

## TABLE OF CONTENTS

UNIT	LESSON	TITLE	PAGE NO.
I	1.1	Globalization	3
	1.2	International Financial Management	14
	1.3	International Monetary System	18
	1.4	IMF,GATT & WTO	29
II	2.1	Balance of Payments	57
III	3.1	International Financial Markets	68
	3.2	Multilateral & Bi-Lateral Institutions	82
	3.3	Global Financial Instruments	105
IV	4.1	Currency Risk Management	136
	4.2	Translation Exposure	143
	4.3	Operating Exposure	149
V	5.1	Foreign Direct Investment	155

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## International Financial Management

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### Objectives

- To have exposure on International Monetary System
- To understand about Balance of Payments and currency Exposure and
- To introduce and familiarize the International Financial Markets and Instruments.

### Unit - I

Globalisation - Implications of Globalisation – Goals of International Financial Management - scope of International Finance – International Monetary System – Bimetallism – Gold Standard – Bretton Woods System – Floating Exchange Rate Regime – European Monetary System – IMF – WTO – GATT.

### Unit - II

Balance of Payments – The Current Account – The Capital Account – significance - Balance of Payments in the World – Balance of Payments Account of India

### Unit - III

International Financial Markets – Sources of International Funds – Multilateral Development Banks – Governments/ Governmental Agencies – International Banks – Security Markets Instruments of International Financial Markets– International Equities – GDRs – ADRs - International Money Market and Bond Market Instruments – Euro Bonds – Repos – Euro Commercial Paper – Medium Term Notes – Floating Rate Notes – Loan Syndicates – Euro Deposits – Euro Issues in India.

## Unit - IV

Currency Risk and Exposure – Types of Currency Risk – Management of Currency Risk – Concept and Measurement of Transaction Exposure - Techniques of Transaction Exposure Management – Translation Exposure – methods – Transaction Exposure Vs. Translation Exposure – Exchange Risk Management – Operating Exposure – measuring and managing Operating Exposure.

## Unit - V

Foreign Direct Investment (FDI) – Forms of FDI – FDI in World – purpose of overseas investment – Benefits to the Host Countries – Effects of FDI – Political Risk.

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## UNIT – I

### Unit Structure

- Lesson 1.1 - Globalisation
- Lesson 1.2 – International Financial Management
- Lesson 1.3 – International Monetary System
- Lesson 1.4 – IMF, GATT & WTO

### Learning Objectives

*After studying this lesson you should be able to*

- Understand Meaning and implication of globalization.
- Know the goals of IFM, Scope of International Financial Management.
- Understand International monetary system
- Describe Gold standard, Bretton woods system, Floating Exchange Rate Regime.
- Understand European Monetary System, IMF, WTO and GATT

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### Lesson 1.1 - Globalisation

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### Learning Objectives

*After studying this lesson you should be able to*

- Understand Meaning of Globalisation
- Analyze the implication of Globalisation in India
- Discuss the problems and challenges of Globalisation

## **Introduction**

The process of Globalisation is an inevitable phenomenon in human history which has been bringing the world closer since the time of early trade and exploration, through the exchange of goods, products, information, jobs, knowledge and culture.

What is unique is the emergence of a modern form of Globalisation in recent decades, aided by the pace and scope of global integration resulting from unmatched advancements and reduction in the cost of technology, communications, science, transport and industry.

Markets have become more interwoven and the production process has been made more efficient by the option to create 'world products,' i.e. products whose components are made in different locations around the world. Also, the ability to ship information and products easily and cheaply from one country to the next and to locate the manufacturing process where labour and work processes are less expensive has changed the pattern of production and consumption across the world.

## **Meaning**

Globalisation is the process of international integration arising from the interchange of world views, products, ideas, and other aspects of culture. Put in simple terms, Globalization refers to processes that promote world-wide exchanges of national and cultural resources. Advances in transportation and telecommunications infrastructure, including the rise of the Internet, are major factors in globalization, generating further interdependence of economic, and cultural activities.

Though several scholars place the origins of globalization in modern times, others trace its history long before the European age of discovery and voyages to the New World. Some even trace the origins to the third millennium BCE. Since the beginning of the 20th century, the pace of globalization has intensified at a rapid rate, especially during the Post Cold War era.

The term globalization has been in increasing use since the mid-1980s and especially since the mid-1990s. In 2000, the International Monetary Fund (IMF) identified four basic aspects of globalization: trade and transactions, capital and investment movements, migration and movement of people and the dissemination of knowledge. Further, environmental challenges such as climate change, cross-boundary water and air pollution, and over-fishing of the ocean are linked with globalization. Globalizing processes affect and are affected by business and work organization, economics, socio-cultural resources, and the natural environment.

Globalisation can be defined as the process of change, increasing interconnectedness and interdependence among countries and economies, bringing the world closer through better world-wide communication, transport and trade links. This process is changing the world dramatically and quickly, affecting economic, social, political and cultural aspects of life.

## Definitions

### OCED Defines Globalisation as

*“The geographic dispersion of industrial and service activities, for example research and development, sourcing of inputs, production and distribution, and the cross-border networking of companies, for example through joint ventures and the sharing of assets”*

International Monetary Fund defines Globalisation as *“The process through which an increasingly free flow of ideas, people, goods, services and capital leads to the integration of economies and societies”*

### The Different Facets of Globalization and their Manifestations

Globalization is manifested in four interrelated developments:

1. The increase in the international exchange of goods and services, and despite all the restrictions therein, the movement of human resources;
2. The internalization of production and real investments;
3. The increased integration of financial markets;
4. The relative high degree of policy convergence among countries.

The statistical evidence on these developments is truly impressive. In the trade area, the ratio of international trade to the GDP of practically all countries has more than doubled over the last two decades. Trade has substantially outpaced the growth of the GDP in all but very few years over the past twenty five years. A major new phenomenon is the size of services in total trade, in particular financial services.

World trade grew at a real per annum rate of 5.5% in 1958-1994. In the following decade, 1995-2004, it registered an annual real growth of 6.3%. This is well above the average growth of the GDP in the same periods. For individual countries, even the large and relatively closed ones, the trend is the same. For example, in the US; trade went from a mere 9% of the US, GDP in 1970 to more than 23% in 2003. In the small European countries and

most of the small developing countries, trade has gone up from levels in the range of 40-50% of the GDP in 1970 to levels in the range of 80-90% in 2003. The increased importance of trade relative to the GDP, is particularly striking in the developing countries. The twenty developing countries classified by an UNCTAD paper as the most dynamic, have increased their share in total world exports from 9.5% in 1980 to 24.3% in 1998; this is all the more impressive in view of the large growth of exports.

In the exchange of human resources, the movement of labour across international borders, legally or illegally, together with the growth of immigration from poor to rich countries has reached such levels that immigration has become an explosive political issue in all the recent political campaigns of western Europe. Even in the US, a traditional country of immigration, the increased scale of economic immigration is beginning to be a standard feature of political campaigns and is heavily exploited by politicians in quest of electoral gains.

In investment cum production area, the internationalization of production is currently manifest in the phenomenal increase of Foreign Direct Investment (FDI) in the US, in Europe, and in some twenty or so developing countries, led by china. For example, china has experienced investment inflows reaching 7.9% of the GDP in 1993 and 8.1 in 2003. This has taken place against the backdrop of real annual growth of china's GDP of 8-9%. In some smaller economies, like Malaysia, these inflows has reached a high of 14.6% of the GDP in 1993. After dipping in 1997 and 1998, net inflows bounced back, but have not resumed a steady pace of growth after 2001. There is also a growing subcontracting of production and a spreading of production facilities by transactional firms.

In the finance arena, business have increased their resources to international sources as testified by the increased volume of floatation of foreign bond; the increased issuance of international bonds in the Euro markets, and increased international lending in direct and indirect forms. Moreover, big companies have substantially increased their stock listings on the various public exchanges.

The financial institutions, led by banks, have become truly international not only in doing international financing like their predecessors have done since the nineteenth century, but in addition, by locating in various countries through some times outright establishment of acquisition of local banks.

On both the assets and liability sides of their balance sheets, banking is now international: loans and deposits are denominated in different currencies originating from and going to different points of the globe.

Just as telling perhaps but more a typical, is the increased convergence of economic policies of governments. This is the result of several factors: the complete triumph of the liberal model has narrowed the scope of choice in economic policies. All countries want to be seen pursuing the right policy model.

The second factor is the emulate–thy–competitor syndrome; countries match the concession and benefits given by their competitors to foreign investors and trans-national firms in order not to suffer a comparative disadvantage.

The third reason is the relative the short time the world has had to fashion policies based on some variation on the orthodox liberal model. The policy convergence however, is stronger among smaller economies than the big ones, because the big economies quite frequently pursue policies dictated by short term expediencies.

The spotty results of the Government controlled model, already cleared in the 1980's and collapse of the socialist economics in 1989, have brought about an almost universal acceptance of liberal and open market organisation and a semi consensus on economic policies. A rather extreme version emerged in the so called "Washington Consenses". This was so called after the meeting in Washington of economists with views concordant with those of the IMF and World Bank as to what model of economic policy to follow. Notwithstanding the challenge to this consensus by various other economists, there is a wide convergence of views today on what are bad policies and a spectrum of accord on what are good ones.

### **Dimensions of Globalization**

Globalization encompasses the following:

1. Doing, or planning to expand, business globally.
2. Giving up the distinction between domestic market and foreign market and developing a global outlook on business.
3. Locating the production and other physical facilities on a consideration of the global dynamics, irrespective of national considerations.
4. Basing product development and product planning on the global market considerations.
5. Global sourcing of factors of production, i.e., raw materials, components, machinery, technology, finance, etc., are obtained from the best source anywhere in the world.
6. Global orientation of organizational structure and management culture.



## Implications of Globalization in India

Globalization is essentially an economic phenomenon which has strong implications. To understand the effect of globalization on Indian economy, society, culture, religion and psyche, it is essential for us to know how and when economic reforms were carried out.

IMF (International Monetary Fund) has prescribed a set of rules for the carrying out of economic reforms. When the Chandra Sekhar's government was defeated at the hands of Congress, Indian economy was undergoing through a chaotic situation.

The 1991 Gulf war aggravated the international oil prices, which seriously affected India's BoP (Balance of Payment) situation. Exports were low and imports were high (due to high price of oil and petroleum). India's economic performance was in doldrums because industrial production plunged to the ground.

Fiscal deficit soared up to new heights, which earned nothing except high rate of inflation. Due to the populist form of government spending in the 1980s, supported by huge borrowings without sufficient return, India's internal and external debt touched the sky.

Short term commercial borrowings from abroad led to a difficult situation for the government. India virtually came to the brink of default. Under this situation, the Government borrowed a huge sum of conditional loan' from IMF. Thus India became obliged to follow IMF prescribed 'structural reforms'.

The IMF package consists of a set of economic policies for a debt-ridden and low performing economy, for the short run which is called 'stabilization measures', and which includes:

### *(i) Monetary Policies*

- Positive real interest rates
- Increase in reserve rate
- More vigorous open market operations
- Credit controls

### *(ii) Realignment of the Exchange Rate to a Near Market Determined Rate.*

### *(iii) Reduction of Budgetary Deficits*

- Increased revenue mobilization efforts

- Review of public investment priorities and identification of a core programme of investment.

*(iv) Real Wage Restraint*

- Removal of formal indexation arrangements

The Long Term 'Structural Reforms' prescribed by IMF include

*(i) Promotion of Private Sector (Domestic-and Foreign)*

- Definitive political commitment
- Rapid improvement in infrastructure
- Improvement in regulatory regimes
- Facilitation of investment approval procedures

*(ii) Commercialization of Public Enterprises-Improvement in Operational Efficiency*

- Privatization programmes

*(iii) Financial Sectors Reforms*

- Movement to market determined rates capital market development, including promotion of stock exchanges

*(iv) Liberalization of Trade Regime*

Removal of import and exchange control and progress towards lower and less-dispersed band of tariffs.

*(v) Price-Flexibility*

*(vi) Tax-Reforms*

- Reduction of distortion effects on resource allocation
- Increased elasticity of tax-system

*(vii) Administrative Reforms*

- Reduction in size of public service

- Safety net well targeted programmes of transfers to vulnerable groups.
- Training, credit and employment programmes for vulnerable group. Impact of Globalization on Indian Economy

Due to globalization, the export sector of the Indian economy received a big boost. The growth performance of the exports improved during 1993-1996.

During the period April-September 2000, the export growth rate touched the figure of 22%, while imports stood at around 15%. Thus India's current account situation improved due to globalization led economic reforms.

Government investment expenditure has been reduced but not fiscal deficit which is still around 5% of GDP (Gross Domestic Product). This is because of high consumption expenditure on the part of the government.

Government is stressing on disinvestment of public sector units. For the employees, government has started VRS (Voluntary Retirement Scheme). Although defense expenditure has gone up, but Government has reduced subsidies on food, fertilizer and electricity. Social sector investment as a percentage of GDP has not increased.

Expenditure on health and education is not substantial. Although efforts of privatization has given an impetus to the private sector, but employment generation by the private sector is meager.

The NDA (National Democratic Alliance) government headed by BJP (Bharatiya Janata Party) has started the 'second generation economic reforms', which includes reforms in all spheres including political institutions, economic machinery, democratic set-up, judiciary, etc.

The proponents of globalization in India have argued that economic integration will improve the locative efficiency of resources, reduce the capital output ratio, and increase the labour productivity, help to develop the export spheres and e\*port culture, increase the inflow of the capital and updated technology into

the country, increase the degree of competition in the domestic economy, reduce the relative prices of industrial and manufactured goods, improve terms of trade in agriculture and in general give a boost to the average growth of the economy in the years to come. To some extent this has proved true.

## The Problem and Challenges of Globalization

If globalization is a non-stoppable train, as, any argue, it seems to be a rather selective one in admitting passengers abroad. Economics possessive of skilled and educated manpower and endowed with well developed production and marketing capacities can get on board to reap significant benefits if they have developed financial systems and assess to technology. It is a system where the benefits accrue only to the capable and prepared. Those who do not have the products and services to sell or the means to market them will assuredly be left in the station.

The same is also true for individuals who have not invested in their human capital and in obtaining the requisite skills for global jobs. Thus, we are faced with the phenomenon of marginalization of people, of firms and of countries; the global system confers a large rent differentials upon the participants and applies exclusion to the non- participants. Unless the means to spread around wealth and prosperity are built into globalization, it will become the domain of the already established, of the capable and skilled. Consequently, enabling capacity – building in trade technology and human – capital is an important issue in the debate on globalization. Unlike export – orientation, globalization involves the entire resource base and know-how of the economic agents. Thus, participatory capacity is an important issue.

Faced with the reality of the requirements of the global economy, nation states confront a host of problems: they have to accept the relative loss of sovereign control and the erosion of the fiscal base if they want to keep up with competitors who grant tax holidays and wave of social charges. At the same time, they are forced to increased their expenditure on infrastructure and education to enter into or keep their presence in the global system. To all that must be added the system consequence of accepting global openness: national governments must extend safety nets for taking care of the casualties of globalization, be it firms, banks or workers, if they are to maintain the social compact and preserve domestic civil peace.

These are contradictory demands on national governments. Another problem concerns the timing and location of the short run benefits and losses in the trade sector. While the countries with higher wages and more exigent environmental standards stand to lose jobs as business shifts some branches of industry to cheaper locations abroad, higher paying jobs have not followed the lost ones in the short run. The theory of international trade asserts that higher value added jobs would replace the last ones. But the theory does not have a clear time – line for the working out of comparative advantage; it has always assumed that the replacement technology is available and the costs of conversion, in particular labour

retaining, are insignificant. Obviously, this is not so when replacement technologies are the private property of businesses, which no longer have national allegiance and will use the technology and locate the jobs where they make the highest profits. In today's world, the major concern of business is the overall global bottom line and the increase in the wealth of the stock holders. The empirical evidence of the industry replacement is hardly clear-cut in the short run. In the US, the evidence over 1992-2004 shows that the number jobs lost has been less than the number newly created jobs.

This is true over a decade but not necessarily true for a particular year. In the short run, job replacement seems to carry migration born for some time by the displaced workers. There are also costly structural impediments to the transition to new jobs. The risk of creating significant constituencies in democratic countries opposed to globalization, as witnessed in Genoa and Seattle, is becoming quite high. Even when international firms own or have access to new technology; the relative cost difference between different locations might tempt them to relocate some jobs abroad. There is evidence on that in the low white collar jobs such as soft wear and high information skill jobs.

India has invested in education and developed a large and surplus stock of skilled manpower, have succeed in attracting lost jobs from global businesses on account of their low wages. Traditionally, wage levels and productivity gains have moved together. However, with openness it is possible that higher productivity might be associated with lower wages for skilled unemployed workers in a different country. We have therefore a break in the observed historical association between wages and productivity across countries with different cost of living.

