UNIT-3 International Finance

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Meaning of Exchange Rate

In simple words foreign exchange means currency of a foreign Country. Foreign money and other instruments denominated in foreign currency are also called foreign exchange in India. Foreign exchange has been defined under section 2(n) of the Foreign Exchange Management Act. It includes the following:
1. Deposits, credits and balances payable in any foreign currency.
2. Drafts. travellers cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency.
3. Drafts, travellers cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency.

From the above definition it follows that foreign exchange refers to foreign money which includes notes, cheques, bills of exchange. bank balances and deposits in foreign currency.

Foreign Exchange Rate

A foreign exchange rate is a rate at which one currency is exchanged for another. It is a value of one currency in terms of the other currency. A foreign exchange rate (usually called as forex rate) is the price a person would pay to buy a unit of currency of another country. For example.
It $1 = 75
It shows the relative value of US Dollar in Indian Rupees and vice versa ti an Indian wished to purchase 1 unit of US dollar, he would have to pay RS 75 in order to procure it, Millions of international transactions get carried out across the globe every single day. As discussed above. they could be exports. imports and foreign investments. These transactions change the demand and supply of different currencies in the foreign exchange market. This occurs on an ongoing basis which results in a change in the value of the relative currencies. The forex rate is published in most financial sections of newspapers. It can also be viewed real time on the internet.

Determination of exchange rate – Fixed, flexible and managed

As discussed in the previous section. an exchange rate is the rate at which one currency is exchanged for the other currency. It is thus the value of one currency in terms of the other. Cross-border transactions require exchange of one currency into other. This is so because every country ha5 its own national currency which may not be an internationally acceptable one. For example Indian Rupee or Bangladesh Tab is not an internationally acceptable currency for payment abroad, A supplier may demand to receive his payment in US dollar5 or Euros rather than in Bangladesh Tab. Therefore, to facilitate these foreign transactions local currencies may be converted to acceptable currencies such as US dollar, Great British Pound or Euro among others.

Fixed Exchange Rate System

Under this system, the relative exchange rates remained constant. Introduced before the world war periods, the objective of this system was to maintain stability and certainty. To achieve the required stability in the external value of a currency, the government would maintain large reserves of gold and/or foreign currencies Two methods under the fixed exchange rate system that were adopted in the past have been briefly discussed below.

1. Gold Standard

The Gold Standard was introduced in England in 1821. It was later adopted in 1870s by United States. Germany and France. By the late 1800s. several other countries followed suit. The system of Gold Standard was used until the beginning of World War I.
Under this system, the exchange rates remained constant. The value of a currency was linked to Gold Reserves that were in possession of a country. Higher the reserves of gold. higher the amount of money in circulation. Smaller the reserves of gold with a country, central bank would have to adjust the money in circulation, keeping the exchange rate fixed.

2. Bretton Woods System of Exchange Rates

After World War U. newly established International Monetary Fund was given the charge of coming up with an Exchange rate conversion mechanism The exchange rates were to remain stable. The system is commonly known as IMF system of exchange rate or the Gold-Bullion Standard.
Under this exchange rate system, all currencies were pegged to the US Dollar. Only USA was expected to maintain gold reserves. Hence, the dollar became a reserve currency. The dollar value was fixed to quantity of gold in the USA. It was fixed at $35 for an ounce of gold. Each country had to declare the pegged value. Once declared, monetary authorities had to maintain the exchange rate with a variation of 1% if required.

This gave the US dollar supremacy as an international acceptable currency for payment settlements, This system worked well until early 1970s. US was running trade deficits and had to finance its deficits by printing more dollars. This altered the US dollar-gold valuations in US. As a result, global reserve currency which was the US dollar $. lost global confidence and its value declined. This led to the collapse of the Bretton Woods system of Exchange rate determination.

Flexible Exchange Rate System
The IMF devised a lucid mechanism of exchange rate determination in 1973 which is referred to as the Balance of Payment method or flexible exchange rate system. This is currently in use. This mechanism of exchange rate determination is primarily a market driven one. Under the Balance of Payment system. exchange rate is determined by the market forces of demand and supply of a foreign currency in a domestic foreign exchange market.

