. An increase in price of oil could lead to such increase in the value of exports. On the other hand, an exogenous increase in the value of imports shifts the supply curve for dollars. The sloping of the supply curve towards right leads to decrease in the value of the dollar. An increase in the price of wheat being imported could lead to such an increase in value of imports.

The relation between country's exports and country's imports is known as the country's terms of trade. Increase in the price of exports with relation to price of imports indicate an improvement in the country's terms of trade and vice versa.

2. Inflation

The relation between the imports and exports of different products of a country is called terms-of-trade. The inflation also affects the exchange rates. Inflation is the relation between import and export of similar products of a country. The import demand curve and export supply curve help in understanding the inflation effects.

3. Service Trade, Income Flows and Transfers

The import and export of services like banking, consulting, tourism, etc., also have an influence on the exchange rates. These imports and exports have a similar affect as that of export and imports of goods. Under this the currency demand curve represents the export of services and the currency supply curve represents the import of services.

When the amount of exports of services exceeds the amount of imports of services, the demand curve shifts to the right, thus resulting in increase in the exchange rate. Whereas, excess in the amount of imports of services over the amount of export of services results in decrease in the exchange rate.

4. Foreign Investment

The demand for the country's currency is represented by the amount of foreign investment in the country. The demand curve of the country's currency shifts to the right when a foreign investment is made irrespective of it either being a direct or portfolio investment or an increase in the bank deposits of non-residents. It results in increase in the exchange rate. Likewise, a resident's investment abroad results in supply of country's currency, thus shifting the currency supply curve to the right and decreasing the exchange rate.

Q15. Explain the determination of exchange rates.

Ans :

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

The demand function for foreign exchange shows functional relationship between alternative rate of exchange and the corresponding amount of foreign exchange demanded. When the rate of exchange is low, the demand for foreign exchange tends to be high because there will be high inclination to import.

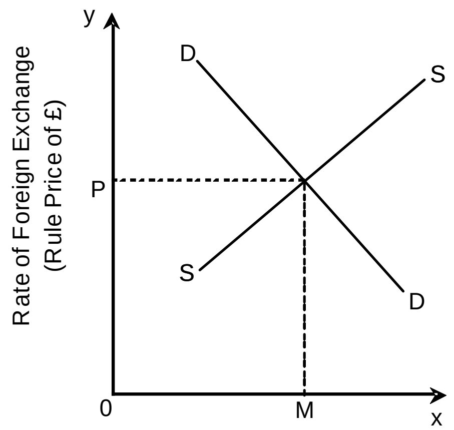


Fig. : Demand and supply of Foreign Exchange (£)

The supply function of foreign exchange represents the functional relationship between the rate of exchange and the amount of foreign exchange supplied. When the rate of exchange is high, more foreign exchange is supplied as there will be more export due to high foreign demand. Equilibrium rate of exchange is determined at a point where demand for foreign exchange equals its supply.

From above Figure, OP is the rate of exchange determined at which OM is the demand as well as supply of foreign exchange. Any variation in demand or supply will lead to a variation in the rate of exchange.

Q16. Write about various quotations of foreign exchange transactions.

Ans : **(Imp.)**

A foreign exchange quotation is also called as foreign exchange quote refers to a statement of willingness for buying or selling of currency at a given price and time. It refers to the price of one currency being expressed in another.

Generally, foreign exchange quotations are expressed as domestic currency price paid for a foreign currency. Some times, compared with many foreign currencies. Since it is not followed globally a standardized system of quoting introduced by inter-banking markets.

i) Inter-bank Quotations

Inter-bank quote is the quote given by one bank to another bank. In foreign exchange transactions, U.S dollar is widely used currency.

There are two ways of stating foreign exchange quotations. They are,

1. Foreign currency price of one dollar (European quote).
2. Dollar price of a unit of foreign currency (American quote).

In the world, mostly foreign currencies are expressed in units of their currency to buy one dollar.

For example, exchange rate between U.S dollar and Swiss Franc is S.F 1.600/$ read as "1.6000 Swiss Francs per dollar.

Which means 1.6000 Swiss francs is paid to buy one U.S dollar. This is expressed in European terms, since foreign currency termed as of one U.S dollar.

The second method which is expressed as $0.6250/ SF, read as $0.6250 dollars per Swiss Franc which means 0.6250 U.S dollars paid to get one Swiss Franc. This is called American terms, since U.S dollar expressed as one unit of foreign currency.

Inter-bank quotations are mostly expressed in European terms.

Even though Japanese terms and Asian terms are used but European terms is popular and used world wide since 1978. This is also the year when telecommunications were introduced in trading.

ii) Direct and Indirect Quotations

Taking home or foreign currencies as base, quotations are divided into two types. They are,

(a) Direct quotation

(b) Indirect quotation.

(a) Direct Quotation: A direct quote is the quote where the exchange rate is expressed in terms of number of units of the domestic currency per unit of foreign currency.

Direct quote refers to unit of domestic currency of a foreign currency. For example, inter-bank foreign exchange quotation "SF 1.6000/$".

In terms of Switzerland it is a direct quotation and for United States it is an indirect quotation.

(b) Indirect Quotation: An indirect quote is where the exchange rate is expressed in terms of number of units of the foreign currency for a fixed number of units of a domestic currency.

Indirect quote refers to a unit of foreign currency of domestic currency.

Consider the given example, but when it is converted as "$0.6250/SF" in terms of United States, it is a direct quote and for Switzerland it is an indirect quote.

The direct quote is called as internal value with regard to domestic currency. Indirect quote is called as internal value with regard to foreign currency.

The assumption which we consider as domestic and foreign currency is the basis for such quotations.

iii) Buying and Selling Rates

There are two rates are one being the buying rate and the other the selling rate. The buying rate is also known as the bid rate. The selling rate is known as the ask rate or offer rate. The bid rate is always given first, followed by the ask rate quote. In other words, the buying rate is the rate at which the banks purchase a foreign currency from the customer. The difference between these two quotes forms the banks' profit and is known as the spread.

Spread = (Ask price – Bid price) / Ask price × 100

The size of spread in respect of a currency depends upon many factors, like its strength, the type of transaction, and its supply and demand position with the transacting bank. The spread is smaller in a widely traded currency because it is easy for the banks to transact in such a currency. In a scarcely traded currency, the banks have to face some difficulty, and hence the spread is large. Again, for individuals and firms, the spread is bigger than for banks. An individual and a firm buy a foreign currency at a higher rate and sell at a rate lower than that quoted in the newspapers, although in big transactions, they get some relief. Similarly, if the bank is temporarily short of a foreign currency, the spread will be larger particularly if the demand for that foreign currency is high. On the contrary, if the supply position of that foreign currency is comfortable, the spread will be lower.

iv) Forward Quotations Expressed on Point Basis

Generally, quotations which are expressed in terms of points are always forward rates.

On the basis of period of maturity terms of points it is also called as cash rates and swap rates.

In a quotation last digit is referred as point, generally right digit of a decimal point. For U.S. dollars, four decimal points are considered. For Japanese Yen only two.

Generally, 0.0001 is a point for other currencies.

Forward quotation is the difference between forward rate and spot rate, but not foreign exchange rate.

Forward bid and ask quotations for more than two years are called swap rates.

Borrowing for short term in one currency and lending another currency for same period is swap.

v) Forward Quotations Expressed in Percentages

Forward quotations not only expressed as points but also in percentages, taking spot rate as deviation. This is helpful is comparison of forward market discounts and premiums which differ in interest rates.

When these percentages take domestic currencies and foreign currencies as basis, they are expressed as,

vi) Forward Quotations in Foreign Currency

In indirect quote, percentages can be calculated as,

$$f¥ = \frac{\text{Spot rate} - \text{Forward rate}}{\text{Forward rate}} \times \frac{360}{n} \times 100$$

Where,

n = Period of contract generally expressed in days.

Example

Foreign currency with respect to home currency spot rate is ¥105.65/$ and four month forward rate is ¥105.04/$.

Sol :

$$f¥ = \frac{\text{Spot rate} - \text{Forward rate}}{\text{Forward rate}} \times \frac{360}{n} \times 100$$

$$\text{Thus, } f¥ = \frac{105.65 - 105.04}{105.04} \times \frac{360}{120} \times 100$$

$$= +1.742\% \text{ per annum}$$

Note

Since it is four months contract, so here n = 120 days.

Since, there is a premium of 1.742% per annum by yen over dollar '+' sign is used.

vii) Forward Quotations in Domestic Currency

In direct quotes percentages can be calculated as,

$$f¥ = \frac{\text{Forward rate} - \text{Spot rate}}{\text{Spot rate}} \times \frac{360}{n} \times 100$$

Example

Consider spot rate of home currency expressed in foreign currency, spot rate \$0.009465215/¥

Sol :

4 months forward rate is \$0.009520183/¥

$$f\,¥ = \frac{\text{Forward rate} - \text{Spot rate}}{\text{Spot rate}} \times \frac{360}{n} \times 100$$

$$f\,¥ = \frac{0.009520183 - 0.009465215}{0.009465215} \times \frac{360}{n} \times 100$$

$$= +1.742\% \text{ per annum}$$

Forward Yen has 1.742% premium over the dollar.

Routers, PLC and websites of related countries central bank are considered as sources for foreign exchange quotations quoted world wide in newspapers, online information is also available.

In India, Reserve Bank of India, Central Bank of India and Foreign Exchange Dealer's Association of India (FEDAI) quotes U.S.dollars, sterling pound, euro and Japanese yen as spread and forward and spot information. There are called reference rates.

viii) Cross Rates

Sometimes the value of a currency in terms of another one is not known, directly. In such cases, one currency is sold for a common currency; and again, the common currency is exchanged for the desired currency. This is known as cross rate trained and the rate established between the two currencies is known as the cross rate. The techniques is similar for both spot and forward cross rates.

3.3.1 Purchasing Power Parity

Q17. Explain the Purchasing Power Parity (PPP) Theory.

Ans :

This is a commodity based theory. It attempts to quantify the inflation–exchange rate relationship. It states that there exists a link between the prices in two countries and the exchange rates between the currencies of these countries. For example, the relatively high U.S. inflation causes the U.S. consumers to increase imports from the United Kingdom and British consumers are ought to lower their demand for U.S. goods. Such forces place upward pressure on the British pound's value. The shifting in consumption from the United States to the United Kingdom will continue until the British pound's value has appreciated to the extent that (1) the prices paid for British goods by U.S. consumers are no

lower than the prices for comparable products made in the United States and (2)the prices paid for U.S. goods by British consumers are not higher than the prices for comparable products made in the United Kingdom.

According to PPP, the foreign currency will adjust as follows:

$$e_f = \frac{1+I_b}{1+I_f} - 1$$

Simplified but less precise relationship based on PPP is

$$e_f \cong I_b - I_f$$

Here ef is the percentage change, Ih is the interest rate on the home deposit and If is the interest rate on foreign deposit.

Even though exchange rates deviate from the levels predicted by PPP in the short run, their deviations are reduced over the long run.

Assumptions

The assumptions of law of one price are:

1. **Movement of Goods**

   The law of one price assumes that there is no restriction on the movement of goods between countries i.e. it is possible to buy goods in one market and sell them in another. This implies that there are no restrictions on international trade, either in the form of a ban on exports or imports or in the form of quotas.

2. **No Transportation Costs**

   The law of one price will be perfect if there will be no transportation costs involved, though there are some transactions which bypass this assumption.

3. **No Transaction Costs**

   This law assumes that there are no transaction costs involved in the buying and selling goods.

4. **No Tariffs**

   The existence of tariffs distorts the law of one price which requires their absence to hold perfectly.

3.3.2 International Fisher Effect

Q18. Explain briefly about international fisher effect.

Asn :

The international Fisher effect uses interest rates to explain why exchange rates change over time, but it is closely related to the PPP theory because interest rates are often highly correlated with inflation rates. If investors of all countries require the same real return, interest rate differentials between countries may be the result of differentials in expected inflation. The IFE theory suggests that foreign currencies with relatively high interest rates will depreciate because the high nominal interest rates reflect expected inflation. The foreign investors will be adversely affected by the effects of a relatively high U.S. inflation rate if they try to capitalize on the high U.S. interest rates. The IFE theory can be applied to any exchange rate, even exchange rates that involve two non-U.S. currencies. According to the IFE, the effective return on a foreign investment should, on average be equal to the interest rate on a local money market investment:

$$E(r) = i_h$$

where r is the effective return on the foreign deposit and i. is the interest rate on the home deposit.

We can also determine the degree by which the foreign currency must change in order to make investments in both countries generate similar returns by the formula:

$$e_f = \frac{I + i_h}{I + i_f} - 1$$

The IFE theory contends that when $i_h > i_f$, e_f will be positive because the relatively low foreign interest rate reflects relatively low inflationary expectations in the foreign country. That is, the foreign currency will appreciate when the foreign interest rate is lower than the home interest rate. This appreciation will improve the foreign return to investors from the home country, making returns on foreign securities similar to returns on home securities.

3.3.3 Interest Rate Parity

Q19. Explain briefly about interest rate parity.

Ans :

The IRP Theory indicates the existence of a link between the nominal interest rates in two countries and exchange rate between their currencies. It follows certain assumptions as under:

1. The transaction costs related to conversion of a currency in to another selling (or) buying of a financial security are zero.

2. The cash flow between different countries is free and there is full mobility of capital.

3. An investor may choose to invest in financial securities, denominated in one's home currency or to invest in financial securities that are denominated in foreign currency.

Understanding forward rates is fundamental to IRP as it pertains to arbitrage.

For example, if the spot rate for 1 USD= 1.065 Canadian Dollars, the forward rate could be computed as follows :

1USD=1.065*[(1+3.64%)/ (1+3.15%)]= 1.0700 CAD

Here,

(1USD = forward rate, 1.065 = spot rate, 3.64% = interest rate of overseas country and 3.15 = interest rate of domestic country.)

The difference between spot rate and forward rate is known as swap points. Here the swap points equal to 50. If the difference is positive, it is called forward premium; a negative difference results in a forward discount.However, the implications of the theory are as below;?

- When domestic interest rate is below foreign interest rates, the foreigncurrency must trade at a forward discount.
- If a foreign currency does not have a forward discount or when the forward discount is not large enough to offset the interest rate advantage, arbitrage opportunity is available for the domestic investors.
- When domestic rates exceed foreign interest rates, the foreign currencymust trade at a forward premium.
- When the foreign currency does not have a forward premium or when theforward premium is not large enough to nullify the domestic country advantage,an arbitrage opportunity will be available for the foreign investors.

3.4 Currency Convertibility and the Strength of the Rupee

Q20. What is Currency Convertibility? Explain about Convertibility of Indian Rupee.

Ans :

Meaning

India is a fast developing country and one of the most preferred countries for investment by foreigners. India could not restrict its foreign trade as It needs to grow further. So government has allowed convertibility of rupee in phased manner on current account transactions. But full convertibility of currency for capital account transactions is still a distant dream. Convertibility of currency means when currency of a country can be freely converted into foreign exchange at market determined rate of exchange that is, exchange rate as determined by demand for and supply of a currency.

For example, convertibility of rupee means that those who have foreign exchange (e.g. US dollars, Pound Sterlings etc.) can get them converted into rupees and vice-versa at the market determined rate of exchange. Rupee is both convertible on capital account and current account.

By capital account convertibility we mean that in respect of capital flows (that is, flows of portfolio capital, direct investment flows, flows of borrowed funds and dividends and interest payable on them) a currency is freely convertible into foreign exchange and vice versa at market determined exchange rate. Current Account Convertibility of rupee Current account convertibility means when foreign exchange (e.g. Pound Sterling, U.S.Dollar etc) received for export of merchandise and services can be freely converted into Indian rupees and vice-versa in case of imports. In the seventies and eighties, many countries switched over to the free convertibility of their currencies into foreign exchange. By 1990, 70 countries of the world had introduced currency convertibility on current account and another 10 countries joined them in 1991.

As a part of new economic reforms initiated in 1991, India also joined the regime and made rupee partly convertible from March 1992 under the "Liberalized Exchange Rate Management scheme".

In this scheme, 60 per cent of all receipts on current account (i.e., merchandise exports and invisible receipts) could be converted freely into rupees at market determined exchange rate quoted by authorised dealers while 40 per cent of them were to be surrendered to Reserve Bank of India at the officially fixed exchange rate. These 40 per cent exchange receipts on current account was meant for meeting Government needs for foreign exchange and for financing imports of essential commodities.

Thus, partial convertibility of rupee on current account meant a dual exchange rate system. Further, full convertibility of rupees at that stage was considered to be risky in view of large deficit in balance of payments on current account. As even after partial convertibility of rupee foreign exchange value of rupee remained stable, this laid down a base for the full convertibility on current account.

Hence, from March 1993, rupee was made convertible for all trade in merchandise. In March' 1994, even indivisibles and remittances from abroad were allowed to be freely convertible into rupees at market determined exchange rate. But this does not mean that one can get any amount of foreign exchange for meeting one's needs e.g. one cannot convert his savings in the country for investment in foreign exchange as could be done by citizens of developed countries like U.K. and USA. However, on capital account rupee remained non-convertible.

Advantages

1. Encouragement to exports

Market rate remains generally higher than the officially determined exchange rate. This implies that from given exports, exporter can get more rupee against foreign exchange. This will help to increase exports.

2. Encourages import substitution

Imports become expensive due to convertibility of rupee. So it discourages imports and boosts import substitution.

3. Incentive to remittances from abroad

Earlier, NRIs used to send money illegally to India such as Hawala money and gold etc. But due to removal of restrictions, NRIs can easily remit money to India. It will help to improve Balance of payment.

4. Reduction in Malpractices

The malpractices like under-invoicing of exports may not arise as rupee is fully convertible and they will get full value for their exports.

5. A self – balancing mechanism

Another important merit of currency convertibility lies in its self-balancing mechanism. When balance of payments is in deficit due to over-valued exchange rate, under currency convertibility, the currency of the country depreciates which gives boost to exports by lowering their prices on the one hand and discourages imports by raising their prices on the other.

In this way, deficit in balance of payments get automatically corrected without intervention by the Government or its Central bank. The opposite happens when balance of payments is in surplus due to the under-valued exchange rate.

Q21. Define capital account convertibility. State its merits and demerits.

Ans :

Meaning

Capital Account Convertibility (CAC) is the freedom to convert local financial assets into foreign financial assets at market determined exchange rates. Referred to as 'Capital Asset Liberation' in foreign countries, it implies free exchangeability of currency at lower rates and an unrestricted mobility of capital.

India, at present has partial capital account convertibility. In India there are conflicting views regarding whether to move towards full convertibility of capital account or not. At present, there are limits on investment by foreign financial investors and also caps on FDI ceiling in most sectors, for example, 74% in banking and communication, 49% in insurance, 0% in retail, etc.

Merits

1. **Unrestricted mobility of Capital:** Capital account convertibility allows free mobility of Capital into a country from the foreign investors. It allows converting the foreign exchange brought into as Capital to convert into rupees at market determined rates, which makes the investors encouraging. It allows the foreign investors to easily move in and move out from an economy. This enables the domestic companies to raise funds from abroad.

2. **Ability to invest in abroad easily:** Capital account convertibility allows the individuals of a nation to invest in abroad by easily converting their rupees into foreign exchange at the rates determined by the Market. This enables those potential domestic investors to acquire & own the assets in abroad.

3. **Improved access to global financial markets:** One can easily invest in the equity and debt markets of another economies alongside a reduction in the cost of capital

Demerits

1. **Easier access to Hawala money:** As it allows converting any foreign receipt into Indian rupees at market determined rates there may be chance that domestic economy will be flooded with foreign exchange which in long run may damage the financial health of an economy.

2. **High volatility of markets:** During the times when the financial markets of an economy are doing good, a country may receive huge foreign investment. But during the adverse times the reverse scenario may happen. For example when the federal reserve Bank of America gave a sign that they are going increase the interest rates the foreign Institutional investors who invested their dollars in Indian stock market had withdrawn their investment from India which adversely impacted the rupee value.

3.5 Financial or Speculative, Price Risk and Exchange Rate

Q22. Define the following terms :

(i) Financial Risk

(ii) Speculative Risk

(iii) Price Risk

(iv) Exchange Rate Risk

Ans :

(i) Financial Risk

Financial risk is one of the high-priority risk types for every business. Financial risk is caused due to market movements and market movements can include a host of factors. Based on this, financial risk can be classified into various types such as Market Risk, Credit Risk, Liquidity Risk, Operational Risk, and Legal Risk.

(a) **Market Risk:** This type of risk arises due to the movement in prices of financial instrument. Market risk can be classified as Directional Risk and Non-Directional Risk. Directional risk is caused due to movement in stock price, interest rates and more. Non-Directional risk, on the other hand, can be volatility risks.