The historical pattern of investment in education is now playing a large role in the working out of the law of comparative advantage. Second, the new job generated in the US have an average hourly pay lower than the lowest ones. In fact, quite many of the new jobs are in services with lower productivity and lower wage rates than lost manufacturing jobs; for example the average hourly wage in some of the fastest growing service jobs, the food industry is \$10.64 with a median of \$8.98 per hour, as compared to \$18.07 and \$17.10 median hourly wages for the lost jobs in production, construction and extraction occupations.

Finally, the asymmetric distribution of benefits across countries is breeding theories about disguised and new forms of economic domination under globalization. Even though such views are often not empirically demonstrated, nonetheless, they are voiced by important segments in openness societies, which have become permanent and non-discrimination opponents of WTO and globalization.

### Self Assessment Questions

1. Explain the globalisation of trade
2. Explain the Implication of globalisation in India.
3. Critically evaluate the challenges of globalisation in India.
4. Discuss the different Facets of Globalization and their Manifestations
5. Explain in brief the problem and Challenges of Globalisation
6. Explain the relationship between Investment, transfer of Technology, and Global Business.

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## Lesson 1.2 - International Financial Management

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### Learning Objectives

*After studying this lesson you should be able to*

- Understand meaning of International finance
- Discuss the Meaning of International Financial Management.
- Understand the History and Background of International Financial Management
- Analyze the scope of International Financial Management

### International Finance

International finance is the branch of financial economics broadly concerned with monetary and macroeconomic interrelations between two or more countries. International finance examines the dynamics of the global financial system, international monetary systems, balance of payments, exchange rates, foreign direct investment, and how these topics relate to international trade. Sometimes referred to as multinational finance, international finance is additionally concerned with matters of international financial management. Investors and multinational corporations must assess and manage international risks such as political risk and foreign exchange risk, including transaction exposure, economic exposure, and translation exposure.

Some examples of key concepts within international finance are the Mundell–Fleming model, the optimum currency area theory, purchasing power parity, interest rate parity, and the international Fisher effect. Whereas the study of international trade makes use of mostly microeconomic concepts, international finance research investigates predominantly macroeconomic concepts.

### International Financial Management

International financial management (IFM) is a term that grew out of the need for individuals and organizations to consider the implications of financial decisions due to cross-border transactions prevalent in the world economy. Thus, international financial

management is the study and application of financial strategy that takes into account the differences and complexities involved in cross border transactions. The term accounts for such topics as raising capital, making acquisitions, investment strategy, managing risk, organizational restructuring, and overall financial policy in global context. Finance managers of such international activities are concerned with aspects like exchange rates, rules regarding taxation, legal complexities and regulations, and risk factors associated with doing business in another nation. Familiarity with international trade agreements is an important part of the topic as well.

Currency exchange rates and differing methods to determine price of assets can have a major impact on the bottom line in international financial management. As such, the topic accounts for the structure of the currency exchange system and how to determine asset prices in a global setting. In addition, IFM is also concerned with how different currencies impact the prices on stock markets.

Decision making in international financial management must account for potential impacts related to various capital structures, approaches to risk management, and how to best leverage taxation systems. IFM will examine how a firm may take advantage of local partnerships in other countries or how to capitalize on international subsidies that are available. Taking into account taxation and exposure to exchange rates, IFM managers will research and decide how to best hedge those exposures and responsibilities.

Valuation and policies for obtaining financing internationally are usually modified when a dealing cross-border investment. International finance management will consider the cost of placing operations in other nations and discern how to best value investments in developing nations. Other areas of concern include penetrating markets and sustaining a presence in those markets effectively.

Additionally, international financial management accounts for differing institutional arrangements, whether formal or informal, that reflect decision making. Differences in legalities, such as protection of creditors and shareholders, impacts both investment and restructuring decisions. This means IMF requires excellent communication skills and building relationships in order to get the job done correctly.

Overall, the main goal of international financial management is to create the most wealth possible for shareholders. Stakeholders also are important for IFM managers. They include suppliers, vendors, employees and end customers who all must be observed from a financial perspective when considering cross-border transactions.



## History and Background

During the post-war years, the GATT was established in order to improve trade. It removed the trade barriers notably over the years, as a result of which international trade grew manifold.

The financial participation of the trader's exporters and importers and the international transactions flowed significantly. It started when different countries started "liberalizing" i.e. when countries agreed to open doors for each other and traded. The advancement of technology and liberalization resulted into the idea of financial management both domestically and globally.

## Domestic Vs International Financial Management (IFM)

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

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

## Importance

Compared to national financial markets international markets have a different shape and analytics. Proper management of international finances can help the organization in achieving same efficiency and effectiveness in all markets, hence without IFM sustaining in the market can be difficult.

Companies are motivated to invest capital in abroad for the following reasons

- Efficiently produce products in foreign markets than that domestically.
- Obtain the essential raw materials needed for production
- Broaden markets and diversify
- Earn higher returns

## Scope of International Finance

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

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

## Self Assessment Questions

1. What is International finance and IFM
2. Discuss the nature and scope of IFM
3. How do we distinguish the management of MNCs and Domestic Firm?

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## Lesson 1.3 - International Monetary System

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### Learning Objectives

*After studying this lesson you should be able to*

- Understand International monetary system
- Describe Gold standard.
- Discuss Bretton woods system.
- Explain Floating Exchange Rate Regime.
- Understand European Monetary System.

### International Monetary System

The international monetary system consists of

- (i) Exchange rate arrangements;
- (ii) Capital flows; and
- (iii) A collection of institutions, rules, and conventions that govern its operation.

Domestic monetary policy frameworks dovetail, and are essential to, the global system. A well-functioning system promotes economic growth and prosperity through the efficient allocation of resources, increased specialization in production based on comparative advantage, and the diversification of risk. It also encourages macroeconomic and financial stability by adjusting real exchange rates to shifts in trade and capital flows.

To be effective, the international monetary system must deliver both sufficient nominal stability in exchange rates and domestic prices, and timely adjustment to shocks and structural changes. Attaining this balance can be very difficult. Changes in the geographic distribution of economic and political power, the global integration of goods and asset markets, wars, and inconsistent monetary and fiscal policies all have the potential to undermine a monetary system. Past systems could not incent systemic countries to adjust policies in a timely manner. The question is whether the current shock of integrating

one-third of humanity into the global economy – positive as it is – will overwhelm the adjustment mechanisms of the current system.

There are reasons for concern. China's integration into the global economy alone represents a much bigger shock to the system than the emergence of the United States at the turn of the last century. China's share of global GDP has increased faster and its economy is much more open.<sup>1</sup> As well, unlike the situation when the United States was on the gold standard with all the other major countries, China's managed exchange rate regime today is distinct from the market-based floating rates of other major economies. History shows that systems dominated by fixed or pegged exchange rates seldom cope well with major structural shocks.

This failure is the result of two pervasive problems: an asymmetric adjustment process and the downward rigidity of nominal prices and wages. In the short run, it is generally much less costly, economically as well as politically, for countries with a balance of payments surplus to run persistent surpluses and accumulate reserves than it is for deficit countries to sustain deficits. This is because the only limit on reserve accumulation is its ultimate impact on domestic prices. Depending on the openness of the financial system and the degree of sterilization, this can be delayed for a very long time.<sup>2</sup> In contrast, deficit countries must either deflate or run down reserves.

Flexible exchange rates prevent many of these problems by providing less costly and more symmetric adjustment. Relative wages and prices can adjust quickly to shocks through nominal exchange rate movements in order to restore external balance. When the exchange rate floats and there is a liquid foreign exchange market, reserve holdings are seldom required.<sup>3</sup> Most fundamentally, floating exchange rates overcome the seemingly innate tendency of countries to delay adjustment.

### **Bimetallism**

In economics, bimetallism is a monetary standard in which the value of the monetary unit is defined as equivalent both to a certain quantity of gold and to a certain quantity of silver; such a system establishes a fixed rate of exchange between the two metals. The defining characteristics of bimetallism are

- Both gold and silver money are legal tender in unlimited amounts.
- The government will convert both gold and silver into legal tender coins at a fixed rate for individuals in unlimited quantities. This is called free coinage because the quantity is unlimited, even if a fee is charged.

The combination of these conditions distinguish bimetallism from a limping standard, where both gold and silver are legal tender but only one is freely coined (example: France, Germany, or the United States after 1873), or trade money where both metals are freely coined but only one is legal tender and the other is trade money (example: most of the coinage of western Europe from the 1200s to 1700s.) Economists also distinguish legal bimetallism, where the law guarantees these conditions, and de-facto bimetallism where both gold and silver coins actually circulate at a fixed rate.

### **The Gold Standard**

In today's national economies and the current international monetary system, fiat currencies are the norm. With no backing other than the full faith and credit of the governments that issue them, the evolution of today's money began with the introduction and acceptance of paper money in the seventeenth century in the form of receipts for deposits of gold in the Bank of Amsterdam. The growing role of the state and its ability to tax and impose tariffs to provide metallic backing made it possible to instill confidence in issues of bank notes convertible into gold and silver and paper currencies spread across Europe as a more convenient vehicle for payments than coins. Bank notes thus became the standard currency for transactions within national economies in the eighteenth and nineteenth centuries.

### **The Gold Exchange Standard**

Towards the end of the 19th century, some of the remaining silver standard countries began to peg their silver coin units to the gold standards of the United Kingdom or the USA. In 1898, British India pegged the silver rupee to the pound sterling at a fixed rate of 1s 4d, while in 1906, the Straits Settlements adopted a gold exchange standard against the pound sterling with the silver Straits dollar being fixed at 2s 4d.

Around the start of the 20th century, the Philippines pegged the silver peso/dollar to the U.S. dollar at 50 cents. This move was assisted by the passage of the Philippines Coinage Act by the United States Congress (March 3, 1903). A similar pegging at 50 cents occurred at around the same time with the silver peso of Mexico and the silver yen of Japan. When Siam adopted a gold exchange standard in 1908, this left only China and Hong Kong on the silver standard.

When adopting the gold standard, many European nations changed the name of their currency from Daler (Sweden and Denmark) or Gulden (Austria-Hungary) to Crown, since the former names were traditionally associated with silver coins and the latter with gold coins.

It is probable that the success of the gold standard also depended on a parallel development that emerged out of the mechanisms the industrializing countries used to ‘manage’ the gold standard—the development of the gold exchange standard. This monetary system differs from the gold standard in that international reserves consist of both gold and convertible currencies so that the system can function with less gold.

Another difference is that, because those convertible currencies tend to be invested in interest-bearing financial assets, the gold exchange standard includes a mechanism that allows for growth in world reserves independent of increases in gold production. The use of a mixture of foreign exchange assets and gold as components of reserve holdings was not just a post-World War I phenomenon. The Scandinavian countries had entered into agreements to use one another’s currencies as early as 1885. By 1913, some 15 central banks held about 12% of their reserves in the form of foreign exchange assets

The mechanisms for settlement of foreign exchange holdings evolved throughout Europe with the development of financial markets and central banks. A government (treasury or central bank) bought and sold foreign exchange in transactions with its own private sector, becoming the creditor by drawing down or building up its own holdings of foreign exchange. This permitted the development of a larger role for the public sector in controlling international payments as these transactions replaced the earlier and less efficient transfers of gold reserves to net out holdings of bills of exchange between private banks in different countries.

Thus, the addition of convertible currency assets as components of international reserves constituted a significant revision of the rules of the game in international payments that persisted until the collapse of Bretton woods in 1971.

### **Bretton Woods: the Dollar Exchange Rate Regime**

The “Revived Bretton Woods system” identified in 2003

International monetary systems over two centuries[16]			
Date	System	Reserve assets	Leaders
1803–1873	Bimetallism	Gold, silver	France, UK
1873–1914	Gold standard	Gold, pound	UK
1914–1924	Anchored dollar standard	Gold, dollar	US, UK, France
1924–1933	Gold standard	Gold, dollar, pound	US, UK, France
1933–1971	Anchored dollar standard	Gold, dollar	US, G-10

1971–1973	Dollar standard	Dollar	US
1973–1985	Flexible exchange rates	Dollar, mark, pound	US, Germany, Japan
1985–1999	Managed exchange rates	Dollar, mark, yen	US, G7, IMF
1999-	Dollar, euro	Dollar, euro, yen	US, Eurozone, IMF

### **The Current Hybrid System**

After the breakdown of the Bretton Woods system, the international monetary system reverted to a more decentralized, market-based model. Major countries floated their exchange rates, made their currencies convertible, and gradually liberalized capital flows. In recent years, several major emerging markets adopted similar policies after experiencing the difficulties of managing pegged exchange rate regimes with increasingly open capital accounts. The move to more market-determined exchange rates has increased control of domestic monetary policy and inflation, accelerated the development of financial sectors, and, ultimately, boosted economic growth.

Unfortunately, this trend has been far from universal. In many respects, the recent crisis represents a classic example of asymmetric adjustment. Some major economies have frustrated real exchange rate adjustments by accumulating enormous foreign reserves and sterilizing the inflows. While their initial objective was to self-insure against future crises, reserve accumulation soon outstripped these requirements. In some cases, persistent exchange rate intervention has served primarily to maintain undervalued exchange rates and promote export-led growth. Indeed, given the scale of its economic miracle, it is remarkable that China's real effective exchange rate has not appreciated since 1990

### **Exchange-Rate Regime**

An exchange-rate regime is the way an authority manages its currency in relation to other currencies and the foreign exchange market. It is closely related to monetary policy and the two are generally dependent on many of the same factors.

The basic types are a floating exchange rate, where the market dictates movements in the exchange rate; a pegged float, where a central bank keeps the rate from deviating too far from a target band or value; and a fixed exchange rate, which ties the currency to another currency, mostly more widespread currencies such as the U.S. dollar or the euro or a basket of currencies.

## Types of Exchange Rate Regime

### ➤ Float

Floating rates are the most common exchange rate regime today. For example, the dollar, euro, yen, and British pound all are floating currencies. However, since central banks frequently intervene to avoid excessive appreciation or depreciation, these regimes are often called managed float or a dirty float.

### ➤ *Pegged Float*

Pegged floating currencies are pegged to some band or value, either fixed or periodically adjusted. Pegged floats are:

### ➤ *Crawling Bands*

The rate is allowed to fluctuate in a band around a central value, which is adjusted periodically. This is done at a preannounced rate or in a controlled way following economic indicators.

### ➤ *Crawling Pegs*

The rate itself is fixed, and adjusted as above.

### ➤ *Pegged with Horizontal Bands*

The rate is allowed to fluctuate in a fixed band (bigger than 1%) around a central rate.

### ➤ *Fixed*

Fixed rates are those that have direct convertibility towards another currency. In case of a separate currency, also known as a currency board arrangement, the domestic currency is backed one to one by foreign reserves. A pegged currency with very small bands (< 1%) and countries that have adopted another country's currency and abandoned its own also fall under this category.

Dollarization occurs when the inhabitants of a country use foreign currency in parallel to or instead of the domestic currency. The term is not only applied to usage of



the United States dollar, but generally to the use of any foreign currency as the national currency. Zimbabwe is an example of dollarization since the collapse of the Zimbabwean dollar.

### **European Monetary System**

European Monetary System (EMS) was an arrangement established in 1979 under the Jenkins European Commission where most nations of the European Economic Community (EEC) linked their currencies to prevent large fluctuations relative to one another.

After the demise of the Bretton Woods system in 1971, most of the EEC countries agreed in 1972 to maintain stable exchange rates by preventing exchange rate fluctuations of more than 2.25% (the European “currency snake”). In March 1979, this system was replaced by the European Monetary System, and the European Currency Unit (ECU) was defined.

#### ***The basic elements of the arrangement were:***

1. The ECU: With this arrangement, member currencies agreed to keep their FX rates within an agreed band which the narrow band of  $\pm 2.25\%$  and a wide band of  $\pm 6\%$ .
2. An Exchange Rate Mechanism (ERM)
3. An extension of European credit facilities.
4. The European Monetary Cooperation Fund: created in October 1972 and allocates ECUs to members' central banks in exchange for gold and US dollar deposits.

Although no currency was designated as an anchor, the Deutsche Mark and German Bundesbank soon emerged as the centre of the EMS. Because of its relative strength, and the low-inflation policies of the bank, all other currencies were forced to follow its lead if they wanted to stay inside the system. Eventually, this situation led to dissatisfaction in most countries, and was one of the primary forces behind the drive to a monetary union (ultimately the euro).

Periodic adjustments raised the values of strong currencies and lowered those of weaker ones, but after 1986 changes in national interest rates were used to keep the currencies within a narrow range. In the early 1990s the European Monetary System was strained by the differing economic policies and conditions of its members, especially the newly reunified Germany, and Britain (which had initially declined to join and only did so in 1990) permanently withdrew from the system in September 1992. Speculative attacks on

the French Franc during the following year led to the so-called Brussels Compromise in August 1993 which established a new fluctuation band of +15%.