Managed Flexibility
Ordinarily the monetary authorities and Government do not interfere in the working of the foreign exchange market in any country. However, if circumstances demand, the Central Bank in any country may influence the demand and supply of foreign exchange. This will result in change of exchange rate. In common practice, when monetary authorities influence exchange rates by altering demand and supply of foreign exchange in the forex market, they are said to be managing the exchange rates.

Concept of Spot Rate, Forward rate and Futures

Foreign Exchange market can also be broadly classified into a spot market or a forward market What distinguishes a Spot market from a Forward market is the timing of actual delivery of foreign exchange. This refers to the date of settlement of the transaction, If the transaction is settled immediately, the transaction is said to be made at the spot and the rate applicable is a Spot Rate. Tithe transaction is made such that the settlement of the same would be made in future the transaction is said to be carried out in the Forward market. The rate applicable in the latter is called a Forward Rate. Let us understand this in detail below.

Spot Rate
A Spot transaction in the foreign exchange market as stated above, in one, that comprises of a bilateral contract between two parties, in which the party settles the payment cri the spat, or for practical purposes within 2 business days or 48 hours of the transaction. This time gap of 48 hours is provided, due to differences in time zones and other banking and administrative delays that could happen while making payment to a party situated in another part of the globe.

Forward Rate

A Forward transaction in the foreign exchange market in one, that comprises of a bilateral contract between two parties, in which the party settles the payment in the future, or for practical purposes past the spot date, for a transaction that is carried out in the present. Therefore, a foreign exchange rate that applies to transactions whore the settlement or payment is made beyond two business days: is called as a Forward Rate. This rate is agreed upon by the contracting parties when the transaction happens, but the payment is settled at an agreed date in the future. It could range up to a year. Although, forward rates in the foreign exchange markets are quoted for 3, 6 and 9 months.
Forward rates are an important facility used by importers and exporters who enter Forward contracts with each other: to cover exchange risks arising out of fluctuations in forex rates in the future, when the payments have to be settled.

Futures
A Foreign exchange Futures are a forex contract where the buyer and seller agree to transact at a predetermined date ¡n future at a pre-agreed price A Future contract differs from a forward rate. While a forward rate applies to over the counter (OTC) transactions, a Future contract is necessarily transacted on an established exchange.
Since Futures contract are traded on exchanges. their formats are more standardized as compared to Forward contracts. The latter are more customized to the needs and specifications of the parties entering a forward contract. While the Futures contract has standard features of contract size and maturity dates etc.

Balanced of trade & balanced of payments

Balance of Payments (BOP) is a summary record of all economic and financial transactions between a nation and the rest of the world, within a specific period. The Balance of Payment is a crucial indicator of a nation's financial stability BOP indicates whether a country is a debtor country or a creditor country.
In other words, a Balance of Payment of a country can be defined as a systematic statement of all economic transactions of a country with the rest of the world usually in one year.
According to the Reserve Bank of India, *The Balance of Payments of a country is a systematic record of all economic transactions between the 'residents' of a country and the rest of the world. It presents a classified record of all receipts on account of goods exported. services rendered and capital received by 'residents' and payments made by them on account of goods imported and services received and from the capital transferred to non-residents or foreigners.'
The above definition implies the following points:
1. The BOP is summary account of all foreign transactions.
2. All economic transactions which are made between residents and foreign entities are recorded.
3. The OP is prepared on an annual basis.

The Balance of Payment is divided into two major components:
A. Current Account
B. Capital Account

A. Current Account

A Current account in a Balance of Payment records all transactions relating to imports and exports of goods and services including all unilateral transfers during a financial year. Current Account can be further subdivided into two components.

(a) Trade Account/Merchandise Account
This account records all transactions related to import and export of goods (visible items). Goods are tangible visible, and their trade can be recorded on ports (airports, seaports and at the borders). Hence this account is also known as Visible or Merchandise Account.