(b) **Credit Risk:** This type of risk arises when one fails to fulfill their obligations towards their counter parties. Credit risk can be classified into Sovereign Risk and Settlement Risk. Sovereign risk usually arises due to difficult foreign exchange policies. Settlement risk, on the other hand, arises when one party makes the payment while the other party fails to fulfill the obligations.

(c) **Liquidity Risk:** This type of risk arises out of an inability to execute transactions. Liquidity risk can be classified into Asset Liquidity Risk and Funding Liquidity Risk. Asset Liquidity risk arises either due to insufficient buyers or insufficient sellers against sell orders and buys orders respectively.

(d) **Operational Risk:** This type of risk arises out of operational failures such as mismanagement or technical failures. Operational risk can be classified into Fraud Risk and Model Risk. Fraud risk arises due to the lack of controls and Model risk arises due to incorrect model application.

(e) **Legal Risk:** This type of financial risk arises out of legal constraints such as lawsuits. Whenever a company needs to face financial losses out of legal proceedings, it is a legal risk.

(ii) Speculative Risk

Speculative risk is a risk category, which results in an uncertain degree of gain or loss when undertaken. All theoretical risks are made as deliberate decisions and are not merely the product of uncontrollable circumstances. The speculative risk is the contrast of pure risk (the possibility of a failure only and no gain potential) because there is some chance of a gain or a loss.

(iii) Price Risk

Price risk is the risk of a decline in the value of a security or an investment portfolio excluding a downturn in the market, due to multiple factors. Investors can employ a number of tools and techniques to hedge price risk, ranging from relatively conservative decisions (e.g., buying put options) to more aggressive strategies

(iv) Exchange Rate Risk

Foreign exchange risk describes the risk that an investment's value may change due to changes in the value of two different currencies. It is also known as currency risk, FX risk and exchange-rate risk. Foreign exchange risk sometimes also refers to risk an investor faces when they need to close out a long or short position in a foreign currency and do so at a loss due to fluctuations in exchange rates.

Exchange-rate risk, also called currency risk, is the risk that changes in the relative value of certain currencies will reduce the value of investments denominated in a foreign currency.

When investing in foreign countries, it's important to consider the fact that currency exchange rates can change the price of the asset as well. Foreign exchange risk (or exchange rate risk) applies to all financial instruments that are in a currency other than your domestic currency.

Example : If you live in the U.S. and invest in a Canadian stock in Canadian dollars, even if the share value appreciates, you may lose money if the Canadian dollar depreciates in relation to the U.S. dollar.

Exchange rate risk is the possibility that changes in currency exchange rates may affect the value of assets or financial transactions. It is common for exchange rates to be reasonably volatile as they are impacted by a broad range of political and economic events.

3.6 Financial Instruments Like Derivatives

Q23. What is Derivative?

(OR)

Define Derivative.

Ans :

Meaning

The term "Derivative" indicates that it has no independent value, i.e., its value is entirely derived from the value of the underlying asset. The underlying asset can be securities, commodities, bullion, currency, livestock or anything else. In other words, derivative means forward, futures, option or any other hybrid contract of predetermined fixed duration, linked for the purpose of contract fulfillment to the value of a specified real or financial asset or to an index of securities.

The Securities Contracts (Regulation) Act 1956 defines "derivative" as under :

"Derivative" includes

(i) Security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.

(ii) A contract which derives its value from the prices, or index of prices of underlying securities.

The above definition conveys that

- The derivatives are financial products.
- Derivative is derived from another financial instrument/contract called the underlying. In the case of Nifty futures, Nifty index is the underlying. A derivative derives its value from the underlying assets. Accounting Standard SFAS133 defines a derivative as, 'a derivative instrument is a financial derivative or other contract with all three of the following characteristics.
- one or more underlyings, and (2) one or more notional amount or payments provisions or both. Those terms determine the amount of the settlement or settlements.
- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors.

Q24. Explain the different types of financial derivatives along with their features in brief.

(OR)

Explain the types of financial derivatives.

Ans : **(Imp.)**

In simple form, the derivatives can be classified into different categories which are shown in the Fig,

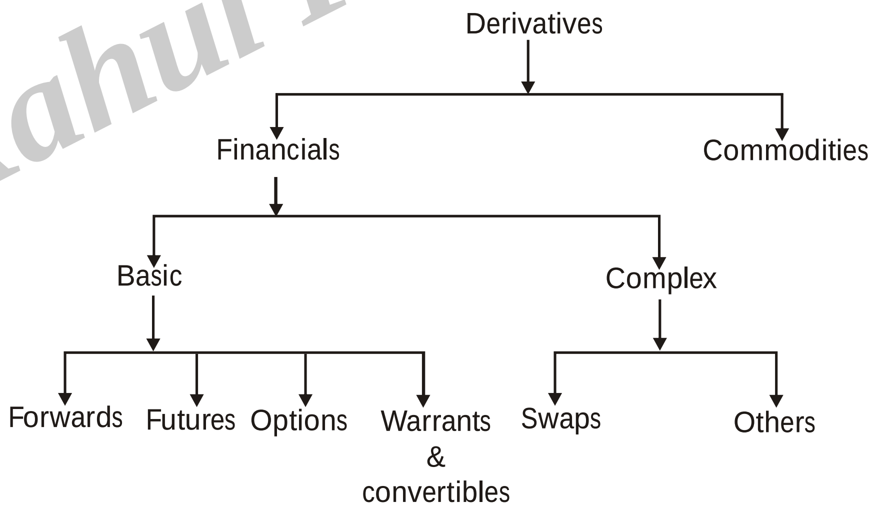


Fig.: Classification of Derivatives

One form of classification of derivative instruments is between commodity derivatives and financial derivatives. The basic difference between these is the nature of the underlying instrument or asset. In a commodity derivatives, the underlying instrument is a commodity which may be wheat, cotton, pepper, sugar, jute, turmeric, corn, soyabeans, crude oil, natural gas, gold, silver, copper and so on. In a financial derivative, the underlying instrument may be treasury bills, stocks, bonds, foreign exchange, stock index, gilt-edged securities, cost of living index, etc. It is to be noted that financial derivative is fairly standard

(I) Basic Financial Derivatives

1. Forward contracts

A forward contract is a simple customized contract between two parties to buy or sell an asset at a certain time in the future for a certain price. Unlike future contracts, they are not traded on an exchange, rather traded in the over-the-counter market, usually between two financial institutions or between a financial institution and one of its client.

The basic features of a forward contract are given in brief here as under:

Features

(i) Forward contracts are bilateral contracts, and hence, they are exposed to counter-party risk. There is risk of non-performance of obligation either of the parties, so these are riskier than to futures contracts.

(ii) Each contract is custom designed, and hence, is unique in terms of contract size, expiration date, the asset type, quality, etc.

(iii) In forward contract, one of the parties takes a long position by agreeing to buy the asset at a certain specified future date. The other party assumes a short position by agreeing to sell the same asset at the same date for the same specified price. A party with no obligation offsetting the forward contract is said to have an open position. A party with a closed position is, sometimes, called a hedger.

(iv) The specified price in a forward contract is referred to as the delivery price. The forward price for a particular forward contract at a particular time is the delivery price that would apply if the contract were entered into at that time. It is important to differentiate between the forward price and the delivery price. Both are equal at the time the contract is entered into. However, as time passes, the forward price is likely to change whereas the delivery price remains the same.

(v) In the forward contract, derivative assets can often be contracted from the combination of under-lying assets, such assets are oftenly known as synthetic assets in the forward market.

(vi) In the forward market, the contract has to be settled by delivery of the asset on expiration date. In case the party wishes to reverse the contract, it has to compulsory go to the same counter party, which may dominate and command the price it wants as being in a monopoly situation.

(vii) In the forward contract, covered parity or cost-of-carry relations are relation between the prices of forward and underlying assets. Such relations further assist in determining the arbitrage-based forward asset prices.

2. Futures

Like a forward contract, a futures contract is an agreement between two parties to buy or sell a specified quantity of an asset at a specified price and at a specified time and place. Futures contracts are normally traded on an exchange which sets the certain standardized norms for trading in the futures contracts.

Features

The futures contracts have following features in brief :

(i) Standardization

One of the most important features of futures contract is that the contract has certain standardized specification, i.e., quantity of the asset, quality of the asset, the date and month of delivery, the units of price quotation, location of settlement, etc.

For example, the largest exchange on which futures contracts are traded are the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME). They specify about each term of the futures contract.

(ii) Clearing house

In the futures contract, the exchange clearing house is an adjunct of the exchange and acts as an intermediary or middleman in futures. It gives the guarantee for the performance of the parties to each transaction. The clearing house has a number of members all of which have offices near to the clearing house. Thus, the clearing house is the counter party to every contract.

(iii) Settlement price

Since the futures contracts are performed through a particular exchange, so at the close of the day of trading, each contract is marked-to-market. For this the exchange establishes a settlement price. This settlement price is used to compute the profit or loss on each contract for that day. Accordingly, the members accounts are credited or debited.

(iv) Daily settlement and margin

Another feature of a futures contract is that when a person enters into a contract, he is required to deposit funds with the broker, which is called as margin. The exchange usually sets the minimum margin required for different assets, but the broker can set higher margin limits for his clients which depend upon the credit-worthiness of the clients. The basic objective of the margin account is to act as collateral security in order to minimize the risk of failure by either party in the futures contract.

(v) Tick size

The futures prices are expressed in currency units, with a minimum price movement called a tick size. This means that the futures prices must be rounded to the nearest tick. The difference between a futures price and the cash price of that asset is known as the basis. The details of this mechanism will be discussed in the forthcoming chapters.

(v) Cash settlement

Most of the futures contracts are settled in cash by having the short or long to make a cash payment on the difference between the futures price at which the contract was entered and the cash price at expiration date. This is done because it is inconvenient or impossible to deliver some-times, the underlying asset. This type of settlement is very much popular in stock indices futures contracts.

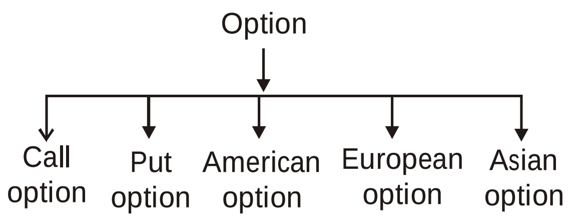
(vii) Delivery

The futures contracts are executed on the expiry date. The counter parties with a short position are obligated to make delivery to the exchange, whereas the exchange is obligated to make delivery to the longs. The period during which the delivery will be made is set by the exchange which varies from contract to contract.

3. Options contracts

An option is a contract between two parties, i.e., between the buyer and the seller. The option contract gives the option holder (Buyer) the right to buy or sell or enter into transaction with the other party (option seller or writer), but are not in an obligation to do so. The purchase and sale of things are to be done at a future date for a price agreed on a present day, at the time of entering the contract.

The option buyer or buyer gives the seller an amount of money called as price or premium, for which the seller is ready to sell as per the terms of the contract or on the will of the buyer. Basically there are about five types of options



(i) Call Option

A call option is a contract that gives an option or right to the buyer (owner) to purchase an underlying asset at a predetermined and agreed fixed price, on or prior to a specific day. The buyer has a right but not an obligation to buy the asset.

On the other hand, the seller is under an obligation to complete the contract by providing or delivering the underlying asset on the date and time, as agreed between the buyer and the seller. Thus, in a call option the buyer is given the right to buy and seller comes under the obligation to sell the asset.

The price fixed for an option is called as strike price or exercise price and denominated in terms of alphabet.

(ii) Put Option

A put option is a contract that provides the right to sell an underlying asset to the buyer, for a particular price and on a specified date. Here the buyer is under an obligation to purchase the asset and the owner has the right to sell the asset.

(iii) American Option

In American option the holder of the instrument can exercise the option at any time (on or before the date of maturity).

(iv) European Option

In European option the owner can exercise the option only at the time of expiration of the contract.

(v) Asian Option

This option is also referred to as an average option. In this option, the return is linked to the average value of the underlying asset, on a particular set of dates, along the life of the contract.

Parties

There are three parties involved in the options contract, the option holder, the option seller and the broker.

(i) Option Buyer/Holder

The option buyer pays a price to the option seller to make him write the option.

(ii) Option Seller

The option seller or writer is an individual who gives an option to the buyer to purchase sell the asset at a price or premium.

(iii) Broker

A broker is a person who deals mostly in securities and acts like an agent to search the buyer and seller and he also receives charges, fees in the form of brokerage commission.

4. Warrants and convertibles

Warrants and convertibles are another important categories of financial derivatives, which are frequently traded in the market.

- Warrant is just like an option contract where the holder has the right to buy shares shares of a specified company at a certain price during the given time period. In other words, the holder of a warrant instrument has the right to purchase a specific number of shares at a fixed price in a fixed period from a issuing company.
- If the holder exercised the right, it increases the number of shares of the issuing company, and thus, dilutes the equities of its shareholders. Warrants are usually issued as sweeteners attached to senior securities like bonds and debentures so that they are successful in their equity issues in terms of volume and price.
- Warrants can be detached and traded separately. Warrants are highly speculative and leverage instruments, so trading in them must be done cautiously.
- Convertibles are hybrid securities which combine the basic attributes of fixed interest and variable return securities.
- Most popular among these are convertible bonds, convertible debentures and convert-ible preference shares. These are also called equity derivative securities.

II) Complex Derivatives

1. Swap contracts

A swap is a contract wherein currencies are exchanged between two parties, it is an exchange of payments or cash flows at a future date. It is defined in the following ways.

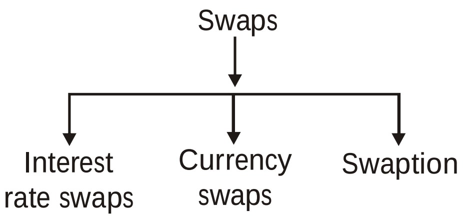
(i) If refers to trading between two parties for the exchange of payments or cash flows.

(ii) It is an agreement between two persons to exchange interest amounts for a specified maturity date and for an agreed price.

(iii) Exchange of one interest payment for another.

For example, fixed or floating interest payments

Types of Swaps



(i) Interest Rate Swaps

If the terms of contract say that only interest payments are to be exchanged and not the principal or base amount, then it is called as interest rate swaps.

(ii) Currency Swaps

Currency swaps refer to an agreement between two parties by exchanging principal and interest amount of one currency with the other currency, for a predetermined period of time. As the exchange takes place between different countries, it is referred to as foreign exchange agreement and is also called as cross currency swap.

(iii) Swaption

A swaption is a contract in which a party acquires an option to enter into a swap agreement. The buyer of the swaption has the right to enter into a swap agreement on the predetermined terms by some specified date in future.

2. Other derivatives

Forwards, futures, options, swaps, etc. are described usually as standard or 'plain vanilla' derivatives. In the early 1980s, some banks and other financial institutions have been very imaginative and designed some new derivatives to meet the specific needs of their clients. These deriva-tives have been described as 'non-standard' derivatives. The basis of the structure of these derivatives was not unique, for example, some non-standard derivatives were formed by combining two or more 'plain vanilla' call and put options whereas some others were far more complex. In fact, there is no boundary for designing the non-standard financial derivatives, and hence, they are sometimes termed as 'exotic options' or just 'exotics'. There are various examples of such non-standard derivatives such as packages, forward start option, compound options, choose options, barrier options, binary options, look back options, shout options, Asian options, basket options, Standard Oil's Bond Issue, Index Currency Option Notes (ICON), range forward contracts or flexible forwards and so on.

Q25. What are the uses of financial derivatives?

(OR)

Explain the uses of financial derivatives.

Ans :

Derivatives are supposed to provide the following services :

1. One of the most important services provided by the derivatives is to control, avoid, shift and manage efficiently different types of risks through various strategies like hedging, arbitraging, spreading, etc. Derivatives assist the holders to shift or modify suitably the risk characteristics of their portfolios. These are specifically useful in highly volatile financial market conditions like erratic trading, highly flexible interest rates, volatile exchange rates and monetary chaos.

2. Derivatives serve as barometers of the future trends in prices which result in the discovery of new prices both on the spot and futures markets. Further, they help in disseminating different information regarding the futures markets trading of various commodities and securities to the society which enable to discover or form suitable or correct or true equilibrium prices in the markets. As a result, they assist in appropriate and superior allocation of resources in the society.

3. As we see that in derivatives trading no immediate full amount of the transaction is required since most of them are based on

margin trading. As a result, large number of traders, speculators arbitrageurs operate in such markets. So, derivatives trading enhance liquidity and reduce trans-action costs in the markets for underlying assets.

4. The derivatives assist the investors, traders and managers of large pools of funds to devise such strategies so that they may make proper asset allocation increase their yields and achieve other investment goals.

5. It has been observed from the derivatives trading in the market that the derivatives have smoothen out price fluctuations, squeeze the price spread, integrate price structure at different points of time and remove gluts and shortages in the markets.

6. The derivatives trading encourage the competitive trading in the markets, different risk taking preference of the market operators like speculators, hedgers, traders, arbitrageurs, etc. resulting in increase in trading volume in the country. They also attract young investors, professionals and other experts who will act as catalysts to the growth of financial markets.

7. Lastly, it is observed that derivatives trading develop the market towards 'complete markets'. Complete market concept refers to that situation where no particular investors be better of than others, or patterns of returns of all additional securities are spanned by the already existing securities in it, or there is no further scope of additional security.

Q26. Explain the importance of Derivatives.

Ans :

1. Hedging risk exposure

Since the value of the derivatives is linked to the value of the underlying asset, the contracts are primarily used for hedging risks. For example, an investor may purchase a derivative contract whose value moves in the opposite direction to the value of an asset the investor owns. In this way, profits in the derivative contract may offset losses in the underlying asset.

2. Underlying asset price determination

Derivates are frequently used to determine

the price of the underlying asset. For example, the spot prices of the futures can serve as an approximation of a commodity price.

3. Market efficiency

It is considered that derivatives increase the efficiency of financial markets. By using derivative contracts, one can replicate the payoff of the assets. Therefore, the prices of the underlying asset and the associated derivative tend to be in equilibrium to avoid arbitrage opportunities.

4. Access to unavailable assets or markets

Derivatives can help organizations get access to otherwise unavailable assets or markets. By employing interest rate swaps, a company may obtain a more favorable interest rate relative to interest rates available from direct borrowing.

Short Question and Answers

1. Define Balance of Payments.

Ans :

Introduction

The balance of payments (BOP) is a statistical statement that systematically summarizes, for a specific period (typically a year or quarter), the economic transactions of an economy with the rest of the world. It covers

(a) All the goods, services, factor income and current transfers an economy receives from or provides to the rest of the world; and

(b) Capital transfers and changes in an economy's external financial claims and liabilities.

Definitions

(i) According to Kindleberger Balance of payments 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".

(ii) According to Prof Benham "Balance of payments of a country is a record of the monetary transactions over a period with the rest of the world".

2. Features of Balance of Payments.

Ans :

Main features of balance of payments are as under :

1. **Systematic Record :** It is a systematic record of receipts and payments of a country with other countries.

2. **Fixed Period of Time :** It is a statement of account pertaining to a given period of time, usually, one year

3. **Comprehensiveness :** It includes all the three items i.e., visible, invisible and capital transfers.

4. **Double Entry System :** Receipts and payments are recorded on the basis of double entry system.

5. **Self-balanced :** From the point of view of accounting, double entry system keeps automatically debit and credit sides of the accounts in balance.

6. **Adjustment of Differences :** Whenever there is difference in actual total receipts and payments, need is felt for necessary adjustment.

3. Current Account.

Ans :

The current account records at exports and imports of merchandise and invisibles. Merchandise includes agricultural commodities and industrial components and products. Invisibles include

(a) Services,

(b) Income flows, and

(c) Unilateral transfers.

Exports of services include spending by foreign tourists in the country and overseas earnings of residents, including firms. This encompasses earnings on various services (like banking, insurance, consulting, and accounting) and earning of royalties, transportation, and communication. Imports of services include resident tourists' spending abroad, payments made to foreign firms for their services, and royalties on foreign books and movies.

Other items under the current account include profits remitted by foreign branches of Indian firms, interest received on foreign investments, interest paid on foreign borrowing, and funds received from foreign governments for the maintenance of their embassies and consulates. In other words, earnings in the form of interest, dividends, and rent, also known as factor income, received by the residents of a country and the income payments (e.g., interest, dividends, rents, etc.) made by the residents of the country to foreigners form part of the current account of the BOP.

Also part of the current account are official transfers like contributions to international institutions, gifts or aid to foreigners, and private transfers like cash remittances by nationals residing abroad (such as non-resident Indians sending money to their relatives in India). As these transfers of funds do not involve any specific services rendered by the residents of the country, they are referred to as unilateral transfers. In the case of unilateral transfers, there is a flow of goods, services, or funds in only one direction, as against the merchandise or services trade in which goods or services flow in one direction and payments flow in the opposite direction.