### **The Outstanding Issues in the International Monetary and Financial Systems**

The outstanding issues in the international monetary and financial systems can be listed under the following headings:

- A. The governance and regulation of the capital and monetary flows:
- B. The management of financial crisis and the foundation of the bank of Last Resort.
- C. The Foreign Exchange System
- D. The Reform of the IMF

### **The Governance and Regulation of Financial Flows**

The Breton Woods system provided no governance for international financial flows. Although Keynes was quite keen on the topic, the other conferees did not seem in 1944 to be much concerned about it. However, the achievement of capital account convertibility in the advanced countries as of 1959 (some four years after realizing current account equilibrium) and the subsequent development of capital markets in the 60's, 70's and 80's propelled this issue to the fore. In the wake up of the Asian crisis in 1977, and the demonstrated globalization of financial markets, it could no longer be ignored.

The articles of agreements of the IMF contained disparate references to financial flows in articles IV and VI. As indicated above, Article IV made the free exchange of finance among member states a fundamental objective of the IMF. Article VI provides permissibility of capital controls as long as they do not impede or restrict payments made from the current account transactions (the balance of trade and unilateral transfers). It also disallows the use of the resources of the fund to support large capital outflows.

The concern with the growth of financial instability impelled the G7 (the group of seven major industrial countries) in February 1999 to establish the "Financial Stability Forum" with the aim of promoting international financial stability through improved exchange of information, cooperation with respect to financial supervision and surveillance, and streamlining standards and norms in the various participant countries. Naturally, this work cannot be confined to financial flows and the financial institutions, as it has direct implications with respect to macroeconomic policies, the various standards of the financial system and its judicial framework.

In each of the various areas, a key standard was established with a lead institution responsible for developing the necessary codes, rules, norms and standards. Consequently, the BIS has over the last decade been the forum in which officials from the participating countries and international organizations, without the presence of private sector agents, have concluded numerous agreements aiming at establishing cooperative modalities for collecting systematically information on capital and monetary flows and disseminating them to members and public.

The forum has reached numerous agreements on codes of behavior such as the code of “Good Practices on Transparency in Monetary and Financial Policies”, and the same for transparency in fiscal policy. It reached agreements on financial regulation and supervision such as “The Core Principles of Effective Banking Supervision” and those of security and insurance.

It also agreed on regulation standards for insolvency, for corporate governance, for auditing and accounting and principles to deal with money laundering. It also agreed to rules and procedures for the treatment of important financial concepts such as risk and exposure as well as setting up modalities of cooperation among officials of member states. An important part of what was achieved is the collection of data and the establishment of a shared database.

Unfortunately, the private sector was not involved directly in devising the new rules and principles and not asked to share any responsibilities. Furthermore, no modalities were agreed for securing its continuous involvement in financial governance, let alone setting up a non-voluntary code of investors’ behavior.

All of this work, with all its due importance, amounted in effect to organizing in the source countries the supervision of their institutions and setting up financial regulations and behavior standards for their institutions. Naturally, global financial governance involves conduct in crises, obligations on the source authorities as well as the recipient country authorities and above all, setting up proper models of conduct and codes of standards for private investors. But this was not to be, as the private sector participation remained strictly voluntary.

As noted earlier, the increased globalization of the world economy and the evolved integration of financial markets have resulted in enormous increase in cross border financial flows, with a concomitant increase in financial instability and frequent eruptions of financial and currency crisis. No doubt, the purpose of the new codes and standards can increase financial stability and prevent, or at least, forewarn of impending crises.

In this context, several other proposals have been put forward to set up a system authority to carry out and enforce financial governance since the 1980's. Some proposals suggest the creation of a worldwide supervisory and regulatory authority, the "World Financial Authority", to regulate and supervise all institutions and markets.

Another variant more concerned with system issues and policies, developed proposals to establish a super agency over all the relevant international organizations to be responsible for the whole system: its policies, regulations, supervision, and crisis management.

All these proposals share the aim of establishing a global authority with a global perspective and enforceable authority to deal with the application of regulations, codes of behavior, and methods of controls and rules of functioning on radically different basis than the piece meal, patchy approach of the present institutions. It is argued that the globalization of the world economy now calls for such an approach.

Another problem concerns the treatment of private sector. Since the private investors and speculators in the source countries are responsible for the bulk of the financial flows, the voluntary character of the application of the established rules and codes to them stands in stark contrast to the summons to obey with consequent sanctions addressed to the recipient and their private concerns.

A code of behavior for investors would be an enormous development. However, there are several objections to such a binding code. The first argue that it is exceedingly difficult to enforce it. The second is an efficiency argument about the distortion of allocation of international investment funds in case of insolvency controls.

The third concerns the deterrence to capital movements it might bring about, in particular, inflows to the poorer countries. The fourth is the desirability of avoiding bureaucratic decision – making and conflict of jurisdictions in case of crisis. The counter arguments are familiar from the work of the BIS and the literature on capital controls and the Tobin tax.

Briefly, it is argued that feasibility is an open empirical question; that the efficiency argument assumes that a code – free system is optimal and is already in place and that the fear of bureaucratic conflicts is exaggerated. On balance, a universal code applied by all an impartial international authority, such as the IMF, should be feasible.

### Self Assessment Questions

1. Discuss the features and components of International monetary system
2. Write a short note on Bretton Wood System
3. Explain the concept of Exchange Rate Regime
4. What are the issues in the International Monetary and Financial System
5. Write a short note on European Monetary System.

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## Lesson 1.4 - IMF, GATT and WTO

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### Learning Objectives

*After studying this lesson you should be able to*

- Understand European Monetary System
- Discuss the Activities, Aims, structure, surveillance, History and Governance of IMF
- Understand the Members quotas and Voting power of members of IMF
- Analyze the Reforms taken place in the IMF
- Elaborate the GATT
- Understand WTO
- Discuss the Principles of trading system



### International Monetary Fund

The International Monetary Fund (IMF) is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. With its near-global membership of 188 countries, the IMF is uniquely

placed to help member governments take advantage of the opportunities—and manage the challenges—posed by globalization and economic development more generally. The IMF tracks global economic trends and performance, alerts its member countries when it sees problems on the horizon, provides a forum for policy dialogue, and passes on know-how to governments on how to tackle economic difficulties.

The IMF provides policy advice and financing to members in economic difficulties and also works with developing nations to help them achieve macroeconomic stability and reduce poverty.

Marked by massive movements of capital and abrupt shifts in comparative advantage, globalization affects countries' policy choices in many areas, including labor, trade, and tax policies. Helping a country benefit from globalization while avoiding potential downsides is an important task for the IMF. The global economic crisis has highlighted just how interconnected countries have become in today's world economy.

### **Key IMF Activities**

The IMF supports its membership by providing

- Policy advice to governments and central banks based on analysis of economic trends and cross-country experiences;
- Research, statistics, forecasts, and analysis based on tracking of global, regional, and individual economies and markets;
- Loans to help countries overcome economic difficulties;
- Concessional loans to help fight poverty in developing countries; and
- Technical assistance and training to help countries improve the management of their economies.

### **Original Aims**

The IMF was founded more than 60 years ago toward the end of World War II (see History). The founders aimed to build a framework for economic cooperation that would avoid a repetition of the disastrous economic policies that had contributed to the Great Depression of the 1930s and the global conflict that followed.

Since then the world has changed dramatically, bringing extensive prosperity and lifting millions out of poverty, especially in Asia. In many ways the IMF's main purpose—to

provide the global public good of financial stability—is the same today as it was when the organization was established. More specifically, the IMF continues to

- Provide a forum for cooperation on international monetary problems
- Facilitate the growth of international trade, thus promoting job creation, economic growth, and poverty reduction;
- Promote exchange rate stability and an open system of international payments; and
- Lend countries foreign exchange when needed, on a temporary basis and under adequate safeguards, to help them address balance of payments problems.

### **An Adapting IMF**

The IMF has evolved along with the global economy throughout its 65-year history, allowing the organization to retain its central role within the international financial architecture

As the world economy struggles to restore growth and jobs after the worst crisis since the Great Depression, the IMF has emerged as a very different institution. During the crisis, it mobilized on many fronts to support its member countries. It increased its lending, used its cross-country experience to advice on policy solutions, supported global policy coordination, and reformed the way it makes decisions.

The result is an institution that is more in tune with the needs of its 188 member countries.

- **Stepping up crisis lending.** The IMF responded quickly to the global economic crisis, with lending commitments reaching a record level of more than US\$250 billion in 2010. This figure includes a sharp increase in concessional lending (that's to say, subsidized lending at rates below those being charged by the market) to the world's poorest nations.
- **Greater lending flexibility.** The IMF has overhauled its lending framework to make it better suited to countries' individual needs. It is also working with other regional institutions to create a broader financial safety net, which could help prevent new crises.
- **Providing analysis and advice.** The IMF's monitoring, forecasts, and policy advice, informed by a global perspective and by experience from previous crises, have been in high demand and have been used by the G-20.



- Drawing lessons from the crisis. The IMF is contributing to the ongoing effort to draw lessons from the crisis for policy, regulation, and reform of the global financial architecture.
- Historic reform of governance. The IMF's member countries also agreed to a significant increase in the voice of dynamic emerging and developing economies in the decision making of the institution, while preserving the voice of the low-income members.

The IMF's main goal is to ensure the stability of the international monetary and financial system. It helps resolve crises, and works with its member countries to promote growth and alleviate poverty. It has three main tools at its disposal to carry out its mandate: surveillance, technical assistance and training, and lending. These functions are underpinned by the IMF's research and statistics.

## Surveillance

The IMF promotes economic stability and global growth by encouraging countries to adopt sound economic and financial policies. To do this, it regularly monitors global, regional, and national economic developments. It also seeks to assess the impact of the policies of individual countries on other economies.

This process of monitoring and discussing countries' economic and financial policies is known as bilateral surveillance. On a regular basis—usually once each year—the IMF conducts in depth appraisals of each member country's economic situation. It discusses with the country's authorities the policies that are most conducive to a stable and prosperous economy, drawing on experience across its membership. Member countries may agree to publish the IMF's assessment of their economies, with the vast majority of countries opting to do so.

The IMF also carries out extensive analysis of global and regional economic trends, known as multilateral surveillance. Its key outputs are three semiannual publications, the *World Economic Outlook*, the *Global Financial Stability Report*, and the *Fiscal Monitor*. The IMF also publishes a series of regional economic outlooks.

The IMF recently agreed on a series of actions to enhance multilateral, financial, and bilateral surveillance, including to better integrate the three; improve our understanding of spillovers and the assessment of emerging and potential risks; and strengthen IMF policy advice.

For more information on how the IMF monitors economies, go to Surveillance in the Our Work section.

## **Technical Assistance and Training**

IMF offers technical assistance and training to help member countries strengthen their capacity to design and implement effective policies. Technical assistance is offered in several areas, including fiscal policy, monetary and exchange rate policies, banking and financial system supervision and regulation, and statistics.

The IMF provides technical assistance and training mainly in four areas:

- Monetary and financial policies (monetary policy instruments, banking system supervision and restructuring, foreign management and operations, clearing settlement systems for payments, and structural development of central banks);
- Fiscal policy and management (tax and customs policies and administration, budget formulation, expenditure management, design of social safety nets, and management of domestic and foreign debt);
- Compilation, management, dissemination, and improvement of statistical data; and
- Economic and financial legislation.

For more on technical assistance, go to Technical Assistance in the Our Work section.

## **Lending**

IMF financing provides member countries the breathing room they need to correct balance of payments problems. A policy program supported by financing is designed by the national authorities in close cooperation with the IMF. Continued financial support is conditional on the effective implementation of this program.

In the most recent reforms, IMF lending instruments were improved further to provide flexible crisis prevention tools to a broad range of members with sound fundamentals, policies, and institutional policy frameworks.

In low-income countries, the IMF has doubled loan access limits and is boosting its lending to the world's poorer countries, with loans at a concessional interest rate.

## **Collaborating with Others**

The IMF collaborates with the World Bank, regional development banks, the World Trade Organization (WTO), UN agencies, and other international bodies. While all of these organizations are involved in global economic issues, each has its own unique areas of responsibility and specialization.

The IMF also works closely with the Group of Twenty (G-20) industrialized and emerging market economies and interacts with think tanks, civil society, and the media on a daily basis.

## **History**

The IMF has played a part in shaping the global economy since the end of World War II.

### **Cooperation and Reconstruction (1944–71)**

As the Second World War ends, the job of rebuilding national economies begins. The IMF is charged with overseeing the international monetary system to ensure exchange rate stability and encouraging members to eliminate exchange restrictions that hinder trade.

### **The End of the Bretton Woods System (1972–81)**

After the system of fixed exchange rates collapses in 1971, countries are free to choose their exchange arrangement. Oil shocks occur in 1973–74 and 1979, and the IMF steps in to help countries deal with the consequences.

### **Debt and Painful Reforms (1982–89)**

The oil shocks of the 1970s, which forced many oil-importing countries to borrow from commercial banks, and the interest rate increases in industrial countries trying to control inflation led to an international debt crisis. When a crisis broke out in Mexico in 1982, the IMF coordinated the global response, even engaging the commercial banks. It realized that nobody would benefit if country after country failed to repay its debts.

The IMF's initiatives calmed the initial panic and defused its explosive potential. But a long road of painful reform in the debtor countries, and additional cooperative global measures, would be necessary to eliminate the problem.

## **Societal Change for Eastern Europe and Asian Upheaval (1990–2004)**

The IMF plays a central role in helping the countries of the former Soviet bloc transition from central planning to market-driven economies.

## **Globalization and the Crisis (2005 - Present)**

The implications of the continued rise of capital flows for economic policy and the stability of the international financial system are still not entirely clear. The current credit crisis and the food and oil price shock are clear signs that new challenges for the IMF are waiting just around the corner.

### ***The Governance of the IMF***

The IMF is accountable to the governments of its member countries. The fund Governance has been a contentious issue between the developing and developed countries since the mid of 1950's. The familiar argument of the former is that the quota system is not fair as a key for decision – making and access to resources. The response of the latter is that it is only normal and fair that each country share in the decision making be commensurate with its contribution to the fund resources.

The economic system is one which states are not equal, some are certainly more economically important than others even though they all have “equal” political sovereignty. This holds in fact when it comes to the contribution of member of states to the system. It also holds in economic theory in analyzing big economy influence over international adjustment. The economic conditions and policies of the major countries fundamentally affect the international economy. Similarly, the effects of global economic changes are more important for the big economies. It is controversial to assert that a decision by the IMF requires more than the assent and active cooperation of the large economy countries than the small ones. Economic analysis explicitly distinguishes between large and small economies when it comes to the international influence of their macroeconomic policies.

### **IMF Members' Quotas and Voting Power, and IMF Board of Governors**

The Board of Governors, the highest decision-making body of the IMF, consists of one governor and one alternate governor for each member country. The governor is appointed by the member country and is usually the minister of finance or the governor of the central bank. All powers of the IMF are vested in the Board of Governors. The Board of Governors may delegate to the Executive Board all except certain reserved powers. The Board of Governors normally meets once a year.

The table below shows quota and voting shares for IMF members. Following the entry into effect of the 2008 Amendment on Voice and Participation on March 3, 2011, quota and voting shares will change as eligible members pay their quota increases.

During this process, this table will be updated regularly. Click here for a table illustrating percentage quota and voting shares before and after implementation of the 2008 Amendment on Voice and Participation, and of subsequent reforms of quotas and governance which were agreed in 2010 but are not yet in effect.