(b) Invisibles
The Invisibles record export and import of Services. Since services are intangible and not visible, they are classified in the Current Account under the Invisibles. The Invisibles also records transactions related to unilateral transfers made abroad or received from abroad. interest from investment and other incomes.

Current Account Balance
The Current Account records all transactions of exports and imports of goods and services. These transactions have a profound effect on the income. output and employment level in a country. As stated previously, receipts from exports are a positive item and adds to the inflow of foreign exchange. On the other hand payment for imports of goods and services are a negative item. They amount to an outflow of foreign exchange. The net value of these items (credit and debit balances) is called as balance on Current Account.

B. Capital Account

All international financial transactions between residents of one country .vith entities of the rest of the world that change the assets (claims) and liabilities of the said country are recorded in the Capital Account The capital account represents the international investment position of a country
Capital Account transactions are very critical. This is because balances of capital account help to absorb the excess surplus of the current account or finance the current account deficit
Capital Account can be further subdivided into the following components:
1. Foreign Investments
(a) Direct Investments
(b) Portfolio Investments
2. External Assistance
3. Commercial Borrowings
4. Banking Capital
5. Rupee Debt Service
6. Other Capital

Capital Account Balance
International transactions of borrowings and lending, foreign investment and monetary movements arc recorded on the credit side if they result in an inflow of foreign exchange. They are recorded on as a debit entry if they result in an outflow of foreign exchange. The net balance of all these transactions is called as Balance on Capital Account.

Importance of Balance of Payments

The Balance of Payment is a crucial financial statement prepared by the Central Bank of any country. The importance of this statement cannot be overstated for the following reasons:

1. It presents a clear picture of a country's economic and financial position.

2 It shows whether a country has excess of foreign exchange or runs a shortage of foreign exchange.

3. It helps to determine if the external value of a country's currency will appreciate or depreciate.

4. The Government can monitor the impact of tariffs on imports and take necessary action to regulate trade and conserve the usage of scarce foreign exchange.

5. It allows the Government to take corrective action on trade fiscal and monetary policy.

6. Since BOP are prepared by countries in a uniform manner, it facilitates international comparison.

Documentation in International Trade and EXIM Financing

International Trade has historically been and continues to be the primary economic interaction between entities of two countries. Over the years. trade volumes have expanded. The participation of countries has also intensified. "is trade becomes a complex activity, with the increase in the number of players, trade size expansion and documentation. importers and exporters are subject to a variety of risks.

1. Bill of Lading
Bill of Lading is a contract of carriage. it is a document provided by the shipping agency for shipping of goods from one destination to another. It is prepared by representatives of the shipping company which is the carrying vessel.
This document is issued in sets. The set number is indicated on each bill of lading. All sets must be accounted for. This is done to maintain safety and to ensure that bill of lading never comes into unauthorized hands. This is so because only one original set is sufficient to take possession of goods at port of discharge.
The bank and shipping company are aware as to the number of signed originals that arc prepared. A bill of lading indicates details about whether the freight has been prepaid or whether freight has still to be collected at the port of discharge.

2. Certificate of Origin
Every product that is traded internationally must bear the details of its origin. Certificate of Origin is an important document which is required by custom authority of importing country. The customs authorities can decide to impose import duty depending on the origin of goods. Certificate of origin is issued by the Chamber of Commerce.
The Certificate cl Origin contains information such as name and address of exporter. details of the importer, seal of Chamber of Commerce. details of the goods, packaging numbers, weights. seal and specifications among others.

3. Bill of Exchange
A Bill of Exchange is a negotiable instrument in which an exporter asks the importer to pay a certain amount of money in future. Importer agrees to pay the exporter the said amount on or before a decided date. The bill of exchange involves the following parties. A drawer — who prepares or writes a bill of exchange; a Drawee — who pays the bill; Payee — the party to whom payment shall be made and a Holder — who has the possession of the bill. Most often bankers are involved in the process. who promise to pay to the Payee. in case the drawee delays payment This document is useful in those cases where the amounts dealt with are large. and where the exporter may want to discount the bill to receive the money before the due date.