4. Capital Account.

Ans :

The capital account of BOP reflects the capital inflows and outflows of the country. The purchases of real assets (physical assets like lands, buildings, and equipment) located abroad and financial securities (e.g., stocks and bonds) issued by foreign governments or foreign companies are called capital transactions. The difference between such purchases made by the residents of one country (say, India) in all other countries, and such purchases by residents of all other countries in India, is called the balance on capital account.

The capital account includes foreign equity investments, loans, and other foreign investments. Foreign equity investments may take the form of either portfolio investments or direct investments. Portfolio investments are cross-border transactions associated with changes in ownership of financial assets and liabilities. Direct investment occurs when there are cross-border outflows and inflows of equity capital. Such ownership of a foreign operating business gives a measure of control to the investors.

5. Reserve Account.

Ans :

The official reserve account of the BOP measures a country's official reserves, which are in the form of liquid assets like the central bank's holding of gold. These reserves also include foreign exchange in the form of balances with foreign banks and the IMF, and the government's holding of SDRs. While an increase in the holdings of foreign currency reserves by the country's central bank (e.g., Reserve Bank of India) is debited to the official reserve account, a decrease in the holdings of foreign currency reserves by the country's central bank is credited to the reserve account.

6. Limitions of BOP.

Ans :

- BOP is an important source of information on economic and financial situation of a country. The analysis of different accounts in a BOP Statement, inter-se, enables one to understand or foresee the circumstantial or structural equilibria.
- Sources of information used to prepare a BOP Statement are varied, namely, central bank, institutions linked with external trade such as Export-Import (EXIM) Bank, and customs authorities, etc.
- A perfect coherence among these sources may not be possible.
- Thus, the account Errors and Omissions serves to bring about an equilibrium between economic operations and their monetary counterparts.
- BOP Statement is established in terms of transactions. That is, it takes into account transactions rather than settlements. But the dates of effective settlements may be far distant in time from the dates of delivery owing to advances accorded, commercial credits, delay in payments or non-payments, etc.

7. What is Foreign Exchange Market?

Ans :

The foreign exchange market is the market where the currency of one country is exchanged for that of another country and where the rate of exchange is determined. The genesis of Foreign Exchange (FE) market can be traced to the need for foreign currencies arising from:

- international trade
- foreign investment and

- lending to and borrowing from foreigners.

In order to maintain an equilibrium in the FE market, demand for foreign currency (or the supply of home currency) should equal supply of foreign currency (or the demand for home currency). In operational terms, the demand for and supply of home currency should be equal. In the event of a disequilibrium situation, the monetary authority of the concerned country normally inter-vanes/steps in to bring out the desired balance by:

- variation in the exchange rate or
- changes in official reserves or
- both

8. Functions of foreign exchange market.

Ans :

(i) It helps in transfer of purchasing power due to international trade and capital transactions include those parties living in countries with different national currencies.

(ii) It facilitates parties to deal in a foreign currency.

(iii) The foreign exchange market is a source of credit for maintaining inventory.

(iv) The foreign exchange market helps in providing "hedging" facilities related to transferring of foreign exchange risk to other person who can handle risk.

(v) It provides specialized instruments like banker's acceptances, letter of credit and are available to finance foreign trade.

9. Define Exchange Rate.

Ans :

The exchange rate refers to the price of currency in one country in terms of currency of another country. Exchange rates are affected by changes in product prices and interest rates. They are essential for business organizations, governments and individuals.

In case of goods or services, the price of currency is affected by the demand for and supply of the currency. Hence, any change in supply and demand forces leads to changes in exchange rate. Equilibrium exchange rate is indicated at a point where demand and supply intersect.

10. Define Derivative.

Ans :

Meaning

The term "Derivative" indicates that it has no independent value, i.e., its value is entirely derived from the value of the underlying asset. The underlying asset can be securities, commodities, bullion, currency, livestock or anything else. In other words, derivative means forward, futures, option or any other hybrid contract of predetermined fixed duration, linked for the purpose of contract fulfillment to the value of a specified real or financial asset or to an index of securities.

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(iv) The specified price in a forward contract is referred to as the delivery price. The forward price for a particular forward contract at a particular time is the delivery price that would apply if the contract were entered into at that time. It is important to differentiate between the forward price and the delivery price. Both are equal at the time the contract is entered into. However, as time passes, the forward price is likely to change whereas the delivery price remains the same.

12. Options contracts.

Ans :

An option is a contract between two parties, i.e., between the buyer and the seller. The option contract gives the option holder (Buyer) the right to buy or sell or enter into transaction with the other party (option seller or writer), but are not in an obligation to do so. The purchase and sale of things are to be done at a future date for a price agreed on a present day, at the time of entering the contract.

The option buyer or buyer gives the seller an amount of money called as price or premium, for which the seller is ready to sell as per the terms of the contract or on the will of the buyer. Basically there are about five types of options

13. Call Option.

Ans :

A call option is a contract that gives an option or right to the buyer (owner) to purchase an underlying asset at a predetermined and agreed fixed price, on or prior to a specific day. The buyer has a right but not an obligation to buy the asset.

On the other hand, the seller is under an obligation to complete the contract by providing or delivering the underlying asset on the date and time, as agreed between the buyer and the seller. Thus, in a call option the buyer is given the right to buy and seller comes under the obligation to sell the asset. The price fixed for an option is called as strike price or exercise price and denominated in terms of alphabet.

14. Put Option.

Ans :

A put option is a contract that provides the right to sell an underlying asset to the buyer, for a particular price and on a specified date. Here the buyer is under an obligation to purchase the asset and the owner has the right to sell the asset.

Choose the Correct Answers

1. The current system of international finance is a ______. [d]
   (a) gold standard (b) fixed exchange rate system
   (c) floating exchange rate system (d) managed float exchange rate system
2. A simultaneous purchase and sale of foreign exchange for two different dates is called ______. [b]
   (a) currency devalue (b) currency swap
   (c) currency valuation (d) currency exchange
3. Hedging is used by companies to: [b]
   (a) Decrease the variability of tax paid
   (b) Decrease the variability of expected cash flows
   (c) Increase the variability of expected cash flows
   (d) Decrease the spread between spot and forward market quotes
4. By definition, currency appreciation occurs when: [c]
   (a) the value of all currencies fall relative to gold.
   (b) the value of all currencies rise relative to gold.
   (c) the value of one currency rises relative to another currency.
   (d) the value of one currency falls relative to another currency.
5. If purchasing power parity were to hold even in the short run, then: [c]
   (a) quoted nominal exchange rates should be stable over time.
   (b) real exchange rates should tend to increase over time.
   (c) real exchange rates should be stable over time.
   (d) real exchange rates should tend to decrease over time.
6. In the foreign exchange market, the ______ of one country is traded for the ______ of another country. [a]
   (a) currency; currency (b) currency; financial instruments
   (c) currency; goods (d) goods; goods
7. A floating exchange rate ______. [d]
   (a) is determined by the national governments involved
   (b) remains extremely stable over long periods of time
   (c) is determined by the actions of central banks
   (d) is allowed to vary according to market forces

8. The date of settlement for a foreign exchange transaction is referred to as: [d]

   (a) Clearing date (b) Swap date

   (c) Maturity date (d) Value date

9. Which one of the following is not a type of foreign exchange exposure? [a]

   (a) Tax exposure (b) Translation exposure

   (c) Transaction exposure (d) Balance sheet exposure

10. The impact of Foreign exchange rate on firm is called as: [a]

   (a) Operating Exposure (b) Transaction exposure

   (c) Translation exposure (d) Business risk

Fill in the Blanks

1. The ________ is a statistical statement that systematically summarizes, for a specific period.
2. The ________ records at exports and imports of merchandise and invisibles.
3. The ________ of the BOP measures a country's official reserves, which are in the form of liquid assets like the central bank's holding of gold.
4. The ________ market is the market where the currency of one country is exchanged for that of another country and where the rate of exchange is determined.
5. The ________ rate refers to the price of currency in one country in terms of currency of another country.
6. PPP stands for ________.
7. ________ Financial risk is one of the high-priority risk types for every business.
8. ________ risk can be classified as Directional Risk and Non-Directional Risk.
9. ________ risk is the risk of a decline in the value of a security or an investment portfolio excluding a downturn in the market, due to multiple factors.
10. ________ risk is a risk category, which results in an uncertain degree of gain or loss when undertaken.

Answers

1. Balance of payments (BOP)
2. Current account
3. Official reserve account
4. Foreign exchange
5. Exchange
6. Purchasing Power Parity
7. Financial
8. Market
9. Price
10. Speculative

UNIT IV

FINANCING INTERNATIONAL TRADE AND MONETARY FUND :

Market instruments, Cash-in-advance, Modes of financing in international trade. World Bank: EXIM Bank. Functions and responsibilities of the Bank and its changing role, Primary responsibility of International Monetary Fund, Exchange rates and international payments, Special rights of the IMF, resources, Operations and current challenges, Multilateral institutions, International Bank for Reconstruction and Development, International Finance Corporation and Bank for International Settlements.

4.1 Market Instruments- Cash-in-advance

Q1. What are the different market instruments are used in International Trade?

Ans : **(Imp.)**

The different market instruments of payment used to settle international transactions are as follows.

1. Cash-in-Advance

With cash-in-advance payment terms, an exporter can avoid credit risk because payment is received before the ownership of the goods is transferred. For international sales, wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters. With the advancement of the Internet, escrow services are becoming another cash-in-advance option for small export transactions. However, requiring payment in advance is the least attractive option for the buyer, because it creates unfavorable cash flow. Foreign buyers are also concerned that the goods may not be sent if payment is made in advance

2. Letters of Credit

Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents. The buyer establishes credit and pays his or her bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. An LC also protects the buyer since no payment obligation arises until the goods have been shipped as promised

3. Documentary Collections

A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents that its buyer needs to the importer's bank (collecting bank), with instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. D/Cs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance).

4. Consignment

Consignment in international trade is a variation of open account in which payment is sent to the exporter only after the goods have been sold by the foreign distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold. Clearly, exporting on consignment is very risky as the exporter is not guaranteed any payment and its goods are in a foreign country in the hands of an independent distributor or agent. Consignment helps exporters become more competitive on the basis of better availability and faster delivery of goods. Selling on consignment can also help exporters reduce the direct costs of storing and managing inventory. The key to success in exporting on consignment is to partner with a reputable and trustworthy foreign distributor or a third-party logistics provider. Appropriate insurance should be in place to cover consigned goods in transit or in possession of a foreign distributor as well as to mitigate the risk of non-payment.

4.2 Modes of Financing in International Trade

Q2. What are the different methods of Financing in International Trade?

Ans :

1. Accounts Receivable Financing

Accounts receivable financing takes place when exporter need funds immediately and may require financing from a bank. In this method, bank provide loan to the exporter which is secured by an assignment of the accounts receivable.

2. Factoring

Factoring can be defined as an agreement in which receivables arising out of sale of goods/ services are sold by a firm (client) to the "factor" (a financial intermediary), as a result of which the title to the goods/ services represented by the receivables passes onto the factor.

3. Letters of Credit

The Letter of Credit (L/C) is one of the oldest forms of trade finance which provides benefits and protection to both exporter and importer and becomes an essential part of many international trade transactions. The L/C is a bank undertaking to make payments on behalf of specified party to beneficiary under specified terms. The beneficiary is paid on presenting required documents in accordance with the terms of the L/C.

4. Banker's Acceptance

A bankers acceptance is drawn on and accepted by a bank, it is referred as a bill of exchange or time draft. It is an obligation for accepting bank to pay the holder of the draft at maturity. A banker's acceptance is beneficial to exporter, importer and issuing bank.

5. Working Capital Financing

The bank even provide short-term loans beyond the acceptance period in case where importer purchase from overseas that represents the acquisition of inventory. The loan amount is used to finance the working capital cycle that starts with purchase of inventory and continues with sale of goods, creation of an account receivable and conversion of cash.

6. Medium-term Capital Goods Financing (Forfeiting)

Forfeiting is a form of trade finance which is used when importer need finance for many years. Forfeiting implies purchase of financial obligations like bills of exchange or promissory notes without any recourse of exporter.

4.3 EXIM Bank

Q3. What is EXIM Bank? Explain the structure of EXIM Bank.

Ans : **(Imp.)**

Enhancing the trading activities across the globe also needs funds which was a great obstacle for Indian importers and exporters. Looking at the requirement of a sound financial institution for financing trading abroad, Government of India established Export – Import Bank in 1982 under Export-Import Bank of India Act 1981. It was mainly set up for promoting global trade and investment at a larger extent. The main function of this non banking financial institution is to provide financial and other assistance to importers and exporters of the country. It also looks after and facilitates the working of other institutions involved in this sector.

Organization Set up

The organization structure of this bank is of diversified nature. It is managed by an apex level body called Board of Directors which is headed by Managing Director. There are 17 other Directors on the board who includes representatives from the Government, Reserve Bank of India, Export Credit Guarantee Corporation of India, public sector banks, and the business community.

The organizational structure can also be presented on the basis of several operating groups which are performing distinguished functions as under:

- **Small and Medium Enterprises**

  The group handles credit proposal from SMEs under various lending programmes of the Bank.

- **Corporate Banking Group** , which handles a variety of financing programs for Export Oriented Units (EOUs), Importers, and overseas investment by Indian companies.

- **Export Services Group** offers variety of advisory and value-added information services aimed at investment promotion.

- **Export Marketing Services Bank** offers assistance to Indian companies, to enable them in establishing their products in overseas markets. The idea behind this service is to promote Indian export. Export Marketing Services covers wide range of export oriented companies and organizations.

- **Project Finance/Trade Finance Group** handles the entire range of export credit services such as supplier's credit, Preshipment Agri Business Group, to spearhead the initiative to promote and support Agri-exports. The Group handles projects and export transactions in the agricultural sector for financing.

- **Besides these, the support services groups, which include**

  Research and Planning, Treasury and Accounts, Loan Administration, Internal audit, Management Information Services, Information Technology, Legal, Human Resources Management and Corporate Communications.

Q4. What are the functions of EXIM Bank?

Ans : **(Imp.)**

EXIM Bank performs the following functions

(a) EXIM Bank provides Finances for the purpose of import and export of goods and services from India.

(b) It also facilitates the funding of import and export from countries other than India.

(c) It finances the import or export of machines and machinery on lease or hires purchase basis as well.

(d) The bank provides refinancing services to banks and other financial institutes for their financing of foreign trade.

(e) It also undertakes the responsibility of underwrite shares/debentures/stocks/bonds of companies engaged in foreign trade.

(f) Apart from financial support, the bank also provides technical and other assistance to traders. This institution provides guidance and assistance in technical as well as administrative matters as there are multiplicity of documentation and foreign trade procedure which becomes sometimes cumbersome for a person.

(g) Undertakes functions of a merchant bank for the importer or exporter in transactions of foreign trade.

(h) Indian businessmen wishing to collaborate with foreign players in other countries can also avail financial assistance.

(i) In order to promote exports EXIM bank also has schemes such as production equipment finance program, export marketing finance, vendor development finance, etc.

(j) Short-term loans or lines of credit are also provided to foreign banks and governments.

(k) EXIM bank can also provide business advisory services and expert knowledge to Indian exporters in respect of multi-funded projects in foreign countries.

Q5. Explain the policies and programs initiated by Exim Bank.

Ans : **(Imp.)**

Policies and Program initiated by EXIM Bank

- The EXIM Bank provides Indian project exporters with a comprehensive range of services to enhance the prospect of their securing export contracts, particularly those funded by Multilateral Funding Agencies like the World Development Bank, Asian Development Bank and European Bank for Reconstruction and Development.
- The Bank extends lines of credit to overseas financial institutions, foreign governments and their agencies, enabling them to finance imports of goods and from India on deferred credit terms.
- EXIM Bank's lines of Credit preclude credit risks for Indian exporters and are of particular relevance to SME export.
- The Bank's Overseas Investment Finance programme offers a variety of facilities for Indian investments acquisitions overseas. The facilities include loan to Indian companies for equity participation in overseas ventures, direct equity participation by EXIM Bank in the overseas venture and non-funded facilities such as letters of credit and guarantees to facilitate local borrowings by the overseas venture.
- The Bank provides financial assistance by way of term loans in Indian rupees/foreign currencies for setting up new production facility,expansion/modernization/ upgradation of existing facilities and for acquisition of production equipment/technology. Such facilities particularly help export oriented Small and Medium Enterprises for creation of export capabilities and enhancement of international competitiveness.
- The Bank has launched the Rural Initiatives Programme with the objective of linking Indian rural industry to the global market. The programme is intended to benefit rural more through creation of export capability in rural enterprises.
- In order to assist the Small and Medium Enterprises, the Bank has put in place the Export Marketing Services (EMS) Programme. Through EMS, the Bank seeks to establish, on best efforts basis, SME sector products in overseas markets, starting from identification prospective business partners to facilitating placement of final orders. The service is provided on success fee basis.
- Under its Export Marketing Finance programme, EXIM Bank supports Small and Medium Enterprises in export marketing efforts including financing the expenditure relating to implementation of strategic and systematic export market development plans
- EXIM Bank supplements its financing programmes with a wide range of value-added information, advisory and support services, which enable exporters to evaluate international risks, exploit export opportunities and improve competitiveness.

4.4 World Bank - Functions and Responsibilities of the Bank and its Changing Role

Q6. Write a note on world bank. Explain the purpose of world bank.

Ans : **(Imp.)**

The IBRD was set up in 1945 along with the IMF to aid in rebuilding the world economy. It was owned by the governments of 151 countries and its capital is subscribed by those governments; it provides funds to borrowers by borrowing funds in the world capital markets, from the proceeds of loan repayments as well as retained earnings. At its funding, the bank's major objective was to serve as an international financing facility to function in reconstruction and development. With Marshall Plan providing the impetus for European reconstruction, the Bank was able to turn its efforts towards the developing countries.

Generally, the IBRD lends money to a government for the purpose of developing that country's economic infrastructure such as roads and power generating facilities. Funds are directed towards developing countries at more advanced stages of economic and social growth. Also, funds are lent only to members of the IMF, usually when private capital is unavailable at reasonable terms. Loans generally have a grace period of five years and are repayable over a period of fifteen or fewer years. The projects receiving IBRD assistance usually require importing heavy industrial equipment and this provides an export market or many US goods. Generally bank loans are made to cover only import needs in foreign convertible currencies and must be repaid in those currencies at long-term rates.

The government assisted in formulating and implementing an effective and comprehensive strategy for the development of new industrial free zones and the expansion of existing ones; reducing unemployment, increasing foreign-exchange earnings and strengthening backward linkages with the domestic economy; alleviating scarcity in term financing; and improving the capacity of institutions involved in financing, regulating and promoting free zones.

The World Bank lays special operational emphasis on environmental and women's issues. Given that the Bank's primary mission is to support the quality of life of people in developing member countries, it is easy to see why environmental and women's issues are receiving increasing attention. On the environmental side, it is the Bank's concern that its development funds are used by the recipient countries in an environmentally responsible way. Internal concerns, as well as pressure by external groups, are responsible for significant research and projects relating to the environment.

The women's issues category, specifically known as Women In Development (WID) is part of a larger emphasis on human resources. The importance of improving human capital and improving the welfare of families is perceived as a key aspect of development. The WID initiative was established in 1988 and it is oriented to increasing women's productivity and income. Bank lending for women's issues is most pronounced in education, population, health and nutrition and agriculture.

Purpose Of World Bank

The World Bank group is a multinational financial institution established at the end of World War II (1944) to help provide long-term capital for the reconstruction and development of member countries. The group is important to multinational corporations because it provides much of the planning and financing for economic development projects involving billions of dollars for which private businesses can act as contractors and suppliers of goods and engineering related services.

The purpose for the setting up of the Bank are

(a) To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peacetime needs and encouragement of the development or productive facilities and resources in less developed countries.

(b) To promote private foreign investment by means of guarantees or participation in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources.

(c) To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and condition of labour in their territories.

(d) To arrange the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, can be dealt with first.

(e) To conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a wartime to a peacetime economy. The World Bank is the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). The IBRD has two affiliates, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA). The Bank, the IFC and the MIGA are sometimes referred to as the "World Bank Group".

Q7. What are the functions of world bank.

Ans :

The principal functions of the IBRD are set forth in Article I of the agreement as follows:

(a) To assist in the reconstruction and development of the territories of its members by facilitating the investment of capital for productive purposes.