Member	Quota		Governor/Alternate	Votes	
	Millions of SDRs	Percent of Total		Number	Percent of Total
Argentina	2,117.10	0.89	Hernán Lorenzino	21,908	0.87
			Mercedes Marcá del Pont		
Australia <sup>3</sup>	3,236.40	1.36	Joe Hockey	33,101	1.31
			Martin Parkinson		
Belgium <sup>3</sup>	4,605.20	1.93	Luc Coene	46,789	1.86
			Marc Monbaliu		
Brazil	4,250.50	1.79	Guido Mantega	43,242	1.72
France	10,738.50	4.51	Pierre Moscovici	108,122	4.29
			Christian Noyer		
Germany	14,565.50	6.12	Jens Weidmann	146,392	5.81
			Wolfgang Schäuble		
Hungary	1,038.40	0.44	Gyorgy Matolcsy	11,121	0.44
			Mihaly Varga		
India	5,821.50	2.44	P. Chidambaram	58,952	2.34
			Raghuram G. Rajan		
Indonesia	2,079.30	0.87	Agus D.W. Martowardojo	21,530	0.85
			Mahendra Siregar		
Iran	1,497.20	0.63	Valiollah Seif	15,709	0.62
Italy	7,882.30	3.31	Fabrizio Saccomanni	79,560	3.16
			Ignazio Visco		

Japan	15,628.50	6.56	Taro Aso	157,022	6.23
Korea	3,366.40	1.41	Oh-Seok Hyun	34,401	1.37
			Choongsoo Kim		
Malaysia	1,773.90	0.74	Mohd. Najib Abdul Razak	18,476	0.73
			Tan Sri Dato' Sri Zeti Akhtar Aziz		
Mexico	3,625.70	1.52	Luis Videgaray Caso	36,994	1.47
			AgustÃn Carstens		
Netherlands	5,162.40	2.17	Klaas Knot	52,361	2.08
			Hans Vijlbrief		
Pakistan	1,033.70	0.43	Yaseen Anwar	11,074	0.44
			Waqar Masood Khan		
Romania	1,030.20	0.43	Mugur Isarescu	11,039	0.44
			Claudiu Doltu		
Russian Federation	5,945.40	2.5	Anton Siluanov	60,191	2.39
			Sergey Ignatiev		
Saudi Arabia	6,985.50	2.93	Ibrahim A. Al-Assaf	70,592	2.8
			Fahad Almubarak		
Singapore	1,408.00	0.59	LIM Hng Kiang	14,817	0.59
			Ravi Menon		
South Africa	1,868.50	0.78	Pravin J. Gordhan	19,422	0.77
			Gill Marcus		
Spain	4,023.40	1.69	Luis de Guindos	40,971	1.63
			Luis M. Linde		
Sweden	2,395.50	1.01	Stefan Ingves	24,692	0.98
			Mikael Lundholm		
Switzerland <sup>3</sup>	3,458.50	1.45	Thomas Jordan	35,322	1.4
			Eveline Widmer-Schlumpf		
Thailand	1,440.50	0.6	Prasarn Trairatvorakul	15,142	0.6
			Pongpen Ruengvirayudh		
Turkey	1,455.80	0.61	Ali Babacan	15,295	0.61
			Erdem Basci		

United Kingdom	10,738.50	4.51	George Osborne	108,122	4.29
			Mark Carney		
United States	42,122.40	17.69	Jacob J. Lew	421,961	16.75
Total	238,118.0	100.04	Vacant	2,519,736	100.04

**General Department and Special Drawing Rights Department.**

**Senior Officials of the International Monetary Fund**

Managing Director	Christine Lagarde
First Deputy Managing Director	David Lipton
Deputy Managing Director	Naoyuki Shinohara
Deputy Managing Director	Nemat Shafik
Deputy Managing Director	Min Zhu
Economic Counsellor	Olivier Blanchard
Financial Counsellor	José Viñals
African Department Director	Antoinette Monsio Sayeh
Asia and Pacific Department Director	Anoop Singh
European Department Director	Reza Moghadam
Communications Department Director	Gerard Rice
Finance Department Director	Andrew Tweedie
Fiscal Affairs Department Acting Director	Sanjeev Gupta
Human Resources Department Director	Mark Plant
Institute for Capacity Development Director	Sharmini A. Coorey
Legal Department General Counsel and Director	Sean Hagan
Middle East and Central Asia Department Director	Masood Ahmed
Monetary and Capital Markets Department Director	José Viñals
Research Department Director	Olivier Blanchard
Secretary's Department Secretary	Jianhai Lin
Statistics Department Director	Louis Marc Ducharme
Strategy, Policy, and Review Department Director	Siddharth Tiwari
Technology and General Services Department Director	Frank Harnischfeger

Technology and General Services Department Chief Information Officer	Susan Swart
Western Hemisphere Department Director	Alejandro Werner
Office of Budget and Planning Director	Daniel Citrin
Office of Internal Audit and Inspection Director	G. Russell Kincaid
Regional Office for Asia and the Pacific Director	Odd Per Brekk
Offices in Europe Director	Emmanuel van der Mensbrugghe
Special Representative to the UN	Axel Albert Emil Bertuch- Samuels
Independent Evaluation Office, Director	Moises J. Schwartz

### The Reform of the IMF

Unlike the General Assembly of the United Nations, where each country has one vote, decision making at the IMF was designed to reflect the position of each member country in the global economy. Each IMF member country is assigned a quota that determines its financial commitment to the IMF, as well as its voting power. To be effective, the IMF must be seen as representing the interests of all of its 188 member countries, from its smallest shareholder Tuvalu, to its largest, the United States.

There are three main issues in this area: the governance of the IMF, **the surveillance and conditionality** and the **reserve system** together with the function of the **bank of last resort**. This lesson has already dealt with the last topic above.

The developing countries have created two institutional modalities to strengthen their influence of the IMF: the group of twenty four and the development committee. The G24 was established more than three decades ago by the group of seventy seven, which founded UNCTAD. It has had a good working program supported by UNCTAD and other international secretariats as well as by the service of independent experts of distinction.

It is fair to say that it has had beneficial influence on the IMF and has, to certain extend, served the interests of developing countries.



In November 2010, the IMF agreed on reform of its framework for making decisions to reflect the increasing importance of emerging market and developing economies.

### ***Giving more say to Emerging Markets***

In recent years, emerging market countries have experienced strong growth and now play a much larger role in the world economy.

The reforms will produce a shift of 6 percent of quota shares to dynamic emerging market and developing countries. This realignment will give more say to a group of countries known as the BRICS: Brazil, Russia, India, and China.

### ***Protecting the Voice of Low-Income Countries***

The reform package also contains measures to protect the voice of the poorest countries in the IMF. Without these measures, this group of countries would have seen its voting shares decline.

### ***Timeline for Implementing the Reform***

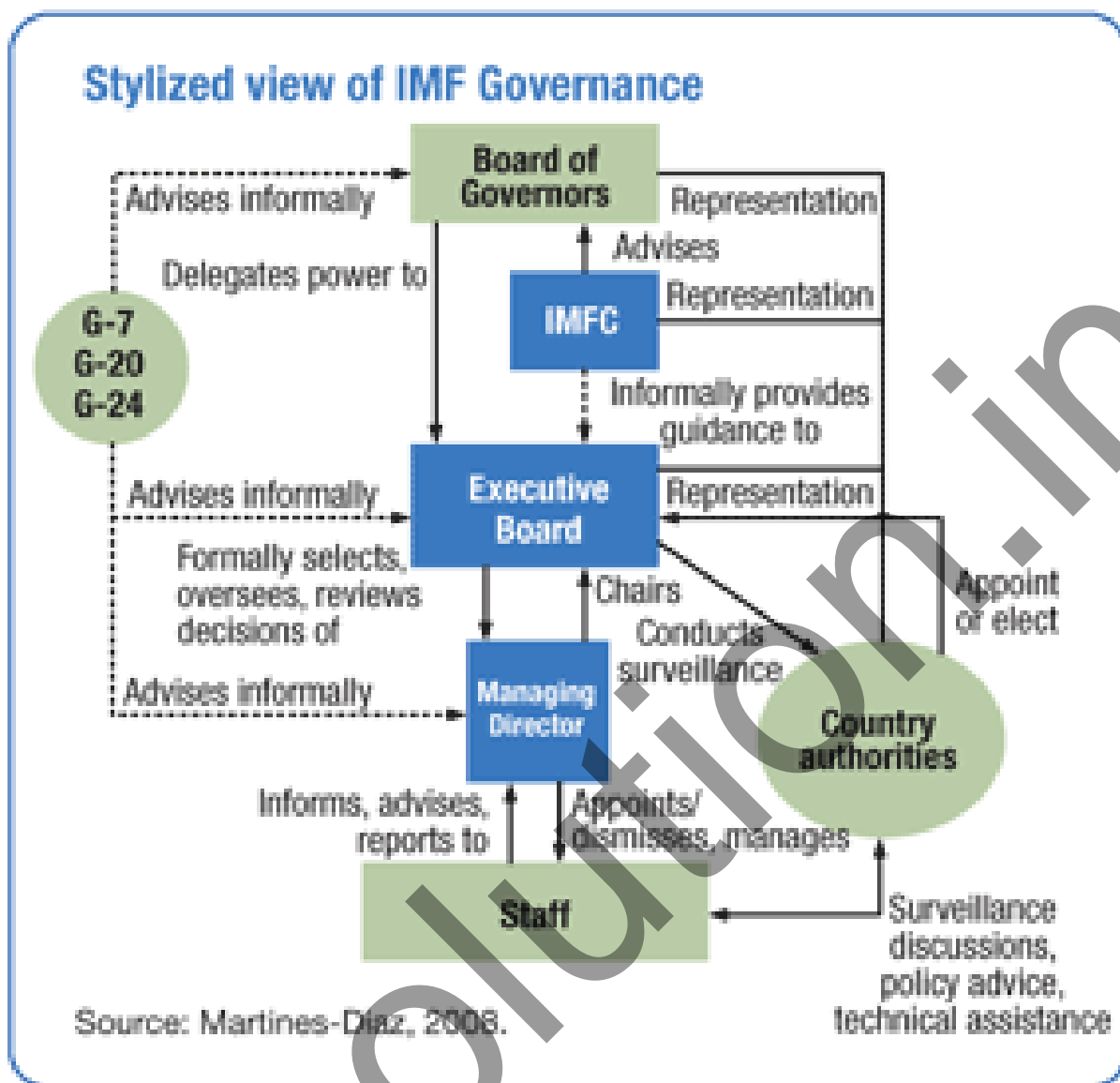
The Board of Governors, the IMF's highest decision-making body, must ratify the new agreement by an 85 percent majority before it comes into effect.

### ***Accountability***

The IMF is accountable to its 188 member governments, and is also scrutinized by multiple stakeholders, from political leaders and officials to, the media, civil society, academia, and its own internal watchdog. The IMF, in turn, encourages its own members to be as open as possible about their economic policies to encourage their accountability and transparency.

### ***Country Representation***

Unlike the General Assembly of the United Nations, where each country has one vote, decision making at the IMF was designed to reflect the position of each member country in the global economy. Each IMF member country is assigned a quota that determines its financial commitment to the IMF, as well as its voting power.



### The Surveillance Function and Conditionality

Conditionality was developed by the IMF in the early 1950's to ensure the paying back of members purchases, thereby preserving the revolving character of its resources. Sometime later, in the 1960's and 1970's, a paternalistic aspect to conditionality came into evidence as the IMF meant to guide the countries under its adjustment programs towards what it regarded the correct path to equilibrium using the correct model. In the 1980's as the debt crisis erupted in Mexico and later on in order indebted countries, conditionality expanded beyond current accounts problems to cover many aspects of financial accounts and to bear on disparate aspects of domestic economic policies. The debt crisis brought domestic financial systems and policies under the purview of conditionality. At the best of dominant members, policy reform emerged into the forefront at the close of the eighties and the beginning of the nineties. The fund acting in coordination with the World Bank

began to lay restrictions and performance clauses on macro and micro economic policies and the two institutions divided the enforcement work among themselves. By the 1990's, the avowed intent and priority of conditionality was placed on policy and structural reforms and new facilities were created to finance such programs.

### **IMF: the Bank of Last Resort**

The IMF has the capacity, like any national monetary authority, to initiate action on its own with its own resources as the custodian of the International Monetary and financial systems. For this reason, the first amendment to the articles of agreement in 1968, introduced the SDRs as the base of the system. However, after much improvement in their characteristics and much extension in their use within the fund, the SDRs have remained a mere 2% fraction of international reserves.

From inception, the IMF was created without resources of its own. Even before Bretton Woods, the vision of Keynes of an autonomously financed union with flexible and discretionary resource base was abandoned in view of the opposition of the US. In its place, the US concept, articulated by Under Secretary Harry Dexter White, was to enshrine an institution based on a resource pool contributed and controlled by the countries with majority quotas. Thus, the new global countries in financial and currency markets have thrust the institution into areas for which it has no adequate resource base independent of the political decisions of its major members.

In recent years, several proposals have been formulated to deal with this lacuna, the most ambitious of which is the proposal of the Meltzer Commission set up by the US Congress. There are a number of issues to be pointed out in this context, some political, some institutional and some technical. The lender of last resort role requires not only resources, but as well enforceable control on all countries.

The financial crises in both Asia and Latin America have some common features and similar sequences. They were predominantly crisis in the financial system. In the majority of cases in Asia, there was no macroeconomic policy mismanagement signaled by the fund in its prior surveillance consultations with the members. Typically, there was a mal-functioning domestic financial system interacting with the typical behavior of the open international financial system. Usually, the start is ignited by banks carrying on their books a great deal of large assets that are non-performing. This leads in short order to failure of the banks to cope with servicing liabilities dominated in foreign exchange. Swiftly, a currency crisis explodes and the balance sheet of the banks and other institutions suffer serve deterioration in their domestic currency net worth. The swift and simultaneous reaction of creditors to

these developments ushers in a country balance of payments crisis and requires usually severe adjustment. The crisis soon propagates into all sectors of the economy and spills over into other countries by, inter alia, altering the risk perception of international investors. The international official system then becomes involved to stem possible systematic risk. As a result, rescue packages would be negotiated with the stricken countries.

These seem to have some important common features. Dramatic increases in interest rates, damaging to the macro economic performance in the first place, increase greatly the interest rate risk of debt and other fixed income securities and inflicts large capital losses on the balance sheet of banks and other financial institutions of the debtors. The hiking of interest rates inflicts a net capital loss on the asset side. The result is serve deterioration in the bank balance sheet that might wipe out their net worth.

### **General Agreement on Tariffs and (GATT)**

The General Agreement on Tariffs and Trade (GATT) was a multilateral agreement regulating international trade. According to its preamble, its purpose was the “substantial reduction of tariffs and other trade barriers and the elimination of preferences, on a reciprocal and mutually advantageous basis.” It was negotiated during the United Nations Conference on Trade and Employment and was the outcome of the failure of negotiating governments to create the International Trade Organization (ITO). GATT was signed in 1947 and lasted until 1994, when it was replaced by the World Trade Organization in 1995.

The original GATT text (GATT 1948) is still in effect under the WTO framework, subject to the modifications of GATT 1994

### **World Trade Organization (WTO)**

#### **Fact File**

*Location* : Geneva Switzerland

*Established* :1 January 1995

*Created by* : Uruguay Round negotiations (198694)

*Membership* : 159 countries on 2 March 2013

*Budget* :196 million Swiss francs for 2011

*Secretariat staff* : 640

*Head* : Roberto Azevêdo (Director-General)

## **Functions**

- Administering WTO trade agreements
- Forum for trade negotiations
- Handling trade disputes
- Monitoring national trade policies
- Technical assistance and training for developing countries
- Cooperation with other international organizations

The World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The goal is to help producers of goods and services, exporters, and importers conduct their business.

The WTO was born out of negotiations, and everything the WTO does is the result of negotiations. The bulk of the WTO's current work comes from the 1986–94 negotiations called the Uruguay Round and earlier negotiations under the General Agreement on Tariffs and Trade (GATT). The WTO is currently the host to new negotiations, under the 'Doha Development Agenda' launched in 2001.

Where countries have faced trade barriers and wanted them lowered, the negotiations have helped to open markets for trade. But the WTO is not just about opening markets, and in some circumstances its rules support maintaining trade barriers — for example, to protect consumers or prevent the spread of disease.

At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations. These documents provide the legal ground rules for international commerce. They are essentially contracts, binding governments to keep their trade policies within agreed limits. Although negotiated and signed by governments, the goal is to help producers of goods and services, exporters, and importers conduct their business, while allowing governments to meet social and environmental objectives.

The system's overriding purpose is to help trade flow as freely as possible — so long as there are no undesirable side effects — because this is important for economic development and well-being. That partly means removing obstacles. It also means ensuring that individuals, companies and governments know what the trade rules are around the world, and giving them the confidence that there will be no sudden changes of policy. In other words, the rules have to be 'transparent' and predictable.

Trade relations often involve conflicting interests. Agreements, including those painstakingly negotiated in the WTO system, often need interpreting. The most harmonious way to settle these differences is through some neutral procedure based on an agreed legal foundation. That is the purpose behind the dispute settlement process written into the WTO agreements.

## Principles of the Trading System

The WTO agreements are lengthy and complex because they are legal texts covering a wide range of activities. They deal with: agriculture, textiles and clothing, banking, telecommunications, government purchases, industrial standards and product safety, food sanitation regulations, intellectual property, and much more. But a number of simple, fundamental principles run throughout all of these documents. These principles are the foundation of the multilateral trading system.

### 1. Most-Favoured-Nation (MFN)

Treating other people equally Under the WTO agreements, countries cannot normally discriminate between their trading partners. Grant someone a special favour (such as a lower customs duty rate for one of their products) and you have to do the same for all other WTO members.