4. Invoke
An invoice also referred to as commercial invoice or export invoice is a document provided by the seller (exporter) to the buyer (importer). It is used by the customs authority of the importing country for the purpose of imposing import duly.
A commercial invoice must be issued and signed by the seller. It should be addressed to the buyer. Include a complete description of goods. its price, specifications, number of units and price payable. The original copy should be marked as Original and the others as copies.

5. Insurance Certificate
Since goods travel long distances and are subject to risks and damage, they need to be adequately Insured, Therefore, an insurance policy that covers these risks is mandatory. k is critical that the insurance policy is effective on the date which is either the same or earlier than the date of transport documents. Bankers may also insist that the insurance policy be taken in the same currency as that mentioned in the payment documents and be taken for a value higher than the payment value.
The insurance certificate must contain details such as name of the parties, name of the Ship/vessel/fight details, insurance policy number? details, insurance value.. claim settlement agent description of goods, number of units of goods, the period of it insurance and so on.

6. Inspection Certificate
A certificate of inspection is prepared on the request of the exporter that is the seller. This Is usually prepared when the seller wants the consignment to be checked before final transportation by a third party. The seller may be required to submit documents such as commercial invoice, bill of lading. banking documents, packing list among others for the purpose of obtaining an Inspection Certificate.

7. Air waybill
An Air waybill is a consignment note which is issued by an international airline company for the goods that they will be transporting. The air waybill Is an evidence of the carriage contract It aids Ii the process of tracking and Is enforceable by law which means it is legally binding.

8. Letter of Credit
A Letter of Credit also termed as LC, Is prepared et the request of the buyer. It is a letter issued by a bank guaranteeing a buyer's payment to a seller on or before a date. In case a buyer is unable to make a payment to the seller on time, the bank will cover the lull payment.

Financing Techniques

Considering the importance of exports in the development of country. value is placed on making export more robust. Export credit has on important role to play In the same process. Generally. export credit can be extended at two levels;
1. Pre-shipment Credit - generally extended for financing production, processing, packaging and procuring raw materials.
2. Post-shipment Credit - extended to fund overseas buyers (importers) in a bid to promote Indian exports.

Financing Techniques In Foreign Trade

Did you know that importers and exporters use a variety of trade financing techniques? Some of them used most often as discussed below.

Bankers' Acceptance:
Since payment risk looms for exporters a Banks acceptance of a Bill of Exchange or a Letter of Credit provides the much-needed guarantee to an exporter that he will receive his payment on the said date. Since the bank accepts the Bill of exchange. it becomes a negotiable instrument that can be traded.

Factoring:
Factoring is a common practice among exporters to accelerate liquidity. Instead of waiting till the end of the credit period extended to the buyer, the exporter ran instead draw a significant chunk of the value of commercial sales invoice either when he delivers the goods or raises an invoice. This is how it works. A commercial bank (Factor) through an agreement with the exporter, purchases his short-term account receivables at a discounted value. Therefore, the factor assumes the risk, k becomes the factor's job to recover the money from the buyer. The exporter is benefitted as he avoids the risk of non-payment and improves his own cash flow.

Forfaiting:
The process of Forfaiting usually involves banks or financial firms (Forfeiter) to offer export finance by purchasing medium to long term accounts receivables from the exporter. Forfaiting generally relates to the export of capital goods, delivery of large projects, where the credit period lies between 6 months to 7 years. Once the commodity or project has been delivered as per terms, the forfaiting agency assume risks. But since the risk is large. and credit payment is long, forfaiting. necessarily requires bank guarantee from the buyers bank also. In this process, the exporter is benefitted as he can get access to liquidity rather than wait for the credit Period to get over.