(b) To promote private foreign investment by means of guarantee of participation in loans and other investments made by private investors and when private capital is not available on reasonable terms, to make loans for productive purposes out of its own resources or from funds borrowed by it.

(c) To promote the long-term balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members.

(d) To arrange loans made or guaranteed by it in relation to international loans through other channels so that more useful and urgent projects, large and small alike, will be dealt with first. It appears that the World Bank was created to promote and not to replace private foreign investment. The Bank considers its role to be a marginal one, to supplement and assist foreign investment in the member countries.

(e) A little consideration will show that the objectives of the IMF and IBRD are complementary. Both aim at increasing the level of national income and standard of living of the member nations. Both serve as lending institutions, the IMF for short-term and the IBRD for long-term capital. Both aim at promoting the balanced growth of international trade.

Q8. Explain the role of world bank.

Ans :

The World Bank is internationally recognized and supported that provides technical & financial assistance to many developing countries in the world. It also aids their advancement, in an economy with a primary goal of reducing poverty. World Bank has the largest knowledge of developing countries. Also, they are the largest source of funding.

The role of world bank is

(a) To help the war-devasted countries by granting them loan for reconstruction.

(b) To provide extensive experience & the financial resources of the bank to help the poor countries increase their economic growth, reducing poverty & a better standard of living.

(c) To grant development loan to the under-developed countries.

(d) To provide loans to various governments for irrigation, agriculture, water supply, heath, educations etc.

(e) To promote foreign investments to other organizations by guaranteeing the loans.

(f) To provide economic, monetary & technical advice to the member countries for any of their projects.

(g) To encourage the development of industries in under-developed countries by introducing the various economic reforms.

4.5 Primary Responsibility of International Monetary Fund (Exchange Rates and International Payments)

Q9. Write a note on IMF. Explain the purpose of IMF.

Ans : **(Imp.)**

The International Monetary Fund (IMF) was established to ensure proper working of the international monetary system. One of the important functions of IMF was to provide reserve credit to member countries facing temporary balance-of-payments problems. For this purpose, a currency pool was maintained.

Each member country was required to contribute to this pool according to its quota, which was fixed on the basis of each country's importance in world trade. These contributions were to be partly in an international reserve currency and partly in the country's domestic currency. Initially, the first part of the payments were made in gold. Later, it was replaced by Special Drawing Rights (SDRs). A country's quota would also determine its access to the pool and its voting power at IMF.

In order to draw from IMF, a member country has to buy reserve assets and other currencies by paying its own currency to IMF. At the time of repayment of the loan, the borrowing country reverses the deal.

IMF's management is vested in its executive board. Out of its 22 directors, six are appointed by governments holding the largest quotas. The rest of the directors are elected by the remaining countries. The board of governors, which is the highest governing body of IMF meets once a year to take major policy decisions. Its members are generally the finance ministers or the central bank governors of the member countries. All the member countries are represented on this board.

Purpose

The main purposes of the International Monetary Fund are:

(a) To promote international monetary cooperation through a permanent institution that provides the machinery for consultation and collaboration on international monetary problems.

(b) To facilitate the expansion and balanced growth of international trade and to contribute, thereby, to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(c) To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.

(d) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(e) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive to national or international prosperity.

(f) In accordance with the above, to shorten the duration and lessen the degree of dis-equilibrium in the international balances of payments of members.

Q10. Explain the role and responsibilities of IMF.

Ans :

Responsibilities of IMF

(i) Promoting international monetary coo-peration

(ii) Facilitating the expansion and balanced growth of international trade

(iii) Promoting exchange stability

(iv) Assisting in the establishment of a multilateral system of payments.

(v) Making its resources available, under adequate safeguards to members experien-cing balance of payments difficulties.The Fund seeks to promote economic stability and prevent crises; to help resolve crises when they do occur, and to promote growth and alleviate poverty. To meet these objectives, it employs three main functions, as discussed here.

Role of IMF

IMF played a significant role in stabilizing the exchange rates thereby facilitating international payment adjustments. Economists across the world have commended its role in enforcing monetary discipline among its members.

(a) IMF brings stability in exchange rate

The IMF has laid down a clear guidance of exchange rate policies. Its policies prevent the member countries from making competitive devaluation to boost up exports. As a result of all these, the system of exchange under the IMF is stable.

(b) IMF's role in development of international trade

The IMF has been instrumental to the growth of international trade. It acts as the reservoir of the currencies of all the member countries. A borrowing country can borrow the currency of another country out of this reservoir. It extends loans in foreign exchange to the member countries for financing the current transactions. It also provides technical advice on monetary and fiscal matters. It conducts research studies and publishes them. This multilateral assistance helps members in solving their problems in trade, thereby promoting international trade.

(c) IMF is strict on multiple exchange rates

The IMF does not permit the member countries to adopt multiple exchange rates leading to restrictive practices. The system of exchange rate combines the element of stability with flexibility. It maintains stability in exchange rates.

(d) IMF's elaborate lending operations

The main operation of the fund is lending to member countries. It has introduced a variety of loan facilities to its members. Initially, the lending operations were confined only for solving the problems of deficit payments.

But now they have been remarkably extended. Member countries can have regular facilities, concessional facilities and special facilities. Credit Tranches and extended fund facility are some of the regular facilities. Structural adjustment facility and enhanced structural adjustment facility are some concessional schemes offered to the member countries. The special facilities offered by the IMF fund include compensatory and contingency financing facility, systematic transformation facility and contingency credit line.

(e) IMF's role in currency convertibility

With the charges introduced after 1973 in the international monetary system, a member can peg its currency to

- Either a single major currency or
- A basket of currencies or
- Allow it to float independently.

A currency is said to be floating when its is left free to find its own parity in the international market. The IMF is the catalyst in the convertibility of currencies. It endeavors to achieve full global convertibility of currencies in the next decade. All developing countries will achieve full convertibility.

(f) IMF's role in Consultation and guidance

The IMF provides the necessary machinery for consultation and collaboration on international monetary problems. Monetary, fiscal and financial problems and also matters relating to exchange and trade affecting international payments are clearly studied. It deputes experts to member countries to deal with the balance of payments problems. It also conducts short term training courses on fiscal, monetary and balance of payments for personnel from member nations.

(g) Boon to developing countries

The IMF is a boon to developing countries. Less developed countries get enormous assistance from IMF like

- Financial assistance to get rid of balance of payment deficits
- Concessional financial assistance for promotion of exports

- Suggestions for overcoming constraints in the development process
- Assistance in the formulation of development oriented monetary, fiscal, exchange and trade policies.
- Extension of central banking advisory services to less developed countries towards the improvement of functioning of their central banks.
- Institutional training for the personnel in member countries; and
- Special Drawing Rights (SDRs) to resolve the problem of international liquidity.

Q11. Explain the functions of IMF.

Ans :

The following are the functions of IMF are :

(a) Surveillance

A core responsibility of the IMF is to encourage a dialogue among its member countries about the national and international consequences of their economic and financial policies, to promote external stability. This process of monitoring and consultation, normally referred to as 'surveillance', has evolved rapidly as the world economy has changed. IMF surveillance has also become increasingly open and transparent in recent years. The initiatives used to inform bilateral surveillance and aimed at promoting global economic stability are as follows:

- The IMF works to improve its ability to assess the member countries' vulner-abilities to crisis, identifying and promoting effective responses to risks to economic stability, including risks from payments imbalances, currency misalignment, and financial market disturbances.
- In collaboration with the World Bank, the IMF conducts in depth assessments of countries' financial sectors under the Financial Sector Assessment Programme (FSAP).

  The Fund is further deepening financial and capital market surveillance, particularly in its analysis of emerging market members.
- The IMF has developed and actively promotes standards and codes of good practice in economic policy making. It is also involved in international efforts to combat money laundering and the financing of terrorism.

The importance of effective surveillance was underscored by the financial crises of the late 1990s. In response, the IMF has undertaken many initiatives to strengthen its capacity to detect vulnerabilities and risks at an early stage, to help member countries strengthen their policy frameworks and institutions, and to improve transparency and accountability.

(b) Technical Assistance

The objective of IMF technical assistance is to contribute to the development of the productive resources of member countries by enhancing the effectiveness of economic policy and financial management. The IMF helps countries strengthen their capacity to design and implement sound economic policies. The IMF helps its member countries build their human and institutional capacity to design and implement effective macroeconomic and structural policies, put in place reforms that strengthen their financial sectors, and reduce vulnerability to crises. The IMF generally provides technical assistance free of charge to any requesting member country within the IMF resource constraints. About three-quarters of the Fund's technical assistance go to low- and lower-middle income countries, particularly in sub-Saharan Africa and Asia, and post-conflict countries. The IMF provides technical assistance in its areas of expertise: namely macro economic policy, tax policy and revenue administration, expenditure management, monetary policy, the exchange rate system, financial sector sustainability, and macro- economic and financial statistics.

Since the demand for technical assistance far exceeds supply, the IMF gives priority in providing assistance where it complements and enhances the IMF's other key forms of assistance, i.e., surveillance and lending.

(c) Lending

Even the best economic policies cannot eradicate instability or avert crises. In the event that a member country does experience financing difficulties, the IMF can provide financial assistance to support policy programmes that will correct underlying macroeconomic problems, limit disruptions to the domestic and global economies, and help restore confidence, stability, and growth. IMF financing instruments can also support crisis prevention. The IMF is accountable to the governments of its member countries. At the apex of its organizational structure is its board of governors, which consists of one governor from each of the IMF's 190 member countries. All governors meet once a year at the IMF-World Bank Annual Meetings.

The IMF's resources are provided by its member countries, primarily through payment of quotas, which broadly reflect each country's economic size. The annual expenses of running the Fund are met mainly by the difference between interest receipts on outstanding loans and interest payments on quota 'deposits'.

Q12. Compare and contrast IMF and World Bank.

Ans : **(Imp.)**

S.No.	Basis of comparison	World Bank	International Monetary Fund
1.	**Meaning**	An international oranization maintaining the global monetary system is the International Monetary Fund	A global organization established to finance and advice the developing nations, in order to make them economically developed is World Bank.
2.	**Focus**	Economic stability	Economic Growth
3.	**Organizational Structure**	It is a single organization with four credit lines.	It has two major institutions, namely International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA).
4.	**Membership**	190 countries	IBRD - 189 countries IDA - 173 countries. IFC - 184 countries. MIGA - 182 countries
5.	**Operations**	Provides assistance	Facilitates lending.
6.	**Objective**	To deal with all the issues related to the financial sector and macroeconomics.	To lessen poverty and promote the long term development of the economy.

4.5.1 Special Rights of the IMF, Resources, Operations and Current Challenges

Q13. What is special drawing rights? Explain the origin of SDRs.

Ans : **(Imp.)**

Meaning

Special Drawing Rights (SDRs), also known as the paper gold, are a form of international reserves created by the IMF in 1969 to solve the problem of international liquidity. They are not paper notes or currency. They are international units of account in which the official accounts of the IMF are kept. They are allocated to the IMF members in proportion to their Fund quotas and are used to settle balance of payments deficits between them.

Origin Of SDRS

SDRs were created through the First Amendment to the Fund Articles of Agreement in 1969 following persistent US deficits in balance of payments to solve the problem of international liquidity. Until December 1971, an SDR was linked to 0.88867 gram of gold and was equivalent to US $1. With the breakdown of the fixed parity system after 1973 when the US dollar and other major currencies were allowed to float, it was decided to stabilize the exchange value of the SDR. Accordingly, the value of the SDR was calculated each day on the basis of a basket of 16 most widely used currencies of the member countries of the Fund. Each country was given a weight in the basket in accordance with its importance in international trade and financial markets.

After the Second Amendment to the Fund Articles of Agreement in 1978, the SDR became an international unit of account. To facilitate its valuation, the numbers of currencies in the "basket" were reduced to five in January 1981. They include the US dollars, the German Deutsche Mark, the British Pound, the French Franc and the Japanese Yen. The present currency composition and weighting pattern of the SDR is revised every five years beginning January 1, 1986. The revision of weights is based on both the values of the exports of goods and services and the balances of their currencies held by other members. In 1977, they were US dollar (39%), German DM (21%), UK pound and French franc (11% each) and Japanese yen (18%). The value of one SDR was equal to US $ 0.6947010000 on February 18,2021.

Q14. Explain the features of SDRs.

Ans :

The following are the salient features of SDRs :

(a) Additional Reserve Asset

The SDRs scheme provides a new international asset, in addition to the traditional assets, i.e., gold, key currencies. Now, the member countries of the IMF can hold and use SDRs along with gold and key currencies as international reserves.

(b) Cheque-Book Currency

In the physical sense, SDRs are a cheque-book currency and are created with the strokes of pen. They are simply book keeping entries at the IMF in accounts for the member countries and the Fund itself. They are just like coupons which can be exchanged for currencies needed by the holder of SDRs for making international payments.

(c) Transferable Asset

SDRs are transferable assets. The member countries are required to provide their currencies in exchange for SDRs. A country can acquire convertible currency from the designated country in exchange for SDRs. Designated country is that which has strong balance of payments or large reserves.

(d) Backing of SDRs

SDRs are a liability of the IMF and asset of the holders. There is no backing for SDRs in the form of an asset like key currency. The real backing is the undertaking given by the member countries to abide by the SDR regulations. The country which agrees to the creation of SDRs is obliged to permit drawl and other countries are obliged to accept them as unit of adjustment.

(e) Basis of SDRs

The creation of SDRs is based on the fundamental principle of credit creation in the banking system. The SDR scheme is an extension of this principle to the international level. The IMF can create new SDRs without any increase in deposits of gold or currency by the participating countries. Thus, issue of SDRs means an increase in world's monetary reserves.

(f) Allocation of SDRs

The SDRs are allocated to the member countries in proportion to their quotas in the IMF. The lion's share goes to the developed countries and the developing countries get only about a quarter.

(g) Special Drawing Account

Under the changed rules, the IMF maintains two separate accounts:

(i) General Account

It deals with the general tansactions of the IMF relating to quotas, subscriptions, ordinary drawings, etc.

(ii) Special Drawing Account

It deals with SDR transactions. The SDRs are created as a percentage of existing resources (quotas).

(h) Paper Gold

Initially the scheme envisaged that the SDRs would be a sort of paper gold. Their value was fixed in terms of gold. But, since 1974, the SDR has been valued on the basis of a currency basket.

(i) Fiduciary Reserve System

The SDR scheme proposes a purely fiduciary reserve system. SDRs are regularly created by the IMF, accepted by the member countries as paper gold reserves and used for the settlement of international payments.

(j) Interest-Bearing Asset

SDRs are an interest-bearing asset The IMF pays interest to the countries holding SDRs and charge interest from the countries using SDRs.

(k) Use of SDRs

Under the SDR scheme, the participating countries will use SDRs to meet their balance of payments requirements or to improve their adverse reserve position. SDRs are not to be used for exchange with other currencies to reinforce foreign exchange reserves.

(l) Limited Use of SDRs

Ordinarily, a country can use SDRs up to 70% of the allotted authorization during a given five years. The remaining 30% is to be held for emergencies. Thus, a restraint has been put on the member countries so that they do not rush into using SDRs without drawing upon their other forms of resources.

(m) Units of Account

Use of SDRs as a unit of account has also started. Some countries have pegged their currencies to SDRs. OPEC countries, and some airlines, monetary organizations and banks are using SDRs as unit of account.

Q15. Explain the merits of SDRs.

Ans :

Merits

Despite these weaknesses, the SDRs scheme possesses the following merits:

(i) SDRs are a new form of international monetary reserves which have been created to free the international monetary system from its exclusive dependence on the US dollar.

(ii) They have rid the world of its dependence on the supply of gold and fluctuations in gold prices.

(iii) They cannot be demonetized like gold or become scarce when the demand for dollar increases in the world.

(iv) Unlike gold, SDRs are cost less to produce because production of gold requires resources to mine, refine, transport and guard it.

(v) SDRs have been created to improve international liquidity so as to correct fundamental disequilibria in balance of payments of Fund members. Under this scheme, the participants receive SDRs under transactions with designation and transaction by agreement unconditionally.

(vi) Fund members are not required to change their domestic economic policies as they are expected under the Fund aid programmes.

(vii) The payment and repayment of SDRs out of the Special Drawing Account is easier and more flexible than under the Fund schemes.

(viii) Last but not the least, SDRs act both as a unit of account and a means of payment of international monetary system.

Q16. Explain the various resources of IMF.

Ans :

The resources of International Monetary Fund (IMF) comprises of following,

(a) Quota

(b) Multilateral Borrowing and

(c) Bilateral Borrowing.

(a) Quota

Quota is the primary resource of International Monetary Fund (IMF) which determines the subscription of member countries. It also determines the voting power of members. National Income and condition of International trade of member country determines their subscription. Each member country contributes 25% of its quota in international reserve assets and 75% in their own currency. The contribution of 25% is made in Special Drawings Rights (SDRs).

In order to raise resources of the fund, a provision is enacted by IMF to sell gold to the people and receive fee from borrowing members. Under the provision, quotas of members countries are revised every five years.

(b) Multilateral Borrowing

This is considered as the second line of defense after quota. Whenever, the quotas are not sufficient to meet the needs of its member states, IMF may take advantage of multilateral borrowing mechanisms.

➢ **New Arrangements to Borrow (NAB)**

The member countries and institutions lend additional resources to the IMF through NAB. It consists of 40 participants. Activation of it requires support from 85% of participants eligible to vote.

➢ **General Arrangements to Borrow (GAB)**

It allows the IMF to borrow specific amount of currencies from 11 industrialized countries under certain situations.

(c) Bilateral Borrowing

This is considered as third line of defense after quota and New Arrangements to Borrow (NAB). In order to meet the financing needs of its members, IMF has entered into several rounds of Bilateral Borrowing Arrangements (BBAs).

Q17. Explain the operations of IMF.

Ans :

The various operations or schemes of International Monetary Fund (IMF) are as follows,

1. Stand by Arrangement

This scheme was introduced in 1952. Under this scheme, countries can borrow at the first indication of its possible need. This would help the country in time, as it would not have to wait for IMFs approval for the loan when the need actually arose.

2. Compensating Financing Facility

This scheme was introduced in 1963, for providing financial assistance to countries facing temporary shortfall in reserves.

3. Buffer Stock Financing Facility

It was introduced in 1969, this scheme provides for countries receiving financial assistance from IMF in order to purchase approved primary products. This help is extended to prevent countries from suffering due to price shocks.

4. Extended Facility

This scheme was introduced in 1974. It allows countries to borrow on a medium-term basis for overcoming balance-of-payments problems caused by structural imbalance.

5. Oil Facility

It was introduced in 1974 and was terminated in 1976. Under this scheme, help was extended to countries most affected by the oil price rise.

6. Enhanced Structural Adjustments Facility

This scheme was established in 1987 and extended in 1994. It was designed for low-income member countries with prolonged balance of payments problems.

7. Trust Fund

As gold was demonetized in 1976, IMF set up this fund with the proceeds from the sale of gold held by it. This fund was used for providing special development loans on concessional terms to those 25 member countries which had the lowest per capita income. It was discontinued in 1981.

Q18. What are the challanges of faced by IMF.

Ans :

1. Governance Structure

A major challenge faced by IMF is directly related to governance of the organisation in practical levels. It has been argued that international organisations such as IMF "face the problem of 'multiple principals' to a much larger extent than public and private enterprises. They are controlled by many governments – governments that often do not agree on what the organisation should do

In other words, there are often disagreements amongst governments in control of IMF in terms of the aims and objectives to be achieved by IMF and the manner in which they need to be achieved and this halts the performance of the organisation to a great extent

2. Increasing Level of Politicisation

Increasing level of politicisation of IMF can be specified as an additional issue that is proving to be obstruction in achievement of core aims and objectives of the organisation.

It has been argued that "IMF lending is not a technocratic process; rather, the Fund is a highly political institution whose policies depend on the interests of not only its largest shareholders but also its bureaucrats, both of whom exercise partial incomplete control over IMF policymaking" (Copelovich, 2010, p.6).

To put it simply, rather than dealing with its aims and objectives in a direct and timely manner, IMF is being hostage to bureaucracy and geopolitical ambitions of specific countries.

3. Leadership Challenges

According to Dunaway (2011) a substantial challenge faced by IMF Managing Director is to be decisive and courageous in terms of facing European leaders and communicating to them the current state of global economic situation and policy changes and other measures that need to be implemented in order to deal with these issues.

4. Performance Evaluation Difficulties

Another difficulty associated with IMF can be specified as challenges of evaluating its performance (Carbaugh, 2010). In other words, IMF aims to achieve a wide range of aims and objectives such as promoting international monetary cooperation and exchange stability, facilitating the expansion and balanced growth of international trade etc. and measuring IMF performance in contributing to the achievement of such a variety of aims presents substantial challenges in practical levels.