This principle is known as most-favoured-nation (MFN) treatment (see box). It is so important that it is the first article of the General Agreement on Tariffs and Trade (GATT), which governs trade in goods. MFN is also a priority in the General Agreement on Trade in Services (GATS) (Article 2) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (Article 4), although in each agreement the principle is handled slightly differently. Together, those three agreements cover all three main areas of trade handled by the WTO.

Some exceptions are allowed. For example, countries can set up a free trade agreement that applies only to goods traded within the group — discriminating against goods from outside. Or they can give developing countries special access to their markets. Or a country can raise barriers against products that are considered to be traded unfairly from specific countries. And in services, countries are allowed, in limited circumstances, to discriminate. But the agreements only permit these exceptions under strict conditions. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all its trading partners — whether rich or poor, weak or strong.

## 2. National Treatment

Treating foreigners and locals equally Imported and locally-produced goods should be treated equally — at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. This principle of “national treatment” (giving others the same treatment as one’s own nationals) is also found in all the three main WTO agreements (Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPS), although once again the principle is handled slightly differently in each of these.

National treatment only applies once a product, service or item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation of national treatment even if locally-produced products are not charged an equivalent tax.

### **Freer Trade: Gradually, Through Negotiation**

Lowering trade barriers is one of the most obvious means of encouraging trade. The barriers concerned include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively. From time to time other issues such as red tape and exchange rate policies have also been discussed.

Since GATT’s creation in 1947-48 there have been eight rounds of trade negotiations. A ninth round, under the Doha Development Agenda, is now underway. At first these focused on lowering tariffs (customs duties) on imported goods. As a result of the negotiations, by the mid-1990s industrial countries’ tariff rates on industrial goods had fallen steadily to less than 4%.

But by the 1980s, the negotiations had expanded to cover non-tariff barriers on goods, and to the new areas such as services and intellectual property.

Opening markets can be beneficial, but it also requires adjustment. The WTO agreements allow countries to introduce changes gradually, through “progressive liberalization”. Developing countries are usually given longer to fulfil their obligations.

### **Predictability: Through Binding and Transparency**

Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future opportunities. With

stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice and lower prices. The multilateral trading system is an attempt by governments to make the business environment stable and predictable.

### ***The Uruguay Round Increased Bindings***

*Percentages of Tariffs Bound Before and After the 1986-94 talks*

	Before	After
Developed countries	78	99
Developing countries	21	73
Transition economies	73	98

*(These are Tariff lines, so Percentages are not Weighted According to Trade Volume or Value)*

In the WTO, when countries agree to open their markets for goods or services, they “bind” their commitments. For goods, these bindings amount to ceilings on customs tariff rates. Sometimes countries tax imports at rates that are lower than the bound rates. Frequently this is the case in developing countries. In developed countries the rates actually charged and the bound rates tend to be the same.

A country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. One of the achievements of the Uruguay Round of multilateral trade talks was to increase the amount of trade under binding commitments (see table). In agriculture, 100% of products now have bound tariffs. The result of all this: a substantially higher degree of market security for traders and investors.

The system tries to improve predictability and stability in other ways as well. One way is to discourage the use of quotas and other measures used to set limits on quantities of imports — administering quotas can lead to more red-tape and accusations of unfair play. Another is to make countries’ trade rules as clear and public (“transparent”) as possible. Many WTO agreements require governments to disclose their policies and practices publicly within the country or by notifying the WTO. The regular surveillance of national trade policies through the Trade Policy Review Mechanism provides a further means of encouraging transparency both domestically and at the multilateral level.



## **Promoting Fair Competition**

The WTO is sometimes described as a “free trade” institution, but that is not entirely accurate. The system does allow tariffs and, in limited circumstances, other forms of protection. More accurately, it is a system of rules dedicated to open, fair and undistorted competition.

The rules on non-discrimination — MFN and national treatment — are designed to secure fair conditions of trade. So too are those on dumping (exporting at below cost to gain market share) and subsidies. The issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade.

Many of the other WTO agreements aim to support fair competition: in agriculture, intellectual property, services, for example. The agreement on government procurement (a “plurilateral” agreement because it is signed by only a few WTO members) extends competition rules to purchases by thousands of government entities in many countries. And so on.

## ***Encouraging Development and Economic Reform***

The WTO system contributes to development. On the other hand, developing countries need flexibility in the time they take to implement the system’s agreements. And the agreements themselves inherit the earlier provisions of GATT that allow for special assistance and trade concessions for developing countries.

Over three quarters of WTO members are developing countries and countries in transition to market economies. During the seven and a half years of the Uruguay Round, over 60 of these countries implemented trade liberalization programmes autonomously. At the same time, developing countries and transition economies were much more active and influential in the Uruguay Round negotiations than in any previous round, and they are even more so in the current Doha Development Agenda.

At the end of the Uruguay Round, developing countries were prepared to take on most of the obligations that are required of developed countries. But, the agreements did give them transition periods to adjust to the more unfamiliar and, perhaps, difficult WTO provisions — particularly so for the poorest, “least-developed” countries. A ministerial decision adopted at the end of the round says better-off countries should accelerate implementing market access commitments on goods exported by the least-developed

countries, and it seeks increased technical assistance for them. More recently, developed countries have started to allow duty-free and quota-free imports for almost all products from least-developed countries. On all of this, the WTO and its members are still going through a learning process. The current Doha Development Agenda includes developing countries' concerns about the difficulties they face in implementing the Uruguay Round agreements.

## Activities of WTO

WTO's main activities are:

- Negotiating the reduction or elimination of obstacles to trade (import tariffs, other barriers to trade) and agreeing on rules governing the conduct of international trade (e.g. antidumping, subsidies, product standards, etc.).
- Administering and monitoring the application of the WTO's agreed rules for trade in goods, trade in services, and trade-related intellectual property rights.
- Monitoring and reviewing the trade policies of our members, as well as ensuring transparency of regional and bilateral trade agreements.
- Settling disputes among our members regarding the interpretation and application of the agreements.
- Building capacity of developing country government officials in international trade matters.
- Assisting the process of accession of some 30 countries who are not yet members of the organization.
- Conducting economic research and collecting and disseminating trade data in support of the WTO's other main activities.
- Explaining to and educating the public about the WTO, its mission and its activities.

The WTO's founding and guiding principles remain the pursuit of open borders, the guarantee of most-favoured-nation principle and non-discriminatory treatment by and among members, and a commitment to transparency in the conduct of its activities. The opening of national markets to international trade, with justifiable exceptions or with adequate flexibilities, will encourage and contribute to sustainable development, raise people's welfare, reduce poverty, and foster peace and stability. At the same time, such market opening must be accompanied by sound domestic and international policies that contribute to economic growth and development according to each member's needs and aspirations.

## Structure of WTO

The WTO is run by its member governments. All major decisions are made by the membership as a whole, either by ministers (who meet at least once every two years) or by their ambassadors or delegates (who meet regularly in Geneva). Decisions are normally taken by consensus. In this respect, the WTO is different from some other international organizations such as the World Bank and International Monetary Fund. In the WTO, power is not delegated to a board of directors or the organization's head.

When WTO rules impose disciplines on countries' policies, that is the outcome of negotiations among WTO members. The rules are enforced by the members themselves under agreed procedures that they negotiated, including the possibility of trade sanctions. But those sanctions are imposed by member countries, and authorized by the membership as a whole. This is quite different from other agencies whose bureaucracies can, for example, influence a country's policy by threatening to withhold credit.

Reaching decisions by consensus among some 150 members can be difficult. Its main advantage is that decisions made this way are more acceptable to all members. And despite the difficulty, some remarkable agreements have been reached. Nevertheless, proposals for the creation of a smaller executive body — perhaps like a board of directors each representing different groups of countries — are heard periodically. But for now, the WTO is a member-driven, consensus-based organization.

### Highest Authority: the Ministerial Conference

So, the WTO belongs to its members. The countries make their decisions through various councils and committees, whose membership consists of all WTO members. Topmost is the ministerial conference which has to meet at least once every two years. The Ministerial Conference can take decisions on all matters under any of the multilateral trade agreements.

### Second Level: General Council in three Guises

Day-to-day work in between the ministerial conferences is handled by three bodies:

- The General Council
- The Dispute Settlement Body
- The Trade Policy Review Body

All three are in fact the same — the Agreement Establishing the WTO states they are all the General Council, although they meet under different terms of reference. Again, all three consist of all WTO members. They report to the Ministerial Conference.

The General Council acts on behalf of the Ministerial Conference on all WTO affairs. It meets as the Dispute Settlement Body and the Trade Policy Review Body to oversee procedures for settling disputes between members and to analyse members' trade policies.

### **Third Level: Councils for Each Broad Area of Trade, and More**

Three more councils, each handling a different broad area of trade, report to the General Council:

- The Council for Trade in Goods (**Goods Council**)
- The Council for Trade in Services (**Services Council**)
- The Council for Trade-Related Aspects of Intellectual Property Rights (**TRIPS Council**)

As their names indicate, the three are responsible for the workings of the WTO agreements dealing with their respective areas of trade. Again they consist of all WTO members. The three also have subsidiary bodies (see below).

Six other bodies report to the General Council. The scope of their coverage is smaller, so they are “committees”. But they still consist of all WTO members. They cover issues such as trade and development, the environment, regional trading arrangements, and administrative issues. The Singapore Ministerial Conference in December 1996 decided to create new working groups to look at investment and competition policy, transparency in government procurement, and trade facilitation.

Two more subsidiary bodies dealing with the plurilateral agreements (which are not signed by all WTO members) keep the General Council informed of their activities regularly.

### **Fourth level: down to the nitty-gritty**

Each of the higher level councils has subsidiary bodies. The **Goods Council** has 11 committees dealing with specific subjects (such as agriculture, market access, subsidies, anti-dumping measures and so on). Again, these consist of all member countries. Also reporting

to the Goods Council is the Textiles Monitoring Body, which consists of a chairman and 10 members acting in their personal capacities, and groups dealing with notifications (governments informing the WTO about current and new policies or measures) and state trading enterprises.

The **Services Council's** subsidiary bodies deal with financial services, domestic regulations, GATS rules and specific commitments.

At the General Council level, the **Dispute Settlement Body** also has two subsidiaries: the dispute settlement "panels" of experts appointed to adjudicate on unresolved disputes, and the Appellate Body that deals with appeals.

### **'HODs' and Other Bodies': the Need for Informality**

Important breakthroughs are rarely made in formal meetings of these bodies, least of all in the higher level councils. Since decisions are made by consensus, without voting, informal consultations within the WTO play a vital role in bringing a vastly diverse membership round to an agreement.

One step away from the formal meetings is informal meetings that still include the full membership, such as those of the Heads of Delegations (HOD). More difficult issues have to be thrashed out in smaller groups. A common recent practice is for the chairperson of a negotiating group to attempt to forge a compromise by holding consultations with delegations individually, in twos or threes, or in groups of 20-30 of the most interested delegations.

These smaller meetings have to be handled sensitively. The key is to ensure that everyone is kept informed about what is going on (the process must be "transparent") even if they are not in a particular consultation or meeting, and that they have an opportunity to participate or provide input (it must be "inclusive").

One term has become controversial, but more among some outside observers than among delegations. The "Green Room" is a phrase taken from the informal name of the director-general's conference room. It is used to refer to meetings of 20-40 delegations, usually at the level of heads of delegations. These meetings can take place elsewhere, such as at Ministerial Conferences, and can be called by the minister chairing the conference as well as the director-general. Similar smaller group consultations can be organized by the chairs of committees negotiating individual subjects, although the term Green Room is not usually used for these.

In the past delegations have sometimes felt that Green Room meetings could lead to compromises being struck behind their backs. So, extra efforts are made to ensure that the process is handled correctly, with regular reports back to the full membership.

The way countries now negotiate has helped somewhat. In order to increase their bargaining power, countries have formed coalitions. In some subjects such as agriculture virtually all countries are members of at least one coalition — and in many cases, several coalitions. This means that all countries can be represented in the process if the coordinators and other key players are present. The coordinators also take responsibility for both “transparency” and “inclusiveness” by keeping their coalitions informed and by taking the positions negotiated within their alliances.

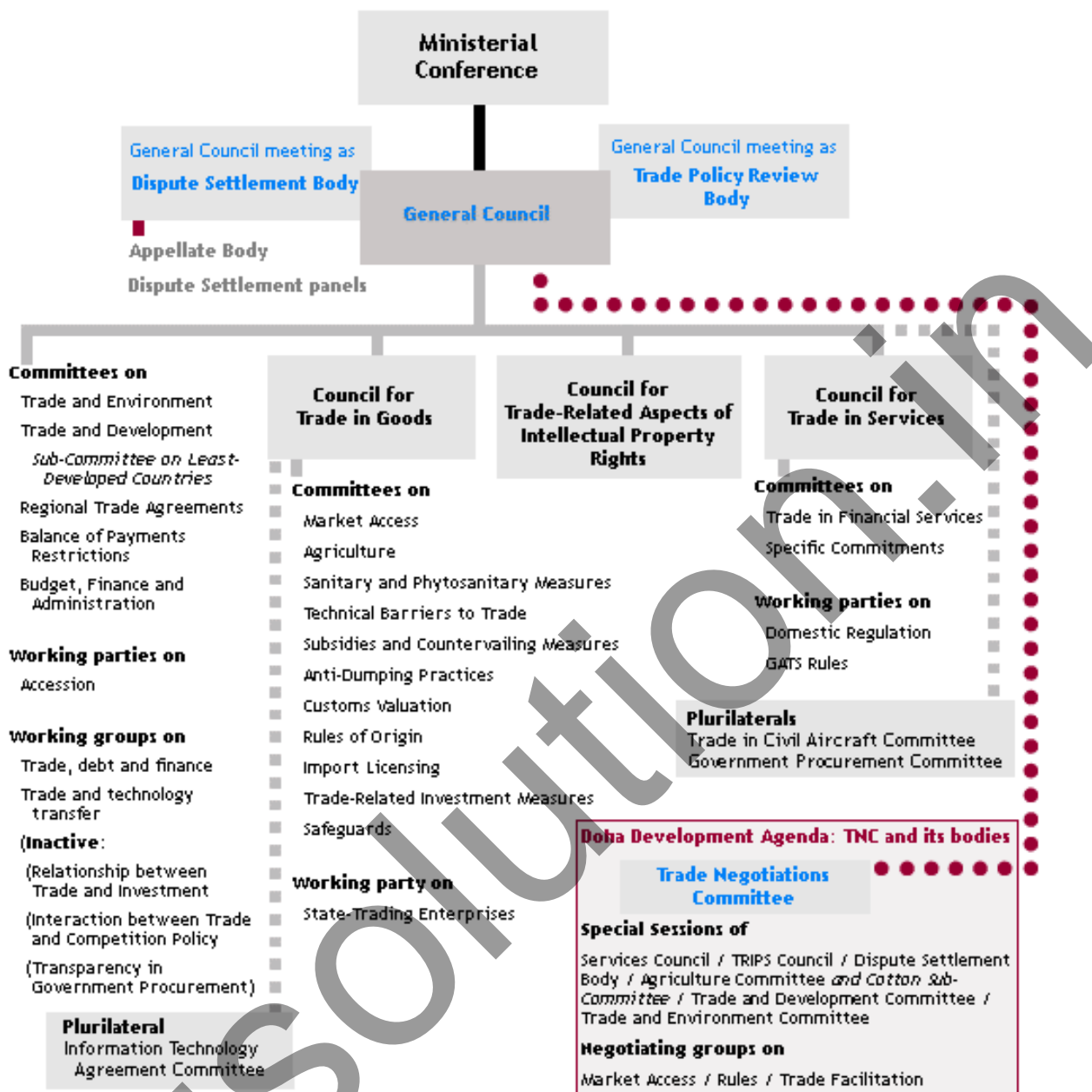
In the end, decisions have to be taken by all members and by consensus. The membership as a whole would resist attempts to impose the will of a small group. No one has been able to find an alternative way of achieving consensus on difficult issues, because it is virtually impossible for members to change their positions voluntarily in meetings of the full membership.

Market access negotiations also involve small groups, but for a completely different reason. The final outcome is a multilateral package of individual countries’ commitments, but those commitments are the result of numerous bilateral, informal bargaining sessions, which depend on individual countries’ interests. (Examples include the traditional tariff negotiations, and market access talks in services.)

So, informal consultations in various forms play a vital role in allowing consensus to be reached, but they do not appear in organization charts, precisely because they are informal.

They are not separate from the formal meetings, however. They are necessary for making formal decisions in the councils and committees. Nor are the formal meetings unimportant. They are the forums for exchanging views, putting countries’ positions on the record, and ultimately for confirming decisions. The art of achieving agreement among all WTO members is to strike an appropriate balance, so that a breakthrough achieved among only a few countries can be acceptable to the rest of the membership.