Export Promotion Schemes

The Government of India has launched several schemes In the last few years to create an environment conducive to exporters and provide support that can allow greater access to global markets, From export financing, refinancing of banks providing export credit, export services, linkages and marketing facilities, there are a large number of institutions from Government W affiliate bodies which are involved in these activities
Some of the agencies involved in Export Promotion in India include:
1. Government of India
2. State Governments
3. Directorate General of Foreign Trade (DGFT)
4. Export Promotion Councils
5. Ministry of Commerce and Industry
6. Central Board of Indirect Taxes and Customs
7. Reserve Bank of India
B. EXIM Bank
9. Commercial Banks (Authorized Dealers)
10. Port Authorities
11 Export Credit Guarantee Corporation
12. Commodity Boards
13. Chambers of Commerce

World Bank and International monetary funds-objectives & functions

World Bank — Objectives and Functions

World Bank, formerly named as the International Bank for Reconstruction and Development (IBRD). primarily aims to finance economic development The World Bank's first loans were extended to war ravaged nations of Europe in the Late 1940& The purpose was to reconstruct these economies. Soon these European economies recovered and became somewhat self-sufficient It was then that the World Bank turned its attention to supporting underdeveloped and developing nation& Since then, the World Bank has extended loans over US S330 billion. The primary intent of the World Bank is to promote social and economic development in the poorest countries. Through its focused loans, it seeks to achieve high productivity, which will lead to increased incomes, so people can lead fuller better, and healthier lives.
The World Bank comprises of two main bodies the International Bank for Reconstruction and Development and the International Development Association. However, the World Bank Group comprises of following arms
1. The International Bank for Reconstruction and Development (IBRD).
2. International Development Association 110*) - the development financing arm,
3. International Finance Corporation (WC).
4. International Centre for Settlement of Investment Disputes (JCSID).
5 Multi-lateral Investment Guarantee Agency (MIGA).

The objectives of the World Bank can be summed up as follows:
1. To assist ¡n reconstruction and development of member nations especially those devastated by war.
2. To channelize productive capital for development purposes
3. To promote long term balanced growth of international trade either directly or by providing guarantees.
4. To help raise productivity, standard of living and conditions of poorest of poor.
5. To finance structural adjustment programs of countries - macroeconomic policy reforms which will lead to long term development and growth of member countries.
6. To provide technical assistance to projects which it supports.
7. To reduce global poverty.
8. To promote a stable macroeconomic environment, encourage investment and long-term planning.

Functions of World Bank

World Bank performs the following functions

1. Finance Projects that result in development in poor countries.
2. Grant development loans In collaboration with National Governments local agencies and multilateral financial organizations.
3. Grant reconstruction loans for war devastated nations.
4. Extend technical economic and monetary assistance for projects supported by World Bank.

S. Encourage trade and industrial development through various activities.

6. Provide equity funding to private enterprises for specific infrastructure projects.
7. Extend loans to member nations for agriculture development. poverty alleviation education and healthcare sanitation and sewage. power and transport and so on.

International Monetary Fund: Objectives and Functions

The formation of EMF was a response to the despondent situation post the Great Depression of the 1930s resulting in a sudden dip in international trade. Bretton Woods Conference discussions were focussed to resolve the financial problems caused due to unpredictable and opaqueness in calculation of exchange rates.

Objectives of IMF

The Objectives of the International Monetary Fund are the following:

1. To promote international monetary cooperation The IMF to provide a machinery and a platform for consultation and collaboration on international monetary problems,
2. To promote exchange rate stability. avoid competitive exchange rate depreciation and maintain orderly exchange arrangements.
3. To establish a multilateral system of payments In respect of international financial transactions.

4 To facilitate the expansion and balanced growth of international trade .which will lead to expansion of employment across member countries.

5. To finance member countries to correct their imbalance of payments.
6. To encourage members to form a pool of resources that can be used in times of Need.

Functions of IMF

The functions of the International Monetary Fund can be summarized as below:

1 To operate as per the Articles of Agreement of the IMF and broad guidelines set forth under the Bretton Woods Conference.

2 To provide short term loans to member countries to correct their temporary Balance of payments disequilibrium

3. To provide technical assistance to member countries to correct its macroeconomic and fiscal policy.

4 To conduct research studies, collect data and publish reports and studies for the development of members.

5. To be a guardian of good conduct with respect to multilateral payment and monetary systems in the world.

6 To provide short term training to staff of national governments and post technical personnel who can train and advise ministries in member nations.