5. Dealing with Social Instability

Justifiably the issue of global social instability has been specified as one of the most complex challenges faced by IMF by its Managing Director Christine Lagarde. This challenge relates to political upheavals in the Middle East and North Africa partially resulted by socially imbalanced growth. The negative impact of political situation and a range of other forces on the state of deteriorating national economies in these regions create additional challenges for IMF.

4.6 Multilateral Institutions

Q19. What are the various Multilateral Institutions?

Ans :

Multilateral Institution refers to an institution which is formed by three or more countries to work on issues that are relevant to each other. Well-known multilateral institions have vast resources and immense influence and supply foreign capital for various purposes.

The following are the various multilateral institutions.

1. IMF

The International Monetary Fund (IMF) was established to ensure proper working of the international monetary system. One of the important functions of IMF was to provide reserve credit to member countries facing temporary balance-of-payments problems. For this purpose, a currency pool was maintained.

Each member country was required to contribute to this pool according to its quota, which was fixed on the basis of each country's importance in world trade. These contributions were to be partly in an international reserve currency and partly in the country's domestic currency. Initially, the first part of the payments were made in gold. Later, it was replaced by Special Drawing Rights (SDRs). A country's quota would also determine its access to the pool and its voting power at IMF.

In order to draw from IMF, a member country has to buy reserve assets and other currencies by paying its own currency to IMF. At the time of repayment of the loan, the borrowing country reverses the deal.

2. IBRD

The IBRD was set up in 1945 along with the IMF to aid in rebuilding the world economy. It was owned by the governments of 151 countries and its capital is subscribed by those governments; it provides funds to borrowers by borrowing funds in the world capital markets, from the proceeds of loan repayments as well as retained earnings. At its funding, the bank's major objective was to serve as an international financing facility to function in reconstruction and development. With Marshall Plan providing the impetus for European reconstruction, the Bank was able to turn its efforts towards the developing countries.

3. IFC

The IFC was established in 1956. There are 184 countries that are members of the IFC and it is legally and financially separate from the IBRD, although IBRD provides some administrative and other services to the IFC. The IFC's main responsibilities are

(a) To provide risk capital in the form of equity and long-term loans for productive private enterprises in association with private investors and management;

(b) To encourage the development of local capital markets by carrying out standby and underwriting arrangements; and

(c) To stimulate the international flow of capital by providing financial and technical assistance to privately controlled finance companies. Loans are made to private firms in the developing member countries and are usually for a period of seven to twelve years.

4. BIS

Banks For International Settlements(BIS) was established in 1930, it was the first international financial organization. The head office of BIS is located at Basel Switzerland. The main objective of BIS is to expedite the financial and monetary relationships among the firms internationally. It includes 63 central banks along with RBI and provide them the rights to vote and represent in the general meeting'conducted by it.

4.6.1 International Bank for Reconstruction and Development

Q20. Write in detail about International Bank for Reconstruction and Development.

Ans :

For answer refer Unit-IV, Q.No. 6

4.6.2 International Finance Corporation

Q21. Write about International Finance Corporation (IFC).

Ans : **(Imp.)**

The IFC was established in 1956. There are 184 countries that are members of the IFC and it is legally and financially separate from the IBRD, although IBRD provides some administrative and other services to the IFC. The IFC's main responsibilities are

(a) To provide risk capital in the form of equity and long-term loans for productive private enterprises in association with private investors and management;

(b) To encourage the development of local capital markets by carrying out standby and underwriting arrangements; and

(c) To stimulate the international flow of capital by providing financial and technical assistance to privately controlled finance companies. Loans are made to private firms in the developing member countries and are usually for a period of seven to twelve years.

The key feature of the IFC is that its loans are made to private enterprises and its investments are made in conjunction with private business. In addition to funds contributed by IFC, funds are also contributed to the same projects by local and foreign investors. IFC investments are for the establishment NE1X enterprises as well as for the expansion and modernization of existing ones. They cover a wide range of projects such as steel, textile production, mining, manufacturing, machinery production, food processing, tourism and local development finance companies. Some projects are locally owned, whereas others are joint ventures between investors in developing and developed countries. In a few cases, joint ventures are formed between investors of two or more developing countries.

The IFC has also been instrumental in helping to develop emerging capital markets.

4.6.3 Bank for International Settlements

Q22. Write about Bank for International Settlements (BIS).

Ans : **(Imp.)**

Banks For International Settlements(BIS) was established in 1930, it was the first international financial organization. The head office of BIS is located at Basel Switzerland. The main objective of BIS is to expedite the financial and monetary relationships among the firms internationally. It includes 63 central banks along with RBI and provide them the rights to vote and represent in the general meeting'conducted by it.

Initially, it was developed for operating as a trustee and agent for international loans which were provided for finalizing the settlement of separations emerging from World War I. Due to this reason, it was termed as 'Bank for International Settlements'.

Functions

1. It conducts research and provides statistics and arranges seminars and workshops which emphasizes on international financial issues. Financial stability institute of BIS conducts seminars and lectures on issues relating to the global financial stability. The BIS acts as a 'think tank' wherein the governors of member central banks, specialists and economists meet and exchange their ideas or perspectives.

2. It is a banker's bank which meets the financial requirements of member central banks. It facilitates gold and foreign exchange transactions for members and maintains central bank reserves. BIS accepts and invests the deposits of foreign exchange reserves for earning a higher rate of return.

3. It acts as a banker and fund manager for other international financial institutions. It assures liquidity for central banks by allowing to buy back the tradable instruments from central banks. Most of the buy back tradable

instruments are developed for meeting the requirements of central banks. For the purpose of competing with private financial institutions, high returns are provided on the funds which are invested by central banks.

4. Its account unit is the special drawing right (SDR) of IMF. It holds abundant equity capital and diversely invested reserves. The reserves are equal to about 7% of the world's total currency.

5. It encourages cooperation between the central banks. In the 1990s, it assessed the ways and means to assist strong financial markets, promote financial stability and encourage the development of stable financial infrastructure between the member countries.

6. It concentrates on expanding its membership due to which the people's bank of China become a member.

7. It has developed some guidelines to have an effective supervision by central banks. In 1997, the Basel committee on banking supervision issued a set of 25 basic principles which outlined the minimum need for having effective regulation and control by central bank. After consulting the central banks of 15 developing market countries, these principles were issued.

Short Question & Answers

1. Letters of Credit

Ans :

Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents. The buyer establishes credit and pays his or her bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. An LC also protects the buyer since no payment obligation arises until the goods have been shipped as promised

2. Documentary Collections

Ans :

A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents that its buyer needs to the importer's bank (collecting bank), with instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. D/Cs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance).

3. Consignment

Ans :

Consignment in international trade is a variation of open account in which payment is sent to the exporter only after the goods have been sold by the foreign distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold. Clearly, exporting on consignment is very risky as the exporter is not guaranteed any payment and its goods are in a foreign country in the hands of an independent distributor or agent. Consignment helps exporters become more competitive on the basis of better availability and faster delivery of goods. Selling on consignment can also help exporters reduce the direct costs of storing and managing inventory. The key to success in exporting on consignment is to partner with a reputable and trustworthy foreign distributor or a third-party logistics provider. Appropriate insurance should be in place to cover consigned goods in transit or in possession of a foreign distributor as well as to mitigate the risk of non-payment.

4. EXIM Bank.

Ans :

Enhancing the trading activities across the globe also needs funds which was a great obstacle for Indian importers and exporters. Looking at the requirement of a sound financial institution for financing trading abroad, Government of India established Export – Import Bank in 1982 under Export-Import Bank of India Act 1981. It was mainly set up for promoting global trade and investment at a larger extent. The main function of this non banking financial institution is to provide financial and other assistance to importers and exporters of the country. It also looks after and facilitates the working of other institutions involved in this sector.

Organization Set up

The organization structure of this bank is of diversified nature. It is managed by an apex level body called Board of Directors which is headed by Managing Director. There are 17 other Directors on the board who includes representatives from the Government, Reserve Bank of India, Export Credit Guarantee Corporation of India, public sector banks, and the business community.

5. Functions of EXIM Bank.

Ans :

(a) EXIM Bank provides Finances for the purpose of import and export of goods and services from India.

(b) It also facilitates the funding of import and export from countries other than India.

(c) It finances the import or export of machines and machinery on lease or hires purchase basis as well.

(d) The bank provides refinancing services to banks and other financial institutes for their financing of foreign trade.

(e) It also undertakes the responsibility of underwrite shares/debentures/stocks/bonds of companies engaged in foreign trade.

(f) Apart from financial support, the bank also provides technical and other assistance to traders. This institution provides guidance and assistance in technical as well as administrative matters as there are multiplicity of documentation and foreign trade procedure which becomes sometimes cumbersome for a person.

6. World Bank.

Ans :

he World Bank lays special operational emphasis on environmental and women's issues. Given that the Bank's primary mission is to support the quality of life of people in developing member countries, it is easy to see why environmental and women's issues are receiving increasing attention. On the environmental side, it is the Bank's concern that its development funds are used by the recipient countries in an environmentally responsible way. Internal concerns, as well as pressure by external groups, are responsible for significant research and projects relating to the environment.

The women's issues category, specifically known as Women In Development (WID) is part of a larger emphasis on human resources. The importance of improving human capital and improving the welfare of families is perceived as a key aspect of development. The WID initiative was established in 1988 and it is oriented to increasing women's productivity and income. Bank lending for women's issues is most pronounced in education, population, health and nutrition and agriculture.

7. Functions of world bank.

Ans :

(a) To assist in the reconstruction and development of the territories of its members by facilitating the investment of capital for productive purposes.

(b) To promote private foreign investment by means of guarantee of participation in loans and other investments made by private investors and when private capital is not available on reasonable terms, to make loans for productive purposes out of its own resources or from funds borrowed by it.

(c) To promote the long-term balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members.

(d) To arrange loans made or guaranteed by it in relation to international loans through other channels so that more useful and urgent projects, large and small alike, will be dealt with first. It appears that the World Bank was created to promote and not to replace private foreign investment. The Bank considers its role to be a marginal one, to supplement and assist foreign investment in the member countries.

8. Responsibilities of IMF

Ans :

(i) Promoting international monetary co-operation

(ii) Facilitating the expansion and balanced growth of international trade

(iii) Promoting exchange stability

(iv) Assisting in the establishment of a multilateral system of payments.

(v) Making its resources available, under adequate safeguards to members experien- cing balance of payments difficulties.The Fund seeks to promote economic stability and prevent crises; to help resolve crises when they do occur, and to promote growth and alleviate poverty. To meet these objectives, it employs three main functions, as discussed here.

9. What is Special Drawing Rights.

Ans :

Meaning

Special Drawing Rights (SDRs), also known as the paper gold, are a form of international reserves created by the IMF in 1969 to solve the problem of international liquidity. They are not paper notes or currency. They are international units of account in which the official accounts of the IMF are kept. They are allocated to the IMF members in proportion to their Fund quotas and are used to settle balance of payments deficits between them.

Origin Of SDRS

SDRs were created through the First Amendment to the Fund Articles of Agreement in 1969 following persistent US deficits in balance of payments to solve the problem of international liquidity. Until December 1971, an SDR was linked to 0.88867 gram of gold and was equivalent to US $1. With the breakdown of the fixed parity system after 1973 when the US dollar and other major currencies were allowed to float, it was decided to stabilize the exchange value of the SDR. Accordingly, the value of the SDR was calculated each day on the basis of a basket of 16 most widely used currencies of the member countries of the Fund. Each country was given a weight in the basket in accordance with its importance in international trade and financial markets.

10. Merits of SDRs.

Ans :

(i) SDRs are a new form of international monetary reserves which have been created to free the international monetary system from its exclusive dependence on the US dollar.

(ii) They have rid the world of its dependence on the supply of gold and fluctuations in gold prices.

(iii) They cannot be demonetized like gold or become scarce when the demand for dollar increases in the world.

(iv) Unlike gold, SDRs are cost less to produce because production of gold requires resources to mine, refine, transport and guard it.

(v) SDRs have been created to improve international liquidity so as to correct fundamental disequilibria in balance of payments of Fund members. Under this scheme, the participants receive SDRs under transactions with designation and transaction by agreement unconditionally.

(vi) Fund members are not required to change their domestic economic policies as they are expected under the Fund aid programmes.

(vii) The payment and repayment of SDRs out of the Special Drawing Account is easier and more flexible than under the Fund schemes.

(viii) Last but not the least, SDRs act both as a unit of account and a means of payment of international monetary system.

Choose the Correct Answers

1. The world Bank was established on : [a]
   (a) 1944 (b) 1945
   (c) 1947 (d) 1950
2. Which of the following statement is correct? [a]
   (a) Every members of the IMF is automatically becomes the member of the World Bank
   (b) The World Bank has 50 founder members
   (c) India was not a founder member of the World Bank
   (d) IMF is the part of World bank.
3. Which of the following institution is not part of the World Bank? [c]
   (a) IBRD (b) IDA
   (c) WHO (d) ICSID
4. Headquarter of the World Bank is in : [d]
   (a) Tokiyo (b) Toronto
   (c) New York (d) Washington DC
6. Which of the following currencies has the largest weightage in the determination of the value os SDR? [c]
   (a) Euro (b) British Pound
   (c) US Dollar (d) Japanese Yen
7. When was IMF established? [b]
   (a) Jan 27, 1945 (b) Dec 27, 1945
   (c) Jun 27, 1945 (d) Dec 27, 1944
8. Where the IMF Headquarter located? [d]
   (a) Bretton Woods (b) Geneva
   (c) New York (D) Washington D.C.
9. Which of the following is known as Paper Gold? [c]
   (a) Japanese Yen (b) US Dollar
   (c) Special Drawing Right (d) British Pound
10. What percentage of member countries make public the IMF report about their country? [d]
    (a) Below 5% (b) 15%
    (c) 50% (d) 90%

Fill in the Blanks

1. __________ are one of the most secure instruments available to international traders.
2. __________ financing takes place when exporter need funds immediately and may require financing from a bank.
3. EXIM Stands for __________
4. The IBRD was set up in __________
5. IMF Stands for __________
6. SDRs were created through the First Amendment to the Fund Articles of Agreement in __________
7. __________ is the primary resource of International Monetary Fund.
8. NAB Stands for __________
9. __________ Institution refers to an institution which is formed by three or more countries to work on issues that are relevant to each other.
10. BIS Stands for __________

ANSWERS

1. Letters of credit
2. Accounts receivable
3. Export-Import Bank
4. 1945
5. International Monetary
6. 1969
7. Quota
8. New Arrangements to Borrow
9. Multilateral
10. Bank for International Settlements

UNIT V	**INTERNATIONAL TRADE PRACTICES:** General Agreement on Tariff and Trade (GATT), Consensus on international trade practices, Journey of GATT, WTO: Global Financial Regulations: Global financial crisis in 2007, New global rules and regulations Volcker Rule, Dodd Frank Act, Basel III Accord, Solvency II rules for the insurance sector, Role of international financial institutions and their role in global regulations.

5.1 General Agreement on Tariff and Trade (GATT)

Q1. What is GATT? State the functions of GATT.

Ans : **(Imp.)**

GATT is a multilateral treaty among the member countries that lays down certain agreed rules for conducting international trade. The member countries contribute together to four-fifth of the total world trade.

The basic aim of GATT is to liberalise world trade negotiations among members countries and, for the last forty seven years, it has been concerned with negotiations on the reduction, even the elimination of trade barriers - tariff and non-tariff - between countries and improving trade relations so that the international trade flows freely and swiftly. It also provides a forum to member countries to discuss their trade problems and negotiate to enlarge their trading opportunities.

Functions

1. Most Favored Nation clause

The "Most favored Nation clause is one of the significant provisions adopted by GATT. Under the concept of Most Favored Nation, all contracting parties of the agreement would be treated as most favored nations. The principal objective is that the benefits extended to one should also be extended to all contracting parties. There should be no discrimination among nations. Trading should be carried on the principle of non-discrimination and reciprocity. This clause discouraged the member countries from granting any new trade concessions unless those were mutually agreed upon. However, many escape clauses were found. Under specific circumstances, less developed countries were allowed to exercise the right to discriminate. For example, dumping and export subsidy might be countered by trade measures only against the offending country. Moreover, special concessions were allowed for trade with former colonies of less developed western countries.

2. Tariff and Non-tariff measures

(i) Tariff measures: Tariffs were the important obstacle to international trade. Therefore, GATT encouraged negotiations for the reduction of hig4 tariffs, The participating countries agreed to cut tariff of thousands of industrial products. Reduction of tariff was on reciprocal and mutually advantageous basis. Article 11 of the GATT provided that all concessions granted by contracting parties must be entered in a schedule of concessions. Once a concession was included in the schedule of concessions, it could not be withdrawn except under specified circumstances.

(ii) Non-tariff measures: Post-World War II witnessed reduced distorting effects of non-trade barriers world trade. The Tokyo Round held during 1973 — 1979 tackled the problems of non-tariff barriers under more effective international discipline. All the agreements provide for special and more favorable treatment for developing countries. The negotiations led to the following non-tariff measures:

- restriction on use of subsidies,
- technical barriers,
- import licensing procedures,
- government procurement,
- custom valuation,
- permission of anti-dumping code.

3. Complaints and waivers

Article XXII of the GATT entertains complaints from contacting party relating to the operation of the agreement. The contracting party who is likely to be deprived of the benefits under GATT agreement can request the other party for consultation.

The basic principle of GATT is that member countries should consult one another on trade matters and problems. Article XXV of the GATT provides the procedure for granting waiver to some contracting party from the application of the provisions of the GATT. Waivers are granted on the approval by two thirds of voting contracting parties.

6. Settlement of disputes

GATT aimed at the smooth settlement of disputes among the contracting parties. GATT allows the member countries to settle problems among them by consulting one another on matters of trade. Initially, the contracting parties should resolve the disputes by holding talks on bilateral basis. In case of failure, the dispute may be referred to panels of independent experts formed under GATT council.

The panel members are drawn from countries which have no direct interest in the disputes. If the offending parties does not act upon the panel's decision, the aggrieved party is authorized to withdraw all concessions offered to the offending party. Since the panel procedure ensures mutually satisfactory settlement, members make increased use of the panel.

5.1.1 Consensus on International Trade Practices

Q2. Explain the Consensus on International Trade Practices.

Ans :

1. Non-discrimination

The principle of non discrimination acts as an introductory statement of GATT. The two important provisions of GATT include,

(a) Article I focuses on the principle of "most-favoured nation's treatment".

(b) Article III focuses on the principle of "Nations treatment".

The provision for the most favoured nations treatment (MFNT) deals with the fair and equal treatment for all member countries irrespective of their economic states. It means that when trade negotiations occurred between any two member countries, they need to be extended, informed to all the member countries. But there are certain exceptions to these multilateral agreements such as,

(i) There exists a few bilateral features instead of multilateral negotiations among the members. For example, the trade concessions conducted between Canada and USA remained to be bilateral and the results were not informed to other countries.

(ii) Some of the safeguard clauses also remained bilateral in nature. For example, any country can impose restrictions on imports from a particular country if it faces problem with its balance of payments.

(iii) According to generalised scheme of preferences (GSP) 1970, the products that were manufactured in less the developed countries tend to enjoy high status and preferences in the developed countries.

(iv) Trade concessions that are allowed among the members of regional trade block.

Government of each member nation should treat both the foreign and domestic products equally without any disparities while fixing taxes and duties. Import duties are imposed on foreign products and are free from any internal tax mechanisms whereas, the domestic products have to pay internal taxes and have been exempted from import duties. Because of this non discrimination process of MFNT, the member nations of GATT are not able to restrict the foreign products to enter into the domestic markets. Both foreign suppliers as well as the domestic producers need to ensure fair and transparent operations.

2. Reciprocity

The principle of reciprocity implies "quid pro quo". According tq this principle, the multilateral trade system should maintain a reciprocal relationship among all the member nations. If government or any other authority reduces the trade restrictions of one member nation then it needs to equally reduce the trade restrictions to even another country. The two ways that are available to assess the reciprocity are,

(a) Exchange of similar concessions i.e., trade concessions against trade concessions.

(b) Exchange of dissimilar concessions i.e., offering trade concessions in response of the quantitative reductions example, quotes.

The criteria may be specific for products or across-the-broad trade barrier reduction. The discussions of GATT rounds focussed on bilateral concessions only whereas the discussions of kennedy round focused on multilateral concessions.

3. Market Access

The principle of market access deals with the open trading system wherein there exists computation among the suppliers belonging to various countries. Any national market should not increase the tariff rates beyond the fixed limitations in order to restrict the entry of foreign producers into the domestic markets. Otherwise the concerned party should be held responsible for the loss of attached party and needs to pay the appropriate compensation.