WTO structure: all WTO members may participate in all councils, committees, etc, except Appellate Body, Dispute Settlement panels, and plurilateral committees



### Self Assessment Questions

1. Outline in detail the outstanding issues in the International Monetary and Financial System
2. Explain the Governance and Regulation of Financial Flows
3. Discuss the Reform of the IMF.

## CASE STUDY

You are the CFO of a large Indian pharmaceutical company. Over the last five years your company has grown primarily through overseas acquisitions. You started acquiring companies in Europe and North America in 2000.

Your balance sheet on March 2005 has assets equivalent of US \$200 million, including those of your subsidiaries.

In the last board meeting, a presentation made by your major European subsidiary painted a worrisome picture. This bulk drug manufacturing facility sources its raw materials from a small South African country, which is facing political unrest. This means that the reliability of this source of raw materials, in the days to come, is poor. Your subsidiary is keen to source this material from a small Taiwanese firm. This Taiwanese firm is willing to supply the raw material but wants payments in US dollars for the January to June 2006 period: in euros for the July to December 2006 period through its Cayman Island bank account.

If this supply contact clicks, it could mean at least two things; one getting a reliable supplier, and two, opening a link in the Far East Market.

You are preparing to present a case for this supply contract to the top management. You search the web to get some data on USD/INR and EUR/INR behaviour.

Download data for these two time series, calculate expected value and variance/standard deviation. Issues like planning horizon, overall variability, and other assumptions should be discussed.

### Question

1. What are the issues that you will take into account and what is the likely responses from the board members?

## CASE STUDY

The export of auto components from India increased from US \$ 330 million in 1997 – 1998 to US \$ 1.4 billion in 2004-2005. The global expansion initiatives of India auto component manufactures into foreign markets were the prime reason for this growth.



Bharat Forge Ltd. Sundram Fastnerers, Tata Auto Comp Systems Ltd. and Antex Auto Ltd. were some of the prominent Indian Auto Component manufactures trying to expand their operations Globally.

The major customers of these companies were automobile majors like the general motors, BMW, Skoda, Volkswagen, Daimler Chrysler, Volvo, Toyota, Etc. Exporting entering into joint ventures, setting up wholly owned manufacturing units (or) acquiring manufacturing units abroad were the preferred modes of entry into foreign markets.

Discuss the possible challenges that Indian auto manufacturers are likely to face in foreign markets, especially from political, legal and competitive forces.

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## UNIT - II

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### Lesson 2.1 - Balance of Payments

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#### Learning Objectives

After reading this lesson you should be able to:-

- Understand the meaning Balance of Payment.
- Explain meaning and importance of Current account, capital account and its significance.
- Understand Balance of Payment of the world.
- Compare balance of payment in the world and balance of payment account in India.

#### Balance of Payments

Balance of payments (BoP) accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, financial capital, and financial transfers. The BoP accounts summarize international transactions for a specific period, usually a year, and are prepared in a single currency, typically the domestic currency for the country concerned. Sources of funds for a nation, such as exports or the receipts of loans and investments, are recorded as positive or surplus items. Uses of funds, such as for imports or to invest in foreign countries, are recorded as negative or deficit items.

When all components of the BOP accounts are included they must sum to zero with no overall surplus or deficit. For example, if a country is importing more than it exports, its trade balance will be in deficit, but the shortfall will have to be counterbalanced in other ways – such as by funds earned from its foreign investments, by running down central bank reserves or by receiving loans from other countries.

While the overall BOP accounts will always balance when all types of payments are included, imbalances are possible on individual elements of the BOP, such as the current account, the capital account excluding the central bank's reserve account, or the sum of the

two. Imbalances in the latter sum can result in surplus countries accumulating wealth, while deficit nations become increasingly indebted. The term “balance of payments” often refers to this sum: a country’s balance of payments is said to be in surplus (equivalently, the balance of payments is positive) by a certain amount if sources of funds (such as export goods sold and bonds sold) exceed uses of funds (such as paying for imported goods and paying for foreign bonds purchased) by that amount. There is said to be a balance of payments deficit (the balance of payments is said to be negative) if the former are less than the latter.

Under a fixed exchange rate system, the central bank accommodates those flows by buying up any net inflow of funds into the country or by providing foreign currency funds to the foreign exchange market to match any international outflow of funds, thus preventing the funds flows from affecting the exchange rate between the country’s currency and other currencies. Then the net change per year in the central bank’s foreign exchange reserves is sometimes called the balance of payments surplus or deficit. Alternatives to a fixed exchange rate system include a managed float where some changes of exchange rates are allowed, or at the other extreme a purely floating exchange rate (also known as a purely *flexible* exchange rate). With a pure float the central bank does not intervene at all to protect or devalue its currency, allowing the rate to be set by the market, and the central bank’s foreign exchange reserves do not change.

Historically there have been different approaches to the question of how or even whether to eliminate current account or trade imbalances. With record trade imbalances held up as one of the contributing factors to the financial crisis of 2007–2010, plans to address global imbalances have been high on the agenda of policy makers since 2009.

## **The Balance of Payments Divided**

The BOP is divided into three main categories: the current account, the capital account and the financial account. Within these three categories there are sub-divisions, each of which accounts for a different type of international monetary transaction.

### **1. The Current Account**

The current account is used to mark the inflow and outflow of goods and services into a country. Earnings on investments, both public and private, are also put into the current account. Within the current account are credits and debits on the trade of merchandise, which includes goods such as raw materials and manufactured goods that are bought, sold or given away (possibly in the form of aid). Services refer to receipts from tourism, transportation (like the levy that must be paid in Egypt when a ship passes through the Suez Canal),

engineering, business service fees (from lawyers or management consulting, for example) and royalties from patents and copyrights. When combined, goods and services together make up a country's balance of trade (BOT). The BOT is typically the biggest bulk of a country's balance of payments as it makes up total imports and exports. If a country has a balance of trade deficit, it imports more than it exports, and if it has a balance of trade surplus, it exports more than it imports.

Receipts from income-generating assets such as stocks (in the form of dividends) are also recorded in the current account. The last component of the current account is unilateral transfers. These are credits that are mostly worker's remittances, which are salaries sent back into the home country of a national working abroad, as well as foreign aid that is directly received.

## **2. The Capital Account**

The capital account is where all international capital transfers are recorded. This refers to the acquisition or disposal of non-financial assets (for example, a physical asset such as land) and non-produced assets, which are needed for production but have not been produced, like a mine used for the extraction of diamonds.

The capital account is broken down into the monetary flows branching from debt forgiveness, the transfer of goods, and financial assets by migrants leaving or entering a country, the transfer of ownership on fixed assets (assets such as equipment used in the production process to generate income), the transfer of funds received to the sale or acquisition of fixed assets, gift and inheritance taxes, death levies and, finally, uninsured damage to fixed assets

## **3. The Financial Account**

In the financial account, international monetary flows related to investment in business, real estate, bonds and stocks are documented. Also included are government-owned assets such as foreign reserves, gold, special drawing rights (SDRs) held with the International Monetary Fund (IMF), private assets held abroad and direct foreign investment. Assets owned by foreigners, private and official, are also recorded in the financial account.

## **The Balancing Act**

The current account should be balanced against the combined-capital and financial accounts; however, as mentioned above, this rarely happens. We should also note that, with

fluctuating exchange rates, the change in the value of money can add to BOP discrepancies. When there is a deficit in the current account, which is a balance of trade deficit, the difference can be borrowed or funded by the capital account. If a country has a fixed asset abroad, this borrowed amount is marked as a capital account outflow. However, the sale of that fixed asset would be considered a current account inflow (earnings from investments). The current account deficit would thus be funded. When a country has a current account deficit that is financed by the capital account, the country is actually foregoing capital assets for more goods and services. If a country is borrowing money to fund its current account deficit, this would appear as an inflow of foreign capital in the BOP.

### **Liberalizing the Accounts**

The rise of global financial transactions and trade in the late-20th century spurred BOP and macroeconomic liberalization in many developing nations. With the advent of the emerging market economic boom - in which capital flows into these markets tripled from USD\$50 million to \$150 million from the late 1980s until the Asian crisis - developing countries were urged to lift restrictions on capital and financial-account transactions in order to take advantage of these capital inflows. Many of these countries had restrictive macroeconomic policies, by which regulations prevented foreign ownership of financial and non-financial assets. The regulations also limited the transfer of funds abroad.

With capital and financial account liberalization, capital markets began to grow, not only allowing a more transparent and sophisticated market for investors, but also giving rise to foreign direct investment (FDI). For example, investments in the form of a new power station would bring a country greater exposure to new technologies and efficiency, eventually increasing the nation's overall GDP by allowing for greater volumes of production. Liberalization can also facilitate less risk by allowing greater diversification in various markets.

### **Balance of payments crisis**

A BOP crisis, also called a *currency crisis*, occurs when a nation is unable to pay for essential imports and/or service its debt repayments. Typically, this is accompanied by a rapid decline in the value of the affected nation's currency. Crises are generally preceded by large capital inflows, which are associated at first with rapid economic growth. However a point is reached where overseas investors become concerned about the level of debt their inbound capital is generating, and decide to pull out their funds. The resulting outbound capital flows are associated with a rapid drop in the value of the affected nation's currency. This causes issues for firms of the affected nation who have received the inbound investments and

loans, as the revenue of those firms is typically mostly derived domestically but their debts are often denominated in a reserve currency. Once the nation's government has exhausted its foreign reserves trying to support the value of the domestic currency, its policy options are very limited. It can raise its interest rates to try to prevent further declines in the value of its currency, but while this can help those with debts denominated in foreign currencies, it generally further depresses the local economy

### Balancing Mechanisms

One of the three fundamental functions of an international monetary system is to provide mechanisms to correct imbalances. Broadly speaking, there are three possible methods to correct BOP imbalances, though in practice a mixture including some degree of at least the first two methods tends to be used. These methods are adjustments of exchange rates; adjustment of a nation's internal prices along with its levels of demand; and rules based adjustment. Improving productivity and hence competitiveness can also help, as can increasing the desirability of exports through other means, though it is generally assumed a nation is always trying to develop and sell its products to the best of its abilities.

### Balance Payments Accounts in India

The Reserve Bank of India (RBI) is responsible for compiling the balance of payments for India. The RBI obtains data on the balance of payments primarily as a by-product of the administration of the exchange control. In accordance with the Foreign Exchange Management Act (FEMA) of 1999, all foreign exchange transactions must be channeled through the banking system, and the banks that undertake foreign exchange transactions must submit various periodical returns and supporting documents prescribed under the FEMA. In respect of the transactions that are not routed through banking channels, information is obtained directly from the relevant government agencies, other concerned agencies, and other departments within the RBI. The information is also supplemented by data collected through various surveys conducted by the RBI. Data are prepared on a quarterly basis and are published in the Reserve Bank of India Bulletin.

Balance of Payment Summary								
SL.No	Item	2007-08	2008-09	2009-10	2010-11	2011-12	2011-12 (Apr- Sept 2011)	2012-13 (Apr- Sept. 2012)
1	<b>Current Account</b>							
2	Exports	166,162	189,001	182,442	256,159	309,774	158,202	146,549

3	Imports	257,629	308,520	300,644	383,481	499,533	247,739	237,221
4	Trade Balance	-91,467	-119,519	-118,203	-127,322	-189,759	-89,537	-90,672
5	Invisibles (net)	75,731	91,604	80,022	79,269	111,604	53,103	51,699
	A. Non factor Service.	38,853	53,916	36,016	44,081	64,098	30,409	29,572
	B. Income	-5,068	-7,110	-8,038	-17,952	-15,988	-7,587	-10,510
	C. Transfers	41,945	44,798	52,045	53,140	63,494	30,281	32,637
6	Goods and Service Balance	-52,614	-65,603	-82,187	-83,241	-125,661	-59,128	-61,100
7	Current Account Balance	-15,737	-27,914	-38,181	-48,053	-78,155	-36,433	-38,973
8	<b>Capital Account</b>							
9	Capital Account Balance	<b>106,585</b>	<b>7,395</b>	<b>51,634</b>	<b>63,740</b>	<b>67,755</b>	<b>43,490</b>	<b>39,989</b>
10	External Assistance(net)	2,114	2,439	2,890	4,941	2,296	640	15
11	External commercial Borrowings(net)	22,609	7,861	2,000	12,160	10,344	8,388	1,726
12	Short-term debt	15,930	-1,985	7,558	12,034	6,668	5,940	9,511
13	Banking Capital Of which:	11,759	-3,245	2,083	4,962	16,226	19,714	14,899
14	Non resident deposit(net)	179	4,290	2,922	3,238	11918	3937	9397
15	Foreign Investment(net) Of which:	43,326	8342	50362	42127	39231	17087	18608
16	A. FDI	15,893	22372	17966	11834	22061	15741	12812
17	B. Portfolio	27,433	-14030	32396	30293	17170	1346	5796
18	Other Flows(net)	10,847	-6,016	-13259	-12,484	-7,008	-8,278	-4,769
19	<b>Errors and Omissions</b>	1,316	440	-12	-2,636	-2,432	-1,338	-653
20	<b>Overall Balance</b>	92,164	-20,080	13,441	13,050	-12,831	5,719	363

21	Reserve Change [increase(-)/ decrease(+)]	-92,164	20,080	-13,441	-13,050	12,831	-5,719	-363
<i>Source: Economic Survey 2012-13. PR: Partially Revised. P: Preliminary.</i>								

### Current Account Goods

The RBI compiles data on merchandise transactions mainly as a by-product of the administration of exchange control. Data on exports are based on export transactions and the collection of export proceeds as reported by the banks. In the case of imports, exchange control records cover only those imports for which payments have been effected through banking channels in India. Information on payments for imports not passing through the banking channels is obtained from other sources, primarily government records and borrowing entities in respect of their external commercial borrowing. Since 1992-93, the value of gold and silver brought to India by returning travelers has been added to the imports data with a contra-entry under current transfers, other sectors. Exports are recorded on an f.o.b. basis, whereas imports are recorded c.i.f. The IMF adjusts imports, for publication, to an f.o.b. basis by assuming freight and insurance to be 10 percent of the c.i.f. value.

### Services

Under the exchange control rules, authorized dealers (i.e., banks authorized to deal in foreign exchange) are required to report details in respect of transactions, other than exports, when the individual remittances exceed a stipulated amount. For receipts below this amount, the banks report only aggregate amounts without indicating the purpose of the incoming remittance. The balance of payments classification of these receipts is made on the basis of the Survey of Unclassified Receipts conducted by the RBI. This sample survey is conducted on a biweekly basis.

### Transportation

This category covers all modes of transport and port services; the data are based mainly on the receipts and payments reported by the banks in respect of transportation items. In addition to the exchange control records, the survey of unclassified receipts is also used as a source. These sources are supplemented by information collected from major airline and shipping companies in respect of payments from foreign accounts. A benchmark Survey of Freight and Insurance on Exports is also used to estimate freight receipts on account of exports.



## **Travel**

Travel data are obtained from exchange control records, supplemented by information from the surveys of unclassified receipts. The estimates of travel receipts also use the information on foreign tourist arrivals and expenditure, received from the Ministry of Tourism as a cross-check of the exchange control and survey data.

## **Other Services**

The insurance category covers all types of insurance (i.e., life, nonlife, and reinsurance transactions). Thus, the entries include all receipts and payments reported by the banks in respect of insurance transactions. In addition to information available from exchange control records, information in the survey of unclassified receipts is also used. The benchmark survey of freight and insurance is used to estimate insurance receipts on account of exports. Other services also cover a variety of service transactions on account of software development, technical know-how, communication services, management fees, professional services, royalties, and financial services. Since 1997-98, the value of software exports for onsite development, expenditure on employees, and office maintenance expenses has been included in other services.

Transactions in other services are captured through exchange control records and the survey of unclassified receipts, supplemented by data from other sources. For example, information on issue expenses in connection with the issue of global depository receipts and foreign currency convertible bonds abroad is obtained from the details filed by the concerned companies with the Foreign Exchange Department, RBI.

## **Income Investment Income**

Information on investment income transactions is obtained from exchange control records and foreign investment surveys, supplemented by information available from various departments of the RBI. Interest payments on foreign commercial loans are also reported under the RBI Foreign Currency Loan reporting system. The data on reinvested earnings of foreign direct investment companies are based on the annual Survey of Foreign Liabilities and Assets, conducted by the RBI. Details of investment income receipts on account of official reserves are obtained from the RBI's internal records. Interest accrued during the year and credited to nonresident Indian deposits is also included under this category.

## **Current Transfers General Government**

The data are obtained from the Controller of Aid Accounts and Audit, government of India, whereas data on PL-480 grants are obtained from the U.S. Embassy in India.