4. Fair Competition

The fourth principle of multilateral trading system emphasize on fair competition. The competition among the countries should be fair and should not be unfair as it may harm other member countries,

5.1.2 Journey of GATT

Q3. Explain the Journey of GATT.

Ans :

There have been a total of eight GATT Rounds since its inception in 1947. The details of these rounds are briefly given in Table.

Year		Subjects Covered	Participating countries
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-61	Geneva (Dillon Round)	Tariffs	26
1964-67	Geneva (Kennedy Round)	Tariffs and Anti-dumping measures	62
1973-79	Geneva (Tokyo Round)	Tariffs, Non-tariff measures and "Framework" agreements	102
1986-93	Geneva (Uruguay Round)	Tariffs, Non-tariff measures, Rules, Services, Intellectual property rights, Dispute settlement, Textiles and Clothing, Agriculture, Establishment of the WTO, etc.	123

1. First Round

The first round of tariff negotiations, the Geneva Round, held in 1947 in Geneva from 10th April to 30th October 1947, was a part of the establishment of the GATT. Just before the end of the first session of the Preparatory Committee, it was decided that the members of the Preparatory Committee should hold negotiations, at the second session to be held at Geneva in 1947, aimed at substantial reduction of tariffs and other barriers to trade on a mutually advantageous basis. The concessions exchanged in the negotiations took the form of:

(i) The complete elimination of certain duties and preferences,

(ii) The reduction of duty preference,

(iii) The binding of duties at existing levels, and

(iv) The binding of duty free treatment.

The participating countries completed 133 sets of bilateral negotiations covering two-thirds of import trade of the countries concerned.

2. Second Round

The second conference for the negotiations was held at Annecy in 1949 with the aim:

(i) To facilitate the extension of GATT to countries which could not participate in the Geneva conference,

(ii) To add nine more countries to increase the strength to 32.

3. Third Round

This Round was known as the Torquay Round, 1951, and the participants who attended this Round were 38 in number. The main issues that were discussed during this round are given below:

(i) About 8700 concessions were negotiated in Torquay.

(ii) Tariff rates were considered and it was found that they had entered the Torquay negotiations at disadvantage.

(iii) The conference was not successful as only 147 out of the accepted 400 agreements could be concluded.

(iv) The success of this conference lay more in the widening of the membership of GATT than in the reduction of tariff.

4. Fourth Round

The Fourth Round, known as the Geneva Round 1956, was attended by 26 countries. The following was the outcome of the talks:

(i) Except the US which went almost by the limits of her negotiating power and granted concessions on imports valued at about $ 900 million and obtained concessions with exports valued at about $400 million, no other country felt satisfied.

(ii) Several countries withdrew from the negotiations owing to inadequate leeway.

(iii) The representatives of European countries returned home with a sense of frustration.

5. Fifth Round

It was known as the Dillon Round, Geneva, 1960-61, and was attended by 26 countries. Three factors had a strong bearing on the decision to hold a tariff negotiating conference in the 1960-61 period.

(i) It related to the step by step progress being made by the European Economic Community towards the establishment of a full customs union comprising the six member states of the community and more particularly those favouring gradual alignment starting in 1961 of the national customs tariffs of Benelux, France, the Federal Republic of Germany and Italy to the new common tariff.

(ii) It was decided to hold a further general round of tariff negotiations especially as these would give an opportunity to negotiate with EEC on its new common tariff.

(iii) The US government had obtained authority in the Trade Agreement Extension Act of 1958 to participate in multilateral tariff negotiations during the four years ending 30 June 1962. If advantage was to be taken of this limited authority, the tariff conference had to be held in the 1960-61 period.

A bilateral tariff agreement between UK and the EEC was announced on 17 May 1962. Agreement included reducing tariffs on a wide variety of industrial goods by one tariff.

6. Sixth Round

This Round was known as the Kennedy Round, 1964-67, and was attended by 62 participants. The following decisions were taken after three years of long discussions:

(a) The President got unprecedented powers to reduce, on a reciprocal basis, almost the entire range of US tariff by 50%, spread over five years.

(b) Negotiations permitted the broadcast of possible tariff reductions; increased access to world markets for agricultural products; and the granting of concessions to the developing countries on a non-reciprocal basis, for products of special interest to the US.

(c) The participants in the negotiations made tariff reductions together account for almost 75% of total world trade and the concessions granted by them represent a volume of trade valued at slightly more than $ 40,000 million.

(d) In the field of non-tariffs:

(i) The agreement relating principally to chemicals should, inter alia, result in the abolition of the American selling price system of valuation applied to imports of certain chemical products under which the US did not empower the President to negotiate on this matter.

(ii) On anti-dumping code, as per Article VI of the GATT, a Committee on Anti-Dumping Practice was established on 1 July 1968, where the signatory countries could consult on matters relating to the administration of anti- dumping systems.

(e) Agriculture Round: The negotiations on grains resulted in agreement on basic minimum and maximum prices for varieties of wheat of major importance in international trade and on the provisions to developing countries of 4.5 million metric tons of grains annually, initially for a three-year period.

(f) The tariff concessions negotiated in this round were to be implemented in stages. The countries could either make the total reduction in tariffs in five equal annual installments, first on 1st Jan 1968; or make 2/5th of the total reduction by 1st July 1968, and subsequent reductions by 1st Jan. 1970, 1971 and 1972. There was nothing to prevent countries from making their tariff cuts earlier than the dates provided for if they so wished.

7. Seventh Round

This Round was known as the Tokyo Round, 1973-79, and was attended by 102 participants. The following decisions were taken during this Round:

(i) This round presented an opportunity to review and improve the working of some of the fundamental provisions of GATT, notably Article I, the most favoured nation (MFN) clause.

(ii) This agreement marks a turning point in international trade relations by recognizing tariff and non-tariff preferential treatment in favour of and among developing countries as a permanent legal feature of the world-trading feature.

(iii) It codifies practices and procedures regarding the use of trade measures by governments to safeguard their external financial position and their balance of payments (BoPs).

8. Eighth Round

Dunkel's Proposals of Uruguay Round.

Uruguay round of multilateral trade negotiations was initiated in September 1986 and concluded on 15th September, 1993. Mr Arthur Dunkel, the then Director General of GATT submitted a proposal on 20th December, 1991 popularly known as Dunkel proposals which envisages trade liberalization in many area like trade related investment measures (trims), trade related Intellectual property rights (Trips), other services, textiles, clothing and agricultural subsidies. These proposals wave discussed in the final round of GATT.

This round of negotiations covers a wide range of subjects like subsidies, safeguards, Trade Related Intellectual Property Rights (TRIPs), Trade related investment measures (TRIMs) and Trade services. An agreement regarding multilateral trading system was finally signed in marrakesh, Morocco, on 15th April, 1994.

9. WTO

The World Trade Organisation was established on January 1, 1995, following the Marrakesh Agreement which was ratified on April 15, 1994. The General Agreement on Tariff and Trade was substituted by the Marrakesh Agreement.

5.2 WTO

Q4. What is WTO? Explain the objectives of WTO.

Ans : **(Imp.)**

The World Trade Organisation or the WTO is the only such global international entity that deals with the rules and regulations related to international trade between different countries. Such regulations and obligations only cover countries that hold membership to the World Trade Organisation. The functioning of the WTO is based on negotiated and signed WTO agreements between member countries. It has to be kept in mind that the WTO agreements will have to be ratified by the parliaments of the member countries.

The World Trade Organisation was established on January 1, 1995, following the Marrakesh Agreement which was ratified on April 15, 1994. The General Agreement on Tariff and Trade was substituted by the Marrakesh Agreement.

Objectives

The purposes and objectives of the WTO are spelled out in the preamble to the Marrakesh Agreement. In a nutshell, these are:

(a) To ensure the reduction of tariffs and other barriers to trade.

(b) To eliminate discriminatory treatment in international trade relations.

(c) To facilitate higher standards of living, full employment, a growing volume of real income and effective demand, and an increase in production and trade in goods and services of the member nations.

(d) To make positive effect, which ensures developing countries, especially the least developed secure a level of share in the growth of international trade that reflects the needs of their economic development.

(e) To facilitate the optimal use of the world's resources for sustainable development.

(f) To promote an integrated, more viable and durable trading system incorporating all the resolutions of the Uruguay Round's multi-lateral trade negotiations.

Above all, to ensure that linkages trade policies, environmental policies with sustainable growth and development are taken care of by the member countries in evolving a new economic order.

Q5. What are the advantages and dis-advantages of WTO?

Ans : **(Imp.)**

Advantages

1. Helps promote peace within nations

Peace is partly an outcome of two of the most fundamental principle of the trading system; helping trade flow smoothly and providing countries with a constructive and fair outlet for dealing with disputes over trade issues. Peace creates international confidence and cooperation that the WTO creates and reinforces.

2. Disputes are handled constructively

As trade expands in volume, in the numbers of products traded and in the number of countries and company trading, there is a greater chance that disputes will arise. WTO helps resolve these disputes peacefully and constructively. If this could be left to the member states, the dispute may lead to serious conflict, but lot of trade tension is reduced by organizations such as WTO.

3. Rules make life easier for all

WTO system is based on rules rather than power and this makes life easier for all trading nations. WTO reduces some inequalities giving smaller countries more voice, and at the same time freeing the major powers from the complexity of having to negotiate trade agreements with each of the member states.

4. Free trade cuts the cost of living

Protectionism is expensive, it raises prices, and WTO lowers trade barriers through negotiation and applies the principle of non-discrimination. The result is reduced costs of production (because imports used in production are cheaper) and reduced prices of finished goods and services, and ultimately a lower cost of living.

5. It provides more choice of products and qualities

It gives consumer more choice and a broader range of qualities to choose from.

6. Trade raises income

Through WTO trade barriers are lowered and this increases imports and exports thus earning the country foreign exchange thus raising the country's income.

7. Trade stimulates economic growth

With upward trend economic growth, jobs can be created and this can be enhanced by WTO through careful policy making and powers of freer trade.

8. Basic principles make life more efficient

The basic principles make the system economically more efficient and they cut costs. Many benefits of the trading system are as a result of essential principle at the heart of the WTO system and they make life simpler for the enterprises directly involved in international trade and for the producers of goods/services. Such principles include; non-discrimination, transparency, increased certainty about trading conditions etc. together they make trading simpler, cutting company costs and increasing confidence in the future and this in turn means more job opportunities and better goods and services for consumers.

9. Governments are shielded from lobbying

WTO system shields the government from narrow interest. Government is better placed to defend themselves against lobbying from narrow interest groups by focusing on trade-offs that are made in the interests of everyone in the economy.

10. The system encourages good governance

The WTO system encourages good government. The WTO rules discourage a range of unwise policies and the commitment made to liberalize a sector of trade becomes difficult to reverse. These rules reduce opportunities for corruption.

Disadvantages

1. The WTO is fundamentally undemo-cratic

The policies of the WTO impact all aspects of society and the planet, but it is not a democratic, transparent institution. The WTO rules are written by and for corporations with inside access to the negotiations. For example, the US Trade Representative gets heavy input for negotiations from 17 "Industry Sector Advisory Committees" Citizen input by consumer, environmental, human rights and labor organizations is consistently ignored. Even simple requests for information are denied, and the proceedings are held in secret.

2. **The WTO won't make us safer**

The WTO would like you to believe that creating a world of free trade will promote global understanding and peace. On the contrary, the domination of international trade by rich countries for the benefit of their individual interests fuels anger and resentment that make us less safe. To build real global security, we need international agreements that respect people's rights to democracy and trade systems that promote global justice.

3. **The WTO tramples labor and human rights**

WTO rules put the rights of corporations to profit over human and labor rights. The WTO encourages a race to the bottom in wages by pitting workers against each other rather than promoting internationally recognized labor standards. The WTO has ruled that it is illegal for a government to ban a product based on the way it is produced, such as with child labor. It has also ruled that governments cannot take into account non commercial values such as human rights, or the behavior of companies that do business with vicious dictatorships such as Burma when making purchasing decisions.

4. **The WTO Would Privatize Essential Services**

The WTO is seeking to privatize essential public services such as education, health care, energy and water. Privatization means the selling off of public assets such as radio airwaves or schools to private corporations, to run for profit rather than the public good. The WTO's General Agreement on Trade in Services, or GATS, includes a list of about 160 threatened services including elder and child care, sewage, garbage, park maintenance, telecommuni-cations, construction, banking, insurance, transportation, shipping, postal services, and tourism. In some countries, privatization is already occurring. Those least able to pay for vital services working class communities and communities of color - are the ones who suffer the most.

5. **The WTO Is Destroying the Environment**

The WTO is being used by corporations to dismantle hard-won local and national environmental protections, which are attacked as barriers to trade. The very first WTO panel ruled that a provision of the US Clean Air Act, requiring both domestic and foreign producers alike to produce cleaner gasoline, was illegal. The WTO declared illegal a provision of the Endangered Species Act that requires shrimp sold in the US to be caught with an inexpensive device allowing endangered sea turtles to escape. The WTO is attempting to deregulate industries including logging, fishing, water utilities, and energy distribution, which will lead to further exploitation of these natural resources.

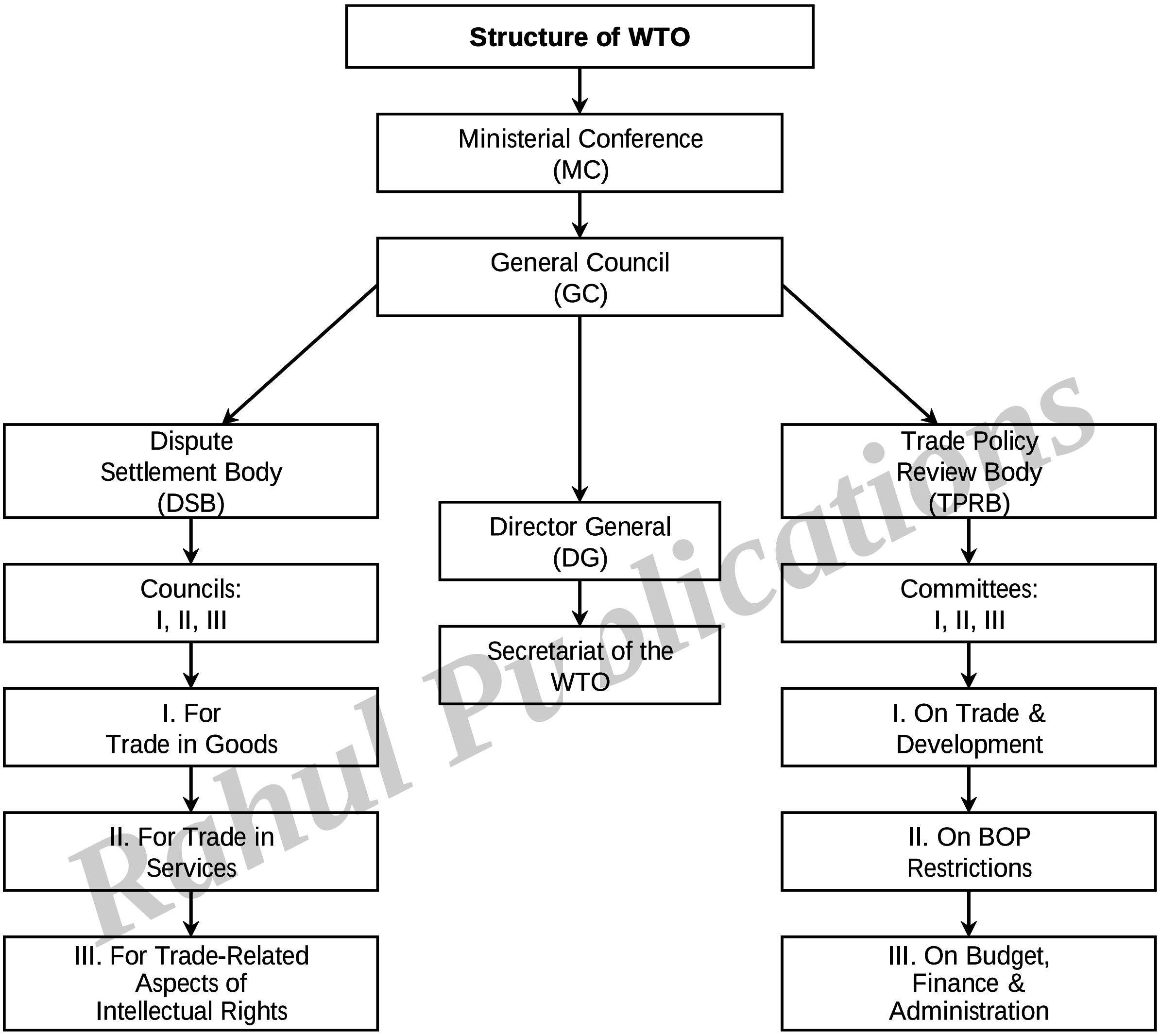
6. **The WTO is Killing People**

The WTO's fierce defense of Trade Related Intellectual Property rights (TRIPs) patents copyrights and trademarks comes at the expense of health and human lives. The WTO has protected for pharmaceutical companies right to profit against governments seeking to protect their people's health by providing lifesaving medicines in countries in areas like sub-saharan Africa, where thousands die every day from HIV/AIDS. Developing countries won an important victory in 2001 when they affirmed the right to produce generic drugs (or import them if they lacked production capacity), so that they could provide essential lifesaving medicines to their populations less expensively. Unfortunately, in September 2003, many new conditions were agreed to that will make it more difficult for countries to produce those drugs. Once again, the WTO demonstrates that it favors corporate profit over saving human lives.

Q6. Explain the structure of WTO.

Ans : **(Imp.)**

The organisational structure of the WTO is outlined in the figure below:



It is the supreme governing body which takes ultimate decisions on all matters. It is constituted by representatives of (usually, Ministers of Trade) all the member countries. The General Council (GC) is composed of the representatives of all the members. It is the real engine of the WTO which acts on behalf of the MC. It also acts as the Dispute Settlement Body as well as the Trade Policy Review Body.

There are three councils, viz.: the Council for Trade in Services and the Council for Trade- Related Aspects of Intellectual Property Rights (TRIPS) operating under the GC. These councils with their subsidiary bodies carry out their specific responsibilities

Further, there are three committees, viz., the Committee on Trade and Development (CTD), the Committee on Balance of Payments Restrictions (CBOPR), and the Committee on Budget, Finance and Administration (CF A) which execute the functions assigned to them by e WTO Agreement and the GC.

The administration of the WTO is conducted by the Secretariat which is headed by the Director General (DG) appointed by the MC for the tenure of four years. He is assisted by the four Deputy Directors from different member countries. The annual budget estimates and financial statement of the WTO are presented by the DG to the CBFA for review and recommendations for the final approval by the GC.

Q7. What are the functions of WTO?

Ans :

The WTO consisting a multi-faced normative framework: comprising institutional substantive and implementation aspects.

The major functions of the WTO are as follows:

(a) To lay-down a substantive code of conduct aiming at reducing trade barriers including tariffs and eliminating discrimination in international trade relations.

(b) To provide the institutional framework for the administration of the substantive code which encompasses a spectrum of norms governing the conduct of member countries in the arena of global trade.

(c) To provide an integrated structure of the administration, thus, to facilitate the implementation, administration and fulfillment of the objectives of the WTO Agreement and other Multilateral Trade Agreements.

(d) To ensure the implementation of the substantive code.

(e) To act as a forum for the negotiation of further trade liberalisation.

(f) To cooperate with the IMF and WB and its associates for establishing a coherence in trade policy-making.

(g) To settle the trade-related disputes.

Q8. Explain the role of WTO in protecting international trade.

Ans :

The protectionism which rose in worldwide exchange after the Second World War offered approach to steady advancement, containing both one-sided progression and standards based multilateral advancement. Globalisation is the after effect of free or less limited exchanging merchandise, administrations, innovation, and capital among different nations. However there are different standing up to issues that limit the development of universal exchange, they are exchange obstructions, monetary help, robbery and all the more particularly infringement of protected innovation rights. This happens due to various exchanging rules, nonappearance of correspondence, and so on. It is here where WTO gives a worldwide stage to the signatory nations to meet and examine their issues and to catch by and large acknowledged answers for smoother change to more prominent unhindered commerce administrations. In this manner WTO effectively contributes for the improvement of respective concessions to facilitated commerce in products, administrations and innovation.

WTO is the main universal association managing the worldwide tenets of exchange between countries. The World Trade Organization appeared with impact from 1-1-1995. The WTO supplanted General Agreement on Tariffs and Trade (GATT). Its primary capacities are:

(a) To take care of the organization of assertions marked at the Uruguay Round.

(b) To keep minds the execution of levy cuts and decrease of non-duty measures.

(c) To analyse remote exchange approaches of the part countries, and to see that such strategies are tuned in to WTO's rules.

(d) To set down techniques for touching base at a concordant arrangement if there should arise an occurrence of exchange clashes.

(e) To give vital consultancy to the part countries on the improvement in the World economy.

(f) To give a worldwide stage where part countries persistently arrange the trading of exchange concessions.

The resultant result is the confirmation to the buyers and makers who realise that they can appreciate more noteworthy selection of items and administrations. At the core of the framework are the WTO's understandings, which are standard procedures for universal business and are marked by the exchanging countries.

Following are the primary standards of the WTO:

(a) Non-separation: It infers both remote and national organisations are dealt with the same. Consequently all countries ought to be dealt with similarly regarding exchange.

(b) Correspondence: Nations should endeavor to give comparable concessions to each other.

(c) Transparency: Negotiations must be reasonable and open with rules meet for all.

(d) Special and differential treatment: It gives that creating nations may require 'positive separation' on account of note-worthy unequal exchange.

Q9. Explain the various agreements of WTO.

Ans :

1. Agreement on Agriculture (AOA)

This agreement give an underlying structure for the long-term reform of the domestic policies and agricultural trade with an aim of initiating increased market orientation in the agricultural trade. This agreement provides guarantees or commitments in the areas of domestic (support) market access and export competition. The non tariff barriers such as quotas should be converted into the corresponding tariff measures by the members.

2. Agreement on Trade in Textiles and Clothing (Multi Fibre Arrangement)

This agreement emphasizes on the removal of import quotas on textiles and clothing under the multi fibre arrangement from the year 1974 onwards, upto a period of 10 years, which means till the end of conversion period, 1st January, 2005. This led to the abolishment of quotas on the textiles and clothing.

3. Agreement on Market Access

The member countries will reduce the rates of tariffs by an average of 37% on industrial and farm goods. The European Union and United States of America will reduce the tariffs between them by 1.5%.

4. Agreement on TRIMs

This agreement had led to the introduction of national treatment of foreign investment and elimination of quantitative restrictions. It recognizes five measures of investment which are incompatible with the provisions of GATT as per the national treatment.

5. Agreement on TRIPs

Before the introduction of TRIPs agreement, the rights of intellectual property relating to trade were regulated by the Paris convention of 1863, which was revised till the year 1967. The Paris convention was moderately liberal and gave the authority to the respective national governments for deciding the terms of patent, subject matter of patent and duration of protection. In pharmaceutical sector, there was significant deviations, as some countries protected the end product, many nations protected the production process and some nations protected neither the product nor the process.

6. Agreement on Services

For the first time, in the subject of trade in services such as insurance, banking, transportation and so on was included within the scope of negotiations in the Uruguay round. The multilateral framework services and principles regulating the trade in services were given by the GATT. This framework was subjected to the conditions of transparency and professive liberalization. It also gives specific compulsions such as maintenance of transparency, granting the MFN status to other member countries and a general commitment for liberalization.

7. Disputes Settlement Body

Under GATT, the process of dispute settlement is a long-term and never ending, as there are significant chances for delays in the procedure, chances of objections being raised at every stage of the process of dispute settlement and the rejections of the penal reports by the offending party.

8. Agreement on Technical Barriers to Trade (TBT)

Excessive or misused industrial standards and safety/environment regulations may be used as trade barriers by some member countries.

9. **Agreement on Import Licensing Procedures**

The purpose of this agreement is to simplify administrative procedures and ensure their fair and transparent operation.

10. Agreement on Safeguards

The purpose of this agreements is to clarify disciplines for requirements and procedures for imposing safeguards and related measures.

11. Trade Policy Review Mechanism (TPRM)

This agreement contains the procedures for the trade policy review mechanism to conduct periodical reviews of member countries trade policies and practices.

Q10. What are the differences between GATT and WTO.

Ans :

S.No.	GATT	WTO
1.	General Agreement on Trade and Tariff	World Trade Organization
2.	It is an agreement	It is an organization
3.	It is concerned with goods.	It is concerned with goods, service and intellectual property
4.	In was established in 1 Jan, 1948	It was established in 1 Jan, 1995
5.	It has weak and slow dispute settlement mechanism	It has strong dispute settlement mechanism.
6.	It was signed by 23 countries.	It was signed by 164 countries.
7.	It was provisional	It is permanent
8.	Member nations who signed this agreement are known as contracting parties.	Participating parties are called member nations.

5.3 Global Financial Regulations

Q11. Write a note on Global Financial Regulations.

Ans :

International Trade involves cross border exchange of goods and services between several business firms. In this process, these participating firms are to follow the rules and regulations framed by countries involved in international trade. In the post globalization era, the world has become a global village and accelerated the foreign trade. It contains both prospects and consequences around. In order to ensure smooth and fair trading activities at the international level, consensus has obtained to frame certain international trade rules and regulations. It provides a proper guidance about common global financial regulations for the business firms involved in international business activities- around the globe. It became more essential after the incident of global financial crisis in the year 2007 to design global financial regulation. There are number of rules framed and designed by international policy makers as regards to international finance such as Volcker Rule, Dodd Frank Act, Basel III Accord and Solvency II rules for the insurance sector etc.

5.3.1 Global financial crisis in 2007

Q12. What was the Global financial crisis in 2007. Explain the impact of Global financial crisis on Indian market and economy?

Ans : **(Imp.)**

The year 2008-09 has witnessed one of the biggest global financial crises. Failure of some of the large financial firms of United States was the beginning of the global financial market meltdown September 2008. It was just the trailer of financial crisis commenced from the most powerful country of the world United States of America and reached several corners of the world. It pushed down the world economy up to a large extent. As a result of this financial breakdown, stock markets had fallen; large financial institutions got collapsed or sold, adverse effects of Export- Import business, increase in interest rates due to the crunch of domestic liquidity, depreciation in the value of domestic currency and foreign exchange reserves. All these factors worked as a driven force for the governments of different countries even of the rich and developed nations to come up with rescue packages to bail out their financial and economic system from the global financial crisis situation.

Impact of Global Financial Crisis on Indian Market and Economy

The Global Financial Crisis had a direct impact on the economy of all the countries around the world in May 2008. The heat of global financial meltdown was felt hard in India too like other developing countries. All the macroeconomic and financial indicators of the country during the financial year 2008-09 had presented negative trend. During that tenure, industrial production reduced to 2.7% from 9.2% average growth in the previous four years, Economic Growth rate stood at only 6.7%, The Index of Bombay Stock Exchange had lost 37.9% of its market value, wealth of general people got affected adversely and even the capital formation in the market substantially affected. Besides, sharp increase in the prices of commodities in the international raised the rate of inflation in the country.

The rate of growth of the advanced economies recorded a slow growth rate. India's bilateral trade stagnated in the financial year 2008-09. The growth in exports stood at mere 5.4% and current account deficit increased up to 2.6%. Restriction and excessive control on credit market in advanced economies made it highly difficult for Indian business houses to raise debt funds from external markets. All these factors were responsible for the depreciation in the value of Indian Rupee against many of the major foreign currencies. In order to face and tackle the global financial crisis, India had intervened in the foreign exchange market to support its currency using its foreign reserves. It was resulted in reduction of foreign exchange reserve from US$ 309.7 billion in 2007-08 to US$ 252 billion during the financial year 2008-09.

Q13. Explain the impact of Global financial crisis on Indian banking sector.

Ans :

- When the entire banking and financial system around the world got collapsed and adversely affected due to the global financial crisis, Indian banking system managed to maintain its position.
- Due to the stringent regulations and efficient monitoring system, Indian banks were not directly exposed to the sub-prime mortgaged assets, derivatives and off balance sheet activities.
- There were no direct exposures of Indian banks to the US sub-prime mortgage market, credit default swap market, to the failed institutions and stressed assets.

- During this time, the total share of bank assets held by foreign banks in India was around 5%. It was almost at the lowest level in comparison with that of other countries.
- The lending practices adopted by the Indian banks were also prudent in their lending practices in the real estate sector.
- Banks were generally issued mortgaged loans and avoided subprime mortgage loans.

Q14. Discuss the measures taken by the RBI to control the financial crisis in India

Ans :

In order to control the impact of global financial crisis, various measures have been taken by the RBI. Some of them are discussed below,

1. Action Plan

An action plan was formulated and implemented by the RBI to saturate the value of Indian rupee and liquidity of foreign exchange for ensuring smooth flow of credit to productive sectors of India.

2. Repo Rate

The RBI reduced the repo rate to 4.75% and reverse repo rate to 3.25% in order to effectively manage the crisis situation.

3. Refinancing Service

RBI initiated and introduced a refinance service facility which will be provided to the banks for then easy access.

4. Market Stabilization

The RBI introduced market stabilization scheme for managing liquidity and synchronizing the entire lending system of the Indian Government.

5. Rupee-Dollar Swap

The RBI initiated a measure by incorporating rupee-dollar swap facility for banks which are the branches of foreign banks. The purpose of this scheme is to help in managing their requirement of short-term funding.

5.4 New Global Rules and Regulations

Q15. Explain briefly about new global rules and regulations.

Ans :

Various rules and regulations were formed and implemented in response to the global financial crisis of 2007. They are as follows :

1. Volcker Rule

The Volcker rule generally prohibits banking entities from engaging in proprietary trading or investing in or sponsoring hedge funds or private equity funds.

The regulations have been developed by five federal financial regulatory agencies, including the Federal Reserve Board, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission.

2. Dodd Frank Act

This Act is framed to regulate and protect consumers along with the financial market. It was initially established with the purpose of preventing the repetition of 2008 financial crisis. It is a comprehensive part of financial reform since the Glass-Steagall Act. The Dodd-Frank Act is named after the two lawmakers who created it: Senator Chris Dodd and Representative Barney Frank. It was signed and came in to effect on July 21, 2010. Protecting consumers and tax payers from the risks of investment made by bank with their deposits is the main aim of this act.

3. Basel III Accord

The Basel III accord is a set of financial reforms that was developed by the Basel Committee on Banking Supervision (BCBS), with the aim of strengthening regulation, supervision, and risk management within the banking industry. Due to the impact of the 2008 Global Financial Crisis on banks, Basel III was introduced to improve the banks' ability to handle shocks from financial stress and to strengthen their transparency and disclosure.

Basel III builds on the previous accords, Basel I and II, and is part of a continuous process to enhance regulation in the banking industry. The accord aims to prevent banks from hurting the economy by taking more risks than they can handle.

4. Solvency II

Solvency II is harmonized framework designed for insurance companies of European Union in the year 2009. Its introduction replaces the patchwork or rules in the areas like, life insurance, non-life insurance and reinsurance. The rules of Solvency II promote competitiveness comparability and transparency in insurance sector.

5.4.1 Volcker Rule

Q16. What is Volcker Rule. Explain the provisions and exceptions of the Volcker Rule.

Ans : **(Imp.)**

The Volcker rule generally prohibits banking entities from engaging in proprietary trading or investing in or sponsoring hedge funds or private equity funds.

The regulations have been developed by five federal financial regulatory agencies, including the Federal Reserve Board, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission.

Provisions

The Volcker Rule prohibits commercial banks from engaging in the following activities:

1. Proprietary trading

The rule prevents banks from using their own accounts to engage in proprietary trading of short-term securities, derivatives, futures, and options. This rule is based on the fact that such high-risk investments do not benefit the bank's depositors.

2. Owning and investing in hedge and private equity funds

The Volcker rule prevents FDIC-insured banks and deposit-taking institutions from acquiring or partnering with hedge funds or private equity funds. Such institutions invest in high-risk investments that banks use to speculate. Using the depositors' funds to invest in hedge funds subjects the funds to a high probability of incurring losses.

Exceptions

Even though the Volcker rule prohibited commercial banks from engaging in certain trading activities, the rule allowed banks to engage in the following trading activities:

1. Government bonds

United States government bonds are considered low-risk investments that commercial banks can buy and sell since they are backed by the government. Examples of such bonds include Treasury bills, Fannie Mae, and Ginnie Mae.

2. Market making and underwriting

Commercial banks are allowed to offer various services such as hedging, market making, underwriting, and insurance services, as well as acting as agents, brokers, or custodians. Offering these services to the banks' clients can help them generate profits. However, the banks are only allowed to offer the services to their clients and not engage in the activities directly.

5.4.2 Dodd Frank Act

Q17. What is Dodd Frank Act? Explain the provisions of Dodd Frank Act.

Ans : **(Imp.)**

This Act is framed to regulate and protect consumers along with the financial market. It was initially established with the purpose of preventing the repetition of 2008 financial crisis. It is a comprehensive part of financial reform since the Glass-Steagall Act. The Dodd-Frank Act is named after the two lawmakers who created it: Senator Chris Dodd and Representative Barney Frank. It was signed and came in to effect on July 21, 2010. Protecting consumers and tax payers from the risks of investment made by bank with their deposits is the main aim of this act.

Key Provisions of Dodd Frank Act

Following are the key provisions laid down in Dodd-Frank Act:

1. The Financial Stability Oversight Council (FSOC)

The Financial Stability Oversight Council (FSOC) is the institution keeps banks and other financial service providers from being "too big to fail." It was one of the most crucial facts responsible for the 2008 financial crisis. The council was assigned the role and responsibility to control and regulate activities of financial service providers and banks by strengthening the rules and regulations on investment propositions.

2. Banking Industry Stress Tests

As per the provisions of this act, the Federal Reserve was assigned the duty to closely monitor the largest banks, financial institutions and big insurance companies in U.S. It was essential to go for some special annual tests in order to ensure that all these large organizations were being prepared for facing the unforeseen future risks, uncertainties, economic recessions and possible future financial crises. These tests were named as Stress Tests. These so-called stress tests used hypothetical scenarios for evaluating the impact of several financial shocks might have on their stability. In case a bank doesn't have enough funds as capital, the Federal Reserve can go for suspension of its share buybacks or put a cap on dividends to maintain the financial position of the bank balanced.

3. The Consumer Financial Protection Bureau

There are number of regulatory bodies formed as per the Dodd-Frank Act. Out of those, Consumer Financial Protection Bureau (CFPB) was one of the most high-profile and notable one. The main objective of this institution was to protect consumers from risky financial schemes. Bureau is empowered to control and regulate companies dealt with exchange of financial products. The CFPB was developed in the light of "Food and Drug Administration (FDA)" to maintain balance in the consumer finance industry. The CFPB was authorized to fine lenders who act against its regulations and oversight. Consumers were also allowed to pledge their grievances and formal complaints to the bureau.

4. The Volcker Rule

The Volcker Rule is being named after the name of former Federal Reserve chairman, Paul Volcker. He was proposer of the said rule. This rule was primarily issued to control and regulate the speculative trading activities performed by banks in United States ignoring the interest and benefits of the consumers. Volcker was the head of the Economic Recovery Advisory Body under Obama Administration in the year 2009. He had pointed about the role of banks in the global financial crisis 2008 as the effect of speculative trading activities. It causes huge amount of losses to the large banks involved in speculating trading activities which ultimately forced Government to control the situation by granting bailout packages to the banks for protecting the people's hard earned money deposited in the banks.

The proposal tabled by Volcker emphasized on keeping a separate division for investment banking in all the commercial banks. Later, this proposal was recommended as an overhaul of financial industry. It is pertinent to note that the Volcker Rule is a part of the Dodd-Frank Act approved in 2010 but came in to effect in the year 2013 finally. On the other hand, the final Dodd-Frank Act was approved in 2014 December by the Federal Reserve, Federal Deposit Insurance Corporation, Securities and Exchange Commission, Office of Comptroller of Currency and the Commodity Futures Trading Commission.

5. Monitoring Risky Derivatives

The Dodd-Frank Act enabled the Securities and Exchange Commission (SEC) to control and regulate derivative trading. These trades consisted of different activities such as exchange of bonds, commodities, currencies, interest rates, market indexes or stocks. Responsibility was fixed on the regulators in charge of derivative trading for identification of risks in trades and takes appropriate action before it accelerates the chances of a financial collapse.

6. Strengthening the Sarbanes-Oxley Act

The Sarbanes-Oxley Act was passed in the year 2002 for dealing with several corporate scandals occurred at publicly traded companies such as Enron. This Act brought reform in the field of corporate responsibility and made CEOs personally accountable for errors identified in accounting and protecting individuals who flag bad behavior mostly the whistleblowers. Dodd-Frank further strengthened number of additional provisions under Sarbanes-Oxley Act. It established a bounty program where whistleblowers were entitled to 10% to 30% of the proceeds from successful litigation settlements that they inspire by reporting on bad behavior. It extended the statute of limitations during which an employee can submit a claim against their employer, doubling it from 90 days to 180 days.

7. Requiring Hedge Funds to Register with the SEC

In the 2008 financial crisis, there was a major issue connected with hedge funds. It was creating confusion and complexity in international trades. The Dodd-Frank Act made it mandatory to register all hedge funds with the SEC. It was proved helpful for the SEC to assess the overall risks associated with hedge funds by using its key informations connected with trades and portfolios.

8. Federal Insurance Office (FIO)

Federal Insurance Office (FIO) is performing under the administration of Treasury Department of U.S. This institute monitors all aspects related to insurance sector and makes sure insurance companies are following the law. In addition to this, the office also regulates non-deserving communities and consumers having access to affordable non-health insurance products. It provides warning signal to the investors and others connected with insurance sector about the collapse in the financial market. It also plays the role of advisory member of the FSOC. FIO works closely with the National Association of Insurance Commissioners (NAIC) and provides advice on important national and international insurance issues.

9. SEC Office of Credit Ratings

Dodd-Frank has created a separate Office of Credit Ratings (OCR) at the SEC to oversee credit ratings agencies like Standard & Poor's and Moody's. These agencies help in updating and creating awareness among investors about the risks involved in buying and selling of securities. These companies played crucial role in the year 2008 crisis by putting their best ratings to special financial products that repacked highly risky debt and were sold as safe investments.

5.4.3 Basel III Accord

Q18. Explain briefly about Basel III Accord.

Ans : **(Imp.)**

The Basel III accord is a set of financial reforms that was developed by the Basel Committee on Banking Supervision (BCBS), with the aim of strengthening regulation, supervision, and risk management within the banking industry. Due to the impact of the 2008 Global Financial Crisis on banks, Basel III was introduced to improve the banks' ability to handle shocks from financial stress and to strengthen their transparency and disclosure.

Basel III builds on the previous accords, Basel I and II, and is part of a continuous process to enhance regulation in the banking industry. The accord aims to prevent banks from hurting the economy by taking more risks than they can handle.

Key Principles of Basel III

1. Minimum Capital Requirements

The Basel III accord raised the minimum capital requirements for banks from 2% in Basel II to 4.5% of common equity, as a percentage of the bank's risk-weighted assets. There is also an additional 2.5% buffer capital requirement that brings the total minimum requirement to 7%. Banks can use the buffer when faced with financial stress, but doing so can lead to even more financial constraints when paying dividends.

2. Leverage Ratio

Basel III introduced a non-risk-based leverage ratio to serve as a backstop to the risk-based capital requirements. Banks are required to hold a leverage ratio in excess of 3%. The non-risk-based leverage ratio is calculated by dividing Tier 1 capital by the average total consolidated assets of a bank.

To conform to the requirement, the Federal Reserve Bank of the United States fixed the leverage ratio at 5% for insured bank holding companies, and at 6% for Systematically Important Financial Institutions (SIFI).

3. Liquidity Requirements

Basel III introduced the usage of two liquidity ratios – the Liquidity Coverage Ratio and the Net Stable Funding Ratio. The Liquidity Coverage Ratio requires banks to hold sufficient highly liquid assets that can withstand a 30-day stressed funding scenario as specified by the supervisors. The Liquidity Coverage Ratio mandate was introduced in 2015 at only 60% of its stated requirements and is expected to increase by 10% each year till 2019 when it takes full effect.

5.4.4 Solvency II rules for the insurance sector

Q19. Explain briefly about Solvency II rules for the insurance sector.

Ans : **(Imp.)**

Solvency II

Solvency II is harmonized framework designed for insurance companies of European Union in the year 2009. Its introduction replaces the patchwork or rules in the areas like, life insurance, non-life insurance and reinsurance. The rules of Solvency II promote competitiveness comparability and transparency in insurance sector.

Objectives

The key objectives of Solvency II are as follows:

- **Improved consumer protection:** It will ensure a uniform and enhanced level of policyholder protection across the EU. A more robust system will give policyholders greater confidence in the products of insurers.
- **Modernized supervision:** The "Supervisory Review Process" will shift supervisors' focus from compliance monitoring and capital to evaluating insurers' risk profiles and the quality of their risk management and governance systems.
- **Deepened EU market integration:** Through the harmonization of supervisors' regimes.
- Increased international competitiveness of EU insurers.