## **Other Sectors**

Transactions relating to workers' remittances are based on the information furnished by authorized dealers regarding remittances received under this category, supplemented by the data collected in the survey of unclassified receipts regularly conducted by the RBI. Redemption, in India, of nonresident dollar account schemes and withdrawals from nonresident rupee account schemes has been included as current transfers, other sectors since 1996-97.

## **Direct Investment**

Basic data are obtained from the exchange control records, but information on noncash inflows and reinvested earnings is taken from the Survey of Foreign Liabilities and Assets, supplemented by other information on direct investment flows. Up to 1999/2000, direct investment in India and direct investment abroad comprised mainly equity flows.

From 2000/2001 onward, the coverage has been expanded to include, in addition to equity, reinvested earnings, and debt transactions between related entities. The data on equity capital include equity in both unincorporated business (mainly branches of foreign banks in India and branches of Indian banks abroad) and incorporated entities.

Because there is a lag of one year for reinvested earnings, data for the most recent year (2003/2004) are estimated as the average of the previous two years. Because of this change in methodology, data for years before 2000/2001 are not comparable with those for data since then. However, as intercompany debt transactions were previously measured as part of other investment, the change in methodology does not make any impact on India's net errors and omissions.

## **Portfolio Investment**

Basic data are obtained from the exchange control records. These are supplemented with information from the Survey of Foreign Liabilities and Assets. In addition, the details of the issue of global depository receipts and stock market operations by foreign institutional investors are received from the Foreign Exchange Department, RBI.

## Other Investment

Most of the information on transactions in other investment assets and liabilities is obtained from the exchange control records, supplemented by information received from the departments of the RBI and various government agencies. Entries for transactions in external assets and liabilities of commercial banks are obtained from their periodic returns on foreign currency assets and rupee liabilities. Data on nonresident deposits with resident banks are obtained from exchange control records, the survey of unclassified receipts, and information submitted by the relevant banks to the RBI.

## Reserve Assets

Transactions under reserve assets are obtained from the records of the RBI. They comprise changes in its foreign currency assets and gold, net of estimated valuation changes arising from exchange rate movement and revaluations owing to changes in international prices of bonds/securities/gold. They also comprise changes in SDR balances held by the government and a reserve tranche position at the IMF, also net of revaluations owing to exchange rate movement.

## Self Assessment Questions

1. What is BOP? Briefly discuss the components of BOPs?
2. What is current account? Discuss in detail the components of current account?
3. What is capital account? What are its components? Discuss.
4. List out the ways used by India in managing current account deficit?

## CASE STUDY

Assume that ABC company has not receivables of 1,00,000 Swiss francs in 90 days. The spot rate of the Swiss franc is \$50 and the Swiss interest rate is 3% over 90 days. Explain briefly how a US firm can implement a money market hedge?

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## UNIT - III

### Unit Structure

Lesson 3.1 International Financial market

Lesson 3.2 Multilateral and Bi-lateral

Lesson 3.3 Global Financial Instruments

### Learning Objectives

*After reading this chapter you will be able to.*

- Understand meaning and significance of International financial markets.
- Describe sources of International Funds.
- Understand Multilateral Development Banks.
- Appreciate International banks.
- Elucidate and explain security Market instrument of international financial markets.
- Focus and discuss International equities, GDRs, ADRs, International Money Market and Bond Market Instruments, Eurobonds, Repos, Euro CPs, MTN, FRN, Loan Syndicates and Euro Deposits.
- Evaluate the Euro Issues in India.

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## Lesson 3.1 - International Financial Market

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### Learning Objectives

*After reading this chapter you will be able to.*

- Understand meaning and significance of International financial markets.
- To describe Foreign exchange market
- To understand Eurocurrency market
- Elaborate Euro credit market
- To analyze Eurobond market

### Introduction

The International Financial Market are financial markets where individuals buy and sell foreign assets such as stock, Bonds, currencies. Its also a place where institutions lay down rules.

To describe the background and corporate use of the following international financial markets:

1. Foreign exchange market,
2. Eurocurrency market,
3. Euro credit market,
4. Eurobond market, and
5. International stock markets.

### Foreign Exchange Market (Forex, Fx, or Currency Market)

**Foreign Exchange Market** is a global decentralized market for the trading of currencies. The main participants in this market are the larger international banks. Financial centers around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekends. EBS and Reuters' dealing 3000 are two main interbank FX trading

The foreign exchange market works through financial institutions, and it operates on several levels. Behind the scenes banks turn to a smaller number of financial firms known as “dealers,” who are actively involved in large quantities of foreign exchange trading. Most foreign exchange dealers are banks, so this behind-the-scenes market is sometimes called the “interbank market”, although a few insurance companies and other kinds of financial firms are involved.

Trades between foreign exchange dealers can be very large, involving hundreds of millions of dollars. Because of the sovereignty issue when involving two currencies, Forex has little (if any) supervisory entity regulating its actions.

The foreign exchange market assists international trade and investment by enabling currency conversion. For example, it permits a business in the United States to import goods from the European Union member states, especially Eurozone members, and pay euros, even though its income is in United States dollars. It also supports direct speculation in the value of currencies, and the carry trade, speculation based on the interest rate differential between two currencies.<sup>[2]</sup>

In a typical foreign exchange transaction, a party purchases some quantity of one currency by paying some quantity of another currency. The modern foreign exchange market began forming during the 1970s after three decades of government restrictions on foreign exchange transactions (the Bretton Woods system of monetary management established the rules for commercial and financial relations among the world’s major industrial states after World War II), when countries gradually switched to floating exchange rates from the previous exchange rate regime, which remained fixed as per the Bretton Woods system.

The foreign exchange market is unique because of the following characteristics:

- Its huge trading volume representing the largest asset class in the world leading to high liquidity;
- Its geographical dispersion;
- Its continuous operation: 24 hours a day except weekends, i.e., trading from 20:15 GMT on Sunday until 22:00 GMT Friday;
- The variety of factors that affect exchange rates;
- The low margins of relative profit compared with other markets of fixed income; and
- The use of leverage to enhance profit and loss margins and with respect to account size.

As such, it has been referred to as the market closest to the ideal of perfect competition, notwithstanding currency intervention by central banks.

According to the Bank for International Settlements,<sup>[3]</sup> the preliminary global results from the 2013 Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets Activity show that trading in foreign exchange markets averaged \$5.3 trillion per day in April 2013. This is up from \$4.0 trillion in April 2010 and \$3.3 trillion in April 2007. FX swaps were the most actively traded instruments in April 2013, at \$2.2 trillion per day, followed by spot trading at \$2.0 trillion.

According to the Bank for International Settlements, as of April 2010, average daily turnover in global foreign exchange markets is estimated at \$3.98 trillion, a growth of approximately 20% over the \$3.21 trillion daily volume as of April 2007. Some firms specializing on foreign exchange market had put the average daily turnover in excess of US\$4 trillion

### **Market Size and Liquidity**

The foreign exchange market is the most liquid financial market in the world. Traders include large banks, central banks, institutional investors, currency speculators, corporations, governments, other financial institutions, and retail investors. The average daily turnover in the global foreign exchange and related markets is continuously growing. According to the 2010 Triennial Central Bank Survey, coordinated by the Bank for International Settlements, average daily turnover was US\$3.98 trillion in April 2010 (vs \$1.7 trillion in 1998). Of this \$3.98 trillion, \$1.5 trillion was spot transactions and \$2.5 trillion was traded in outright forwards, swaps and other derivatives.

In April 2010, trading in the United Kingdom accounted for 36.7% of the total, making it by far the most important centre for foreign exchange trading. Trading in the United States accounted for 17.9% and Japan accounted for 6.2%.

In April 2013, for the first time, Singapore surpassed Japan in average daily foreign-exchange trading volume with \$383 billion per day. So the rank became: the United Kingdom (41%), the United States (19%), Singapore (5.7)%, Japan (5.6%) and Hong Kong (4.1%)

Turnover of exchange-traded foreign exchange futures and options have grown rapidly in recent years, reaching \$166 billion in April 2010 (double the turnover recorded in April 2007). Exchange-traded currency derivatives represent 4% of OTC foreign exchange turnover. Foreign exchange futures contracts were introduced in 1972 at the Chicago Mercantile Exchange and are actively traded relative to most other futures contracts.

Most developed countries permit the trading of derivative products (like futures and options on futures) on their exchanges. All these developed countries already have fully convertible capital accounts. Some governments of emerging economies do not allow foreign exchange derivative products on their exchanges because they have capital controls. The use of derivatives is growing in many emerging economies. Countries such as Korea, South Africa, and India have established currency futures exchanges, despite having some capital controls.

Foreign exchange trading increased by 20% between April 2007 and April 2010 and has more than doubled since 2004. The increase in turnover is due to a number of factors: the growing importance of foreign exchange as an asset class, the increased trading activity of high-frequency traders, and the emergence of retail investors as an important market segment. The growth of electronic execution and the diverse selection of execution venues has lowered transaction costs, increased market liquidity, and attracted greater participation from many customer types. In particular, electronic trading via online portals has made it easier for retail traders to trade in the foreign exchange market. By 2010, retail trading is estimated to account for up to 10% of spot turnover, or \$150 billion per day (see retail foreign exchange platform).

Foreign exchange is an over-the-counter market where brokers/dealers negotiate directly with one another, so there is no central exchange or clearing house. The biggest geographic trading center is the United Kingdom, primarily London, which according to The City UK estimates has increased its share of global turnover in traditional transactions from 34.6% in April 2007 to 36.7% in April 2010. Due to London's dominance in the market, a particular currency's quoted price is usually the London market price. For instance, when the International Monetary Fund calculates the value of its special drawing rights every day, they use the London market prices at noon that day.

### **Market Participants**

Unlike a stock market, the foreign exchange market is divided into levels of access. At the top is the interbank market, which is made up of the largest commercial banks and securities dealers. Within the interbank market, spreads, which are the difference between the bid and ask prices, are razor sharp and not known to players outside the inner circle. The difference between the bid and ask prices widens (for example from 0 to 1 pip to 1–2 pips for a currencies such as the EUR) as you go down the levels of access. This is due to volume. If a trader can guarantee large numbers of transactions for large amounts, they can demand a smaller difference between the bid and ask price, which is referred to as a better spread. The levels of access that make up the foreign exchange market are determined



by the size of the “line” (the amount of money with which they are trading). The top-tier interbank market accounts for 39% of all transactions.<sup>[60]</sup> From there, smaller banks, followed by large multi-national corporations (which need to hedge risk and pay employees in different countries), large hedge funds, and even some of the retail market makers.

According to Galati and Melvin, “Pension funds, insurance companies, mutual funds, and other institutional investors have played an increasingly important role in financial markets in general, and in FX markets in particular, since the early 2000s.” (2004) In addition, he notes, “Hedge funds have grown markedly over the 2001–2004 period in terms of both number and overall size” Central banks also participate in the foreign exchange market to align currencies to their economic needs.

### **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.

### **Central Banks**

National central banks play an important role in the foreign exchange markets. They try to control the money supply, inflation, and/or interest rates and often have official or unofficial target rates for their currencies. They can use their often substantial foreign exchange reserves to stabilize the market. Nevertheless, the effectiveness of central bank “stabilizing speculation” is doubtful because central banks do not go bankrupt if they make large losses, like other traders would, and there is no convincing evidence that they do make a profit trading.

### **Foreign Exchange Fixing**

Foreign exchange 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 market. Banks, dealers and traders use fixing rates as a trend indicator.

The mere expectation or rumor of a central bank foreign exchange intervention might be enough to stabilize a currency, but aggressive intervention might be used several times each year in countries with a dirty float currency regime. Central banks do not always achieve their objectives. The combined resources of the market can easily overwhelm any central bank. Several scenarios of this nature were seen in the 1992–93 European Exchange Rate Mechanism collapse, and in more recent times in Asia.

### **Hedge Funds as Speculators**

About 70% to 90% of the foreign exchange transactions are speculative. In other words, the person or institution that bought or sold the currency has no plan to actually take delivery of the currency in the end; rather, they were solely speculating on the movement of that particular currency. Hedge funds have gained a reputation for aggressive currency speculation since 1996. They control billions of dollars of equity and may borrow billions more, and thus may overwhelm intervention by central banks to support almost any currency, if the economic fundamentals are in the hedge funds' favor.

### **Investment Management Firms**

Investment management firms (who typically manage large accounts on behalf of customers such as pension funds and endowments) use the foreign exchange market to facilitate transactions in foreign securities. For example, an investment manager bearing an international equity portfolio needs to purchase and sell several pairs of foreign currencies to pay for foreign securities purchases.

Some investment management firms also have more speculative specialist currency overlay operations, which manage clients' currency exposures with the aim of generating profits as well as limiting risk. While the number of this type of specialist firms is quite small, many have a large value of assets under management and, hence, can generate large trades.

### **Retail Foreign Exchange Traders**

Individual Retail speculative traders constitute a growing segment of this market with the advent of retail foreign exchange platforms, both in size and importance. Currently, they participate indirectly through brokers or banks. Retail brokers, while largely controlled and regulated in the USA by the Commodity Futures Trading Commission and National Futures Association have in the past been subjected to periodic Foreign exchange fraud. To deal with the issue, in 2010 the NFA required its members that deal in the Forex markets

to register as such (I.e., Forex CTA instead of a CTA). Those NFA members that would traditionally be subject to minimum net capital requirements, FCMs and IBs, are subject to greater minimum net capital requirements if they deal in Forex.

A number of the foreign exchange brokers operate from the UK under Financial Services Authority regulations where foreign exchange trading using margin is part of the wider over-the-counter derivatives trading industry that includes Contract for differences and financial spread betting.

There are two main types of retail FX brokers offering the opportunity for speculative currency trading: *brokers* and *dealers* or *market makers*. *Brokers* serve as an agent of the customer in the broader FX market, by seeking the best price in the market for a retail order and dealing on behalf of the retail customer. They charge a commission or mark-up in addition to the price obtained in the market. *Dealers* or *market makers*, by contrast, typically act as principal in the transaction versus the retail customer, and quote a price they are willing to deal at.

### **Non-Bank Foreign Exchange Companies**

Non-bank foreign exchange companies offer currency exchange and international payments to private individuals and companies. These are also known as foreign exchange brokers but are distinct in that they do not offer speculative trading but rather currency exchange with payments (i.e., there is usually a physical delivery of currency to a bank account).

It is estimated that in the UK, 14% of currency transfers/payments are made via Foreign Exchange Companies. These companies' selling point is usually that they will offer better exchange rates or cheaper payments than the customer's bank. These companies differ from Money Transfer/Remittance Companies in that they generally offer higher-value services.

### **Money Transfer/Remittance Companies and Bureaux De Change**

Money transfer companies/remittance companies perform high-volume low-value transfers generally by economic migrants back to their home country. In 2007, the Aite Group estimated that there were \$369 billion of remittances (an increase of 8% on the previous year). The four largest markets (India, China, Mexico and the Philippines) receive \$95 billion. The largest and best known provider is Western Union with 345,000 agents globally followed by UAE Exchange

Bureaux de change or currency transfer companies provide low value foreign exchange services for travelers. These are typically located at airports and stations or at tourist locations and allow physical notes to be exchanged from one currency to another. They access the foreign exchange markets via banks or non bank foreign exchange companies.

### **Determinants of Exchange Rates**

The following theories explain the fluctuations in exchange rates in a floating exchange rate regime (In a fixed exchange rate regime, rates are decided by its government):

1. International parity conditions: Relative Purchasing Power Parity, interest rate parity, Domestic Fisher effect, International Fisher effect. Though to some extent the above theories provide logical explanation for the fluctuations in exchange rates, yet these theories falter as they are based on challengeable assumptions [e.g., free flow of goods, services and capital] which seldom hold true in the real world.
2. Balance of payments model: This model, however, focuses largely on tradable goods and services, ignoring the increasing role of global capital flows. It failed to provide any explanation for continuous appreciation of dollar during 1980s and most part of 1990s in face of soaring US current account deficit.
3. Asset market model: views currencies as an important asset class for constructing investment portfolios. Assets prices are influenced mostly by people's willingness to hold the existing quantities of assets, which in turn depends on their expectations on the future worth of these assets. The asset market model of exchange rate determination states that "the exchange rate between two currencies represents the price that just balances the relative supplies of, and demand for, assets denominated in those currencies."

None of the models developed so far succeed to explain exchange rates and volatility in the longer time frames. For shorter time frames (less than a few days) algorithms can be devised to predict prices. It is understood from the above models that many macroeconomic factors affect the exchange rates and in the end currency prices are a result of dual forces of demand and supply.

The world's currency markets can be viewed as a huge melting pot: in a large and ever-changing mix of current events, supply and demand factors are constantly shifting, and the price of one currency in relation to another shifts accordingly. No other market encompasses (and distills) as much of what is going on in the world at any given time as foreign exchange.