Solvency II is not just about capital. It is a comprehensive programme of regulatory requirements for insurers, covering authorization, corporate governance, supervisory reporting, public disclosure and risk assessment and management, as well as solvency and reserving.

Level 1 - Primary legislation

This defines a proposal's broad principles. Solvency II's Level 1 is the "Solvency II Framework Directive", formally entitled the "Directive on the taking up and pursuit of the business of insurance and reinsurance".

The Solvency II Framework Directive was adopted and published in the Official Journal of the EU in December 2009. Certain provisions of this Directive, including the implementation deadline, were amended by the Omnibus II Directive. After much delay, this was adopted by the Council of the EU in April 2014 and entered into force on 22 May 2014, following publication in the Official Journal.

The Solvency II Framework Directive replaces the EU's existing 14 insurance and reinsurance directives. It must be transposed into national law in each of the 28 Member States.

Level 2 - Implementing measures

Solvency II Level 2 implementing measures spell out the detailed requirements that insurers must meet. They are set out in Delegated Regulation 2015/35 of 10 October 2014, published in January 2015. This has direct effect in EU Member States, so does not need to be transposed into national laws. There are Implementing Technical Standards and Regulatory Technical Standards in addition.

Level 3 - Guidelines

Guidelines are one of the tools used to increase supervisory convergence. Guidelines are not binding on Supervisory Authorities, but do present an opportunity to harmonise outcomes from Supervisory Authority decisions as they are based on the 'comply or explain' principle. To help national supervisors to implement Solvency II, EIOPA designed Guidelines and Recommendations on how to put Solvency II's detailed provisions into effect.

Level 4 - Post-implementation enforcement

After the deadline for implementation, the European Commission is responsible for ensuring that member states are complying with the legislation. If they are not doing so, the Commission will take enforcement action.

5.5 Role of International Financial Institutions and their Role in Global Regulations

Q20. Explain the Role of international financial institutions and their role in global regulations.

Ans : **(Imp.)**

1. Role of IMF in Global Regulations

The following points highlight the role of IMF in global regulations,

(i) It supervises and directs the operation and evolution of the system by offering a legal framework which is used for consultation and cooperation.

(ii) It supports the implementation of the domestic policies which are consistent and stable with balance of payments, adjustment and financial stability.

(iii) It helps in maintaining the trade and payment systems that are found to be free from any kind of restrictions and exchange rate stability.

(iv) It increases official reserves stock by SDR (Special Drawing Rate) assignments and its credit activity and this inturn leads to the establishment of reserve positions.

(v) The important instruments of IMF which enables it to attain its objectives include,

  (a) Employing surveillance over countries policies.

  (b) Power to assign SDRs.

  (c) It has expanded the financial assistance so as to include the reviewed policies.

2. Role of World Bank in Global Regulations

The following points highlight the role of world bank in global regulations,

(i) It provides reconstruction and developmental loans to those countries which are severely effected through wars and economical crisis.

(ii) It acts as a guarantor for the loans provided by other organizations to promote foreign investments.

(iii) It promotes economic reforms to encourage industrial sector of developing countries.

(iv) It decides the number of loans to be given with certain terms and conditions.

(v) It individually fix the rate of interest based on the terms and conditions decided for a particular project.

3. Role of WTO in Global Regulations

The following points highlight the role of WTO in global regulations,

(i) It plays an important role in third world countries, as majority of them are in the transition period and are moving from the planned economic system to market based economic system. Several programmes were arranged by WTO's Secretariat's Training and Technical Cooperation Institute for training the public officials and the negotiators. It makes a provision to supply information on tariff and trade to the third world countries to assist them in their export.

(ii) It manages and controls the operations and functions of the international trade center. It helps in letting out the information and suggestions on various export markets and marketing methods. It helps in starting the export promotion and marketing services and provides training to the human resources who are required for these services.

(iii) It cooperates with the international monetary fund, the world bank and other multilateral institutions in order to increase the cohesiveness in the global economic policy making.

(iv) It gathers the general information with respect to policies and tariffs from its member countries on a regular basis.

(v) Its agreements assign/allot particular transition periods to the third world countries to adjust to the new and complex situations.

4. Role of International Development Association (IDA)

International Development Association (IDA) was established in 1960 as a component of the world bank group. The main objective of IDA is to provide financial support and assistance to LDCs on more liberal basis compared to IBRD.

The following points highlight the role of IDA,

(i) It generates funds from its developed country members and earnings of IBRD.

(ii) It enables all members of IBRD to join it at any time any where.

(iii) It extended its credit term from 40 to 50 years with zero interest, and repayment may begin after ten- years in the form of local currency.

(iv) it provides loans only to the poorest developing countries of the world.

5. Role of International Finance Corporation (IFC)

International Finance Corporation was initiated in 1956. Its main objective is to provide equity and long-term loans as risk capital to private companies in relation to investors and management of private sector.

The following points highlight the role of IFC,

(i) It provides loans only to the private business corporation.

(ii) It provides funds not only for new businesses but also for developing exiting businesses of private sector for a period of 7 to 12 years.

Short Question and Answers

1. What is GATT?

Ans :

GATT is a multilateral treaty among the member countries that lays down certain agreed rules for conducting international trade. The member countries contribute together to four-fifth of the total world trade.

The basic aim of GATT is to liberalise world trade negotiations among members countries and, for the last forty seven years, it has been concerned with negotiations on the reduction, even the elimination of trade barriers - tariff and non-tariff - between countries and improving trade relations so that the international trade flows freely and swiftly. It also provides a forum to member countries to discuss their trade problems and negotiate to enlarge their trading opportunities.

2. Tariff measures

Ans :

Tariffs were the important obstacle to international trade. Therefore, GATT encouraged negotia-tions for the reduction of hig4 tariffs, The participating countries agreed to cut tariff of thousands of industrial products. Reduction of tariff was on reciprocal and mutually advantageous basis. Article 11 of the GATT provided that all concessions granted by contracting parties must be entered in a schedule of concessions. Once a concession was included in the schedule of concessions, it could not be withdrawn except under specified circumstances.

3. Uruguay Round

Ans :

Uruguay round of multilateral trade negotiations was initiated in September 1986 and concluded on 15th September, 1993. Mr Arthur Dunkel, the then Director General of GATT submitted a proposal on 20th December, 1991 popularly known as Dunkel proposals which envisages trade liberlization in many area like trade related investment measures (trims), trade related Intellectual property rights (Trips), other services, textiles, clothing and agricultural subsidies. These proposals wave discussed in the final round of GATT.

This round of negotiations covers a wide range of subjects like subsidies, safeguards, Trade Related Intellectual Property Rights (TRIPs), Trade related investment measures (TRIMs) and Trade services. An agreement regarding multilateral trading system was finally signed in marrakesh, Morocco, on 15th April, 1994.

4. WTO

Ans :

The World Trade Organisation or the WTO is the only such global international entity that deals with the rules and regulations related to international trade between different countries. Such regulations and obligations only cover countries that hold membership to the World Trade Organisation. The functioning of the WTO is based on negotiated and signed WTO agreements between member countries. It has to be kept in mind that the WTO agreements will have to be ratified by the parliaments of the member countries.

The World Trade Organisation was established on January 1, 1995, following the Marrakesh Agreement which was ratified on April 15, 1994. The General Agreement on Tariff and Trade was substituted by the Marrakesh Agreement.

5. Functions of WTO

Ans :

The major functions of the WTO are as follows:

(a) To lay-down a substantive code of conduct aiming at reducing trade barriers including tariffs and eliminating discrimination in international trade relations.

(b) To provide the institutional framework for the administration of the substantive code which encompasses a spectrum of norms governing the conduct of member countries in the arena of global trade.

(c) To provide an integrated structure of the administration, thus, to facilitate the implementation, administration and fulfillment of the objectives of the WTO Agreement and other Multilateral Trade Agreements.

(d) To ensure the implementation of the substantive code.

6. Agreement on Agriculture (AOA)

Ans :

This agreement give an underlying structure for the long-term reform of the domestic policies and agricultural trade with an aim of initiating increased market orientation in the agricultural trade. This agreement provides guarantees or commitments in the areas of domestic (support) market access and export competition. The non tariff barriers such as quotas should be converted into the corresponding tariff measures by the members.

7. Global Financial Regulations.

Ans :

International Trade involves cross border exchange of goods and services between several business firms. In this process, these participating firms are to follow the rules and regulations framed by countries involved in international trade. In the post globalization era, the world has become a global village and accelerated the foreign trade. It contains both prospects and consequences around. In order to ensure smooth and fair trading activities at the international level, consensus has obtained to frame certain international trade rules and regulations.

It provides a proper guidance about common global financial regulations for the business firms involved in international business activities- around the globe. It became more essential after the incident of global financial crisis in the year 2007 to design global financial regulation. There are number of rules framed and designed by international policy makers as regards to international finance such as Volcker Rule, Dodd Frank Act, Basel III Accord and Solvency II rules for the insurance sector etc.

8. Global financial crisis in 2007.

Ans :

The year 2008-09 has witnessed one of the biggest global financial crises. Failure of some of the large financial firms of United States was the beginning of the global financial market meltdown September 2008. It was just the trailer of financial crisis commenced from the most powerful country of the world United States of America and reached several corners of the world. It pushed down the world economy up to a large extent. As a result of this financial breakdown, stock markets had fallen; large financial institutions got collapsed or sold, adverse effects of Export- Import business, increase in interest rates due to the crunch of domestic liquidity, depreciation in the value of domestic currency and foreign exchange reserves. All these factors worked as a driven force for the governments of different countries even of the rich and developed nations to come up with rescue packages to bail out their financial and economic system from the global financial crisis situation.

9. Volcker Rule

Ans :

The Volcker rule generally prohibits banking entities from engaging in proprietary trading or investing in or sponsoring hedge funds or private equity funds.

The regulations have been developed by five federal financial regulatory agencies, including the Federal Reserve Board, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission.

10. Dodd Frank Act

Ans :

This Act is framed to regulate and protect consumers along with the financial market. It was initially established with the purpose of preventing the repetition of 2008 financial crisis. It is a comprehensive part of financial reform since the Glass-Steagall Act. The Dodd-Frank Act is named after the two lawmakers who created it: Senator Chris Dodd and Representative Barney Frank. It was signed and came in to effect on July 21, 2010. Protecting consumers and tax payers from the risks of investment made by bank with their deposits is the main aim of this act.

11. Basel III Accord

Ans :

The Basel III accord is a set of financial reforms that was developed by the Basel Committee on Banking Supervision (BCBS), with the aim of strengthening regulation, supervision, and risk management within the banking industry. Due to the impact of the 2008 Global Financial Crisis on banks, Basel III was introduced to improve the banks' ability to handle shocks from financial stress and to strengthen their transparency and disclosure.

Basel III builds on the previous accords, Basel I and II, and is part of a continuous process to enhance regulation in the banking industry. The accord aims to prevent banks from hurting the economy by taking more risks than they can handle.

Choose the Correct Answer

1. When did the World Trade Organization come into effect? [d]
   (a) March 6, 1996 (b) April 8, 1994
   (c) February 5, 1994 (d) January 1, 1995
2. How many members are present in the WTO? [d]
   (a) 207 (b) 195
   (c) 160 (d) 164
3. Where is the headquarters of the WTO located? [b]
   (a) Austria (b) Geneva
   (c) New York (d) Washington DC
4. Which of these institutions is not a part of the World Bank community? [c]
   (a) IFC (b) IDA
   (c) WTO (d) IBRD
5. Along with the World Bank and _________________, WTO is the third economic pillar of worldwide dimensions. [b]
   (a) International Economic Association (IEA) (b) International Monetary Funds (IMF)
   (c) International Development Bank (IDB) (d) International Funding Organisation (IFO)
6. Which of the following statements is false? [a]
   (a) India's vote share in the International Monetary Fund is 10%.
   (b) Both the IMF and the IBRD have headquarters in Washington.
   (c) The IBRD is also known as the World Bank.
   (d) Both the IMF and the World Bank are known as the Bretton Woods twins.
7. Among the following options, which one is not the objective of the WTO? [b]
   (a) To protect environment
   (b) To improve the balance of payment situation of the member countries
   (c) To improve the standard of living of people of the member countries
   (d) To enlarge production and trade of goods
8. Who is the current Director-General of WTO? [d]
   (a) Pascal Lamy (b) Mahmoud Riad
   (c) Chedli Klibi (d) Roberto Azevêdo
9. TRIPS (Trade-Related Aspects of Intellectual Property Rights) agreement is administered by the _______ . [c]
   (a) World Bank (WB)
   (b) United Nations Organization (UNO)
   (c) World Trade Organization (WTO)
   (d) United Nations Conference on Trade and Development (UNCTAD)
10. Who is most recently appointed as the Ambassador and Permanent Representative of India to WTO? [d]
    (a) JS Deepak (b) TS Deepak
    (c) Anwar Hussain Shaik (d) Brajendra Navnit

Fill in the Blanks

1. ________ is a multilateral treaty among the member countries that lays down certain agreed rules for conducting international trade.
2. The World Trade Organisation was established on ________.
3. The ________ or the WTO is the only such global international entity that deals with the rules and regulations related to international trade between different countries.
4. AOA Stands for ________.
5. The ________ Crisis had a direct impact on the economy of all the countries around the world in May 2008.
6. The ________ generally prohibits banking entities from engaging in proprietary trading or investing in or sponsoring hedge funds or private equity funds.
7. ________ is harmonized framework designed for insurance companies of European Union in the year 2009.
8. FSOC Stands for ________.
9. BCBS Stands for ________.
10. ________ introduced a non-risk-based leverage ratio to serve as a backstop to the risk-based capital requirements.

ANSWERS

1. GATT
2. January 1, 1995,
3. World Trade Organisation
4. Agreement on Agriculture.
5. Global Financial
6. Volcker Rule
7. Solvency II
8. Financial Stability Oversight Council
9. Basel Committee on Banking Supervision
10. Basel III

FACULTY OF MANAGEMENT

BBA III Year VI-Semester(CBCS) Examination

MODEL PAPER - I

INTERNATIONAL FINANCE

Time: 3 Hours | Max. Marks : 80

PART – A (5 × 4 = 20 Marks)
[Short Answer Type]

Note: Answer all the questions.

ANSWERS

1. Answer any five of the following in not exceeding 20 lines each.

(a) Define Globalization. **(Unit-I, SQA-1)**

(b) Define International Financial Function. **(Unit-I, SQA-6)**

(c) Need of Risk Management. **(Unit-II, SQA-3)**

(d) Define Exposure **(Unit-II, SQA-1)**

(e) Define Balance of Payments. **(Unit-III, SQA-1)**

(f) Call Option. **(Unit-III, SQA-12)**

(g) Consignment **(Unit-IV, SQA-3)**

(h) What is GATT? **(Unit-V, SQA-1)**

PART – B (5 × 12 = 60 Marks)
[Essay Answer Type]

Note: Answer the following questions in not exceeding four pages each, using the internal choice.

2. (a) Explain the Recent trends in IFM. **(Unit-I, Q.No.18)**

OR

(b) How International Financial Management is different from Financial Management at Domestic Level. **(Unit-I, Q.No.10)**

3. (a) What are the differences between Transaction Exposure and Translation Exposure? **(Unit-II, Q.No.16)**

OR

(b) What types of Exchange Exposures is a multinational enterprises subjected to? **(Unit-II, Q.No.9)**

4. (a) Describe the components of Balance of Payments. **(Unit-III, Q.No.4)**

OR

(b) Define Exchange Rate. What are the different factors influencing Exchange Rates. **(Unit-III, Q.No.14)**

5. (a) What are the different methods of Financing in International Trade? **(Unit-IV, Q.No.2)**

OR

(b) (i) Write about International Finance Corporation (IFC). **(Unit-IV, Q.No.21)**

(ii) Write about Bank for International Settlements (BIS). **(Unit-IV, Q.No.22)**

6. (a) What is Volcker Rule. Explain the provisions and exceptions of the Volcker Rule. **(Unit-V, Q.No.16)**

OR

(b) Explain briefly about Solvency II rules for the insurance sector. **(Unit-V, Q.No.19)**

FACULTY OF MANAGEMENT

BBA III Year VI-Semester(CBCS) Examination

MODEL PAPER - II

INTERNATIONAL FINANCE

Time: 3 Hours Max. Marks : 80

PART – A (5 × 4 = 20 Marks)

[Short Answer Type]

Note: Answer all the questions.

ANSWERS

1. Answer any five of the following in not exceeding 20 lines each.

(a) Define International Trade. **(Unit-I, SQA-7)**

(b) Disadvantages of Globalization. **(Unit-I, SQA-10)**

(c) Risk Management **(Unit-II, SQA-2)**

(d) Risk Financing **(Unit-II, SQA-4)**

(e) Define Derivative. **(Unit-III, SQA-10)**

(f) Limitions of BOP. **(Unit-III, SQA-6)**

(g) Merits of SDRs. **(Unit-IV, SQA-10)**

(h) WTO **(Unit-V, SQA-4)**

PART – B (5 × 12 = 60 Marks)

[Essay Answer Type]

Note: Answer the following questions in not exceeding four pages each, using the internal choice.

2. (a) Explain the factors responsibility for Fast Strides in International Financial Functions. **(Unit-I, Q.No.13)**

OR

(b) Explain the various challenges in IFM. **(Unit-I, Q.No.17)**

3. (a) What is Transaction Exposure? How to manage Transaction Exposure. **(Unit-II, Q.No.10)**

OR

(b) An Indian importer purchased a machine at 1 million dollar. The exchange rate at the time of contract is ` 45,000/$. The machine takes about 30 days to reach the Indian Seashore from the place of its export. In the next 30 days rupee is likely to depreciate to ` 46.50/$. Calculate the transactions exposure of the importer. **(Unit-II, Prob.2)**

4. (a) What is Foreign Exchange Market (Forex Market)? Explain the characteristics of Foreign Exchange Market. **(Unit-III, Q.No.9)**

OR

(b) Explain the different types of financial derivatives along with their features in brief. **(Unit-III, Q.No.24)**

5. (a) Compare and contrast IMF and World Bank. **(Unit-IV, Q.No.12)**

OR

(b) What is EXIM Bank. Explain the structure of EXIM Bank. **(Unit-IV, Q.No.3)**

6. (a) What was the Global financial crisis in 2007. Explain the impact of Global financial crisis on Indian market and economy? **(Unit-V, Q.No.12)**

OR

(b) What is WTO? Explain the objectives of WTO. **(Unit-V, Q.No.4)**

FACULTY OF MANAGEMENT

BBA III Year VI-Semester(CBCS) Examination

MODEL PAPER - III

INTERNATIONAL FINANCE

Time: 3 Hours Max. Marks : 80

PART – A (5 × 4 = 20 Marks)
[Short Answer Type]

Note: Answer all the questions.

ANSWERS

1. Answer any five of the following in not exceeding 20 lines each.

(a) Importance of globalization. **(Unit-I, SQA-9)**

(b) Define Multinational Corporations MNC's. **(Unit-I, SQA-2)**

(c) Transaction Exposure **(Unit-II, SQA-6)**

(d) Between Transaction Exposure and Translation Exposure. **(Unit-II, SQA-9)**

(e) What is Foreign Exchange Market? **(Unit-III, SQA-7)**

(f) Define Exchange Rate. **(Unit-III, SQA-9)**

(g) World Bank. **(Unit-IV, SQA-6)**

(h) Global Financial Regulations. **(Unit-V, SQA-7)**

PART – B (5 × 12 = 60 Marks)
[Essay Answer Type]

Note: Answer the following questions in not exceeding four pages each, using the internal choice.

2. (a) Briefly explain the Significance of International Finance. **(Unit-I, Q.No.9)**

OR

(b) Explain the reasons for the emergence of globalization in present scenario. **(Unit-I, Q.No.19)**

3. (a) Explain the various methods of risk management. **(Unit-II, Q.No.6)**

OR

(b) Total translation exposure of a company is ` 1.5 million. The exposure is in French francs. Interest rates are 8 and 11% for the franc and the rupee respectively. How is hedging to be done? Sport rate is ` 6 per FFr. The rupee is likely to depreciate by 6%. **(Unit-II, Prob.7)**

4. (a) Explain the effect of BOP on different exchange rates. **(Unit-III, Q.No.8)**

OR

(b) Who are the Major Participants in foreign exchange market? **(Unit-III, Q.No.12)**

5. (a) What are the different market instru- ments are used in International Trade? **(Unit-IV, Q.No.1)**

OR

(b) What is special drawing rights? Explain the origin of SDRs. **(Unit-IV, Q.No.13)**

6. (a) Explain the Role of international financial institutions and their role in global regulations. **(Unit-V, Q.No.20)**

OR

(b) What is GATT? State the functions of GATT. **(Unit-V, Q.No.1)**