Supply and demand for any given currency, and thus its value, are not influenced by any single element, but rather by several. These elements generally fall into three categories: economic factors, political conditions and market psychology.

## **Eurocurrency Market**

Up until the 1950's, most international trade was conducted in £'s (instead of the currencies of whatever countries were trading). English banks facilitated international trade taking deposits and making loans so that importers/exporters in other countries could simply sign over deposits in order to pay for goods. Also, financing purchases was simple in that firms could simply take out loans in £'s from these English banks.

In 1956, the Suez Canal crisis put downward pressure on the £. Attempting to alleviate the pressure, the Bank of England prohibited loans of £'s to foreign borrowers (the logic being that if the foreign investors did not have pounds, they could not put pressure on the pound by selling them). The banks did not like this because it took away a very profitable piece of their business.

English banks decided to take deposits and make loans in \$US so that they could continue to finance international trade, except with \$US instead of £'s. This was the start of the

### **Definition**

The Eurocurrency market is the market for deposits placed under a regulatory regime different than the regulations applied to the deposits used to execute domestic transactions.

The money market for borrowing and lending currencies that are held in the form of deposits in banks located outside the countries in which those currencies are issued as legal tender.

The Eurocurrency market is simply a market for bank time deposits and loans denominated in a currency other than that of the country in which the bank is located. The international money market consists of the Eurocurrency market and its linkages to the major domestic money markets.

Money market that provides banking services to a variety of customers by using foreign currencies located outside of the domestic marketplace. The concept does not have anything to do with the European Union or the banks associated with the member

countries, although the origins of the concept are heavily derived from the region. Instead, it represents any deposit of foreign currencies into a domestic bank. For example, if Japanese yen is deposited into a bank in the United States, it is considered to be operating under the auspices of the Eurocurrency market.

## **Eurocurrency Market**

Eurocurrency is any deposit of a currency in a country other than that of the currency's origin. For example, a deposit of \$US in a bank in France is a deposit of Eurodollars. The entire market for loans and deposits in Eurocurrency is the Eurocurrency Market. The Eurocurrency Market does not have buyers and sellers, it has lenders and borrowers. Note that the prefix "Euro" is historical in nature, referring to the fact that the market was initially centred in Europe. Today, however, a deposit of \$US in a Japanese bank is still referred to as Eurocurrency.

From relatively humble beginnings, the Eurocurrency deposits have developed into a market measured in the trillions of dollars (as of 1989 the total value of eurocurrency deposits globally was over \$5 trillion US). The Eurocurrency market was created to avoid capital controls imposed by governments. It grew in response to further capital controls, especially by the U.S. government (for example the Interest Equalization Tax of 1963 applied to interest earned from \$US loans to foreign firms (since repealed), and Regulation Q (also since repealed) which put a limit on the rate that could be paid by American banks on deposits).

Generally, Euro banks are able to pay higher rates on deposits and charge lower rates on loans than purely domestic banks. They are able to do this because they can often avoid government regulations such as reserve requirements and the need to pay deposit insurance. This lowers the cost of operations for Euro banks and these lower costs can be passed through to the clients. As well, Euro currency loans are generally very large and the customers are well known firms. This means that the banks are not subject to as much default risk and can charge lower margins on the large loans.

Of course, Euro banks have to offer higher rates on Euro currency deposits because of the higher risk to the depositor. Part of the risk comes from the fact that Euro banks do not follow the same regulations as domestic banks (these regulations are usually meant to protect depositors). However, a large part of the extra risk comes from **sovereign risk**. This is the risk that governments impose new regulations that restrict the movement of capital or control foreign currency transactions. This may mean that any Euro currency deposits held in that country become inaccessible for the owner.

While euro banks will offer better rates than purely domestic banks, the difference between Euro currency rates and domestic rates will be limited by arbitrage. It must be that:

Euro-loan rate > Domestic deposit rate

Euro-deposit rate < Domestic loan rate

If one of these did not hold then arbitrageurs could simply borrow in the cheaper market and deposit in the money in the in the market where they would get a higher return.

Generally, the advantage of Euro currency rates over domestic rates runs somewhere between 25 and 100 basis points.

There are several Euro currency centres around the world where Euro banks conduct most of their business. The largest are: London, the Cayman Islands, Bahrain, Singapore and some "International Banking Facilities" that have been set up in the U.S.

Approximately 80% of the Euro currency market involves banks lending to, and depositing with, other banks. This is done on a Bid-Ask basis with the bid being the rate offered on deposits and the ask rate charged on loans.

A main characteristic of Euro currency loans is that they are usually floating rate (this also referred to as **rollover pricing** or as **cost-plus pricing**) and are typically set as a percentage over LIBOR.

### **International Bond Market**

Bonds are an important source of long term capital for firms. A bond is debt. A firm (or government) issues a certificate, called a bond that states that the firm will make **coupon payments** to the holder of the bond and will, at maturity pay the holder the **par value** of the bond. Coupon payments are simply the interest payments on the debt and the par value is the principal. Firms sell these bonds to investors (thereby borrowing money). The key difference between borrowing money by issuing bonds rather than borrowing directly from a bank is that there exists a **secondary market** for bonds. That is, if you buy a bond from a firm (lending that firm money) you can later sell the bond to another investor. The act of firms selling bonds directly to investors is termed the **primary market**, while investors trading bonds among themselves is the secondary market.

There exists a well developed domestic market for bonds (Canadian firms issuing bonds denominated in Canadian dollars and selling them in Canada). However, there also

exists an international bond market. The international bond market is really a set of loosely connected individual markets around the world. There are many different bond markets in many countries, taken together as a whole they constitute the international bond market. The international bond market can be broken down into two parts:

- 1) **Foreign Bonds**
- 2) **Eurobonds**

- 1) **Foreign bonds** are simply bonds issued in a bond market by a foreign company. For example, a Japanese firm issuing a U.S. dollar denominated bond in the U.S. is issuing a foreign bond.

Because foreign bonds are simply a part of the domestic bond market, the only real difference is their treatment under the law. In many countries, foreign bonds are subject to different tax treatment, registration requirements et cetera.

The most important foreign bond markets are located in Zurich, New York, Tokyo, Frankfurt, London and Amsterdam.

The reasons that a company may go to another country to issue bonds include the simple fact that there may not be enough demand in the domestic market. Going to a foreign market opens up a whole new set of potential investors to the firm. For instance, a German pharmaceutical firm may wish to borrow DM 500 million. However, its investment bank tells it that there is only demand for DM 250 million of its bonds. In order to float the rest it would have to offer a much higher yield. But, for some reason there is demand in the US for the debt of pharmaceutical firms, and that demand is not being met by US companies. The German firm could then float an issue in Germany (in DM) and also float an issue in the US (in \$US) in order to sell all of the bonds it wants. Of course, the firm may choose to swap its new \$US debt for DM debt at the same time.

Note that issuing a bond in Zurich (for instance) does not mean that the firm is necessarily borrowing from Swiss lenders. Generally, a foreign firm issues a Swiss Franc denominated bond in Zurich and most of the buyers of that bond will also be foreign. Basically, the Sfr is simply a unit of account for the transaction between the buyer and the lender.

A taxonomy has arisen for foreign bonds. Foreign bonds issued in the U.S. are termed **Yankee bonds**, in Japan they are called **Samurai bonds**, in England **Bulldog bonds** and in the Netherlands **Rembrandt bonds**.



- 2) **Eurobonds** are bonds denominated in one currency but issued in a country that is not the home of that currency. For example, a bond denominated in \$Can but issued in London is a Eurobond. Similarly, a Sfr denominated bond issued in Germany is a Eurobond.

Most countries have very few regulations governing the issuance of Eurobonds (since they are not denominated in that country's currency, the government does not care all that much about them). While some countries have tried to control issues of bonds denominated in their currency even if issued in a foreign country, this is very hard to do for obvious reasons. One thing that this means is that interest paid on Eurobonds is usually free of all **withholding taxes**.

A withholding tax is when the government takes a portion of each interest payment before the lender gets it. The borrower (the firm issuing the bond) withholds a part of the interest and gives it to the government. With a withholding tax, the firm issuing the bonds would have to pay a higher rate of interest in order to compensate lenders. In the Euro bond market, therefore, firms can often pay a lower rate by avoiding the tax.

Most Euro bonds are bearer bonds. The owner of the bond is not registered with the firm that initially issued the bond. Actually having physical possession of the bond is evidence of ownership. This makes Euro bonds attractive to investors who wish to remain anonymous (to avoid taxes or for other reasons).

Eurobonds have been popular as a source of funds for firms because they allow borrowers and lenders to avoid taxes and government regulations. The rate of growth in the Euro bond market has slowed over the last 8-10 years because of reductions in these factors in the domestic bond market. Governments realized that securities issues were going offshore to avoid regulations and therefore were forced to reduce the regulatory burden for domestic issues. This is best exemplified by the introduction in the early 1980's of the **Prompt Offering Prospectus** method of issuing securities in Canada which reduced the time needed for established firms to register and issue new securities from weeks (sometimes months) to a few days (the Prompt Offering Prospectus was introduced in response to similar legislation in the U.S. known by the term **shelf registration**).

The Euro bond market is still large and is driven in large part by firm's ability and desire to engage in swaps.

## **Euro Credit Market**

The market where financial banking institutions provide banking services denominated in foreign currencies. They may accept deposits and provide loans. Loans provided in this market are medium-term loans, unlike loans made in the Eurocurrency market.

### **Self Assessment Questions**

1. What is FOREX market? Explain the unique characteristics of FOREX market.
2. Discuss the role of major participants of FOREX market.
3. What is Euro currency market? Explain the strength and weakness of Euro.
4. Write short note about international bond market.

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## Lesson 3.2 - Multilateral and Bilateral Institutions

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### Learning Objectives

*After reading this chapter you will be able to.*

- Understand meaning and significance of International financial markets.
- Describe sources of International Funds.
- Understand Multilateral Development Banks.
- Appreciate International banks.



## Multilateral Development Banks (MDBs)

It is an institution, created by a group of countries, that provides financing and professional advising for the purpose of development. MDBs have large memberships including both developed donor countries and developing borrower countries.

MDBs finance projects in the form of long-term loans at market rates, very-long-term loans (also known as credits) below market rates, and through grants. This lesson describes the role of different MDBs briefly for creating awareness.

The following are usually classified as the main MDBs:

- World Bank
- European Investment Bank (EIB)
- African Development Bank (AfDB)
- Islamic Development Bank (IDB)
- Asian Development Bank (AsDB)
- European Bank for Reconstruction and Development (EBRD)
- Inter-American Development Bank Group

There are also several “sub-regional” multilateral development banks. Their membership typically includes only borrowing nations. The banks lend to their members, borrowing from the international capital markets.

Because there is effectively shared responsibility for repayment, the banks can often borrow more cheaply than could any one member nation.

These banks include:

- Corporación Andina de Fomento (CAF)
- Caribbean Development Bank (CDB)
- Central American Bank for Economic Integration (CABEI)
- East African Development Bank (EADB)
- West African Development Bank (BOAD)
- Black Sea Trade and Development Bank (BSTDB)
- Eurasian Development Bank (EDB)

There are also several multilateral financial institutions (MFIs). MFIs are similar to MDBs but they are sometimes separated since they have more limited memberships and often focus on financing certain types of projects.

- European Commission (EC)
- International Finance Facility for Immunisation (IFFIm)
- International Fund for Agricultural Development (IFAD)
- Nordic Investment Bank (NIB)
- OPEC Fund for International Development (OPEC Fund)
- Nederlandse Financieringsmaatschappij voor Ontwikkelingslanden NV (FMO)

### **International Bank for Reconstruction and Development (Ibrd or the World Bank)**

The International Bank for Reconstruction and Development (the IBRD or the World Bank) came to be established by the international Economic Conference at Bretton Woods in July 1944. The World Bank started functioning from June 1946.

#### **Objectives of the World Bank**

The objectives of the World Bank set forth in the Bretton Woods Agreement are as follows:

- To render assistance in the reconstruction and development of member countries by facilitating investment of capital for productive purposes and help restoration of economies from enormous destruction brought about by the World War II (1939-45) (Reconstruction), and also to provide encouragement to the development of productive resources of less developed countries (hence the word 'Development' in the full title of the World Bank)
- To promote private foreign investment by means such as participation in loans or guarantee for loans made by private investors, as also to supplement private investment by its own (World Bank's) loans or finances.
- To promote long-term balanced growth of international trade and help achieve equilibrium in balance of payments position of member countries by encouraging international investments for the development of productive resources and thereby rendering assistance in raising productivity, and standard of living of people in the member-countries.
- To make arrangements for loans or guarantees in respect of international loans so that large and small useful projects are rendered assistance.

## **Membership and Organisation of the World Bank**

The World Bank (as also the International Monetary Fund - IMF) had 149 members in April 1986.

All powers of the World Bank are vested in and exercised by the Board of Governors. Each member-country sends its one Governor for a period of 5 years. There is also an Alternate Governor. These Governors meet once annually. For the purpose of carrying out day-to-day functions of the World Bank, the Governors have delegated their powers to a Board of Executive Directors who meet once every month. At present there are 22 Executive Directors-six are appointed by five member-countries contributing the largest shares of the World Bank's capital, and 16 Executive Directors are elected by the Governors of the remaining member-countries. These Executive Directors are elected for a period of 2 years.

The President of the World Bank is also the Chairman of the Board of Executive Directors. The voting powers of the Executive Directors are in proportion to the capital subscribed by member-countries. The Executive Directors are responsible for matters of policy and their approval is necessary for all the loans by the World Bank.

The day-to-day administration of the World Bank (including making recommendations regarding granting of loans and recommendations regarding questions of policy to the Executive Directors) is the responsibility of the President of the World Bank.

The President of the World Bank is assisted by a number of Vice-Presidents and Directors of various Departments for different regions. The President of the World Bank carries on his duties with the assistance of about 6,000 staff members who carry on the day-to-day routine working of the World Bank.

### **Member Countries**

The organizations that make up the World Bank Group are owned by the governments of member nations, which have the ultimate decision-making power within the organizations on all matters, including policy, financial or membership issues.

Member countries govern the World Bank Group through the Boards of Governors and the Boards of Executive Directors. These bodies make all major decisions for the organizations.

To become a member of the Bank, under the IBRD Articles of Agreement, a country must first join the International Monetary Fund (IMF). Membership in IDA, IFC and MIGA are conditional on membership in IBRD.

In tandem with the IMF, and in consultation with other World Bank Group staff, the Corporate Secretariat Vice Presidency coordinates the process for new membership and maintains the information relating to the status of membership which includes the membership lists.

### **Board of Governors**

The Boards of Governors consist of one Governor and one Alternate Governor appointed by each member country. The office is usually held by the country's minister of finance, governor of its central bank, or a senior official of similar rank. The Governors and Alternates serve for terms of five years and can be reappointed.

If the country is a member of the Bank and is also a member of the International Finance Corporation (IFC) or the International Development Association (IDA), then the appointed Governor and his or her alternate serve ex-officio as the Governor and Alternate on the IFC and IDA Boards of Governors. They also serve as representatives of their country on the Administrative Council of the International Center for Settlement of Investment Disputes (ICSID) unless otherwise noted. Multilateral Investment Guarantee Agency (MIGA) Governors and Alternates are appointed separately.

### **Role of the Board of Governors**

All powers of the Bank are vested in the Boards of Governors, the Bank's senior decision-making body according to the Articles of Agreement. However, the Boards of Governors has delegated all powers to the Executive Directors except those mentioned in the Articles of Agreement. These powers include:

- Admit and suspend members;
- Increase or decrease the authorized capital stock;
- Determine the distribution of the net income of the Bank;
- Decide appeals from interpretations of the Articles of Agreement by the Executive Directors;
- Make formal comprehensive arrangements to cooperate with other international organizations;

- Suspend permanently the operations of the Bank;
- Increase the number of elected Executive Directors; and
- Approve amendments to the Articles of Agreement.

### **Board of Directors**

The Boards of Directors consist of the World Bank Group President and 25 Executive Directors\*. The President is the presiding officer, and ordinarily has no vote except a deciding vote in case of an equal division. The Executive Directors as individuals cannot exercise any power nor commit or represent the Bank unless specifically authorized by the Boards to do so. With the term beginning November 1, 2010, the number of Executive Directors increased by one, totaling 25.

Alternates to Executive Directors have full power to act in the absence of their respective Executive Directors. Furthermore, Senior Advisors and Advisors assist the Executive Directors in their work, who can, along with the Alternates to Executive Directors, attend most Board meetings in an advisory capacity, without voting rights.

### **Previous Compositions**

The first Boards consisted of 12 Executive Directors, as prescribed in the IBRD Articles of Agreement, Article V Section 4(b). Increases in the number of elected Executive Directors require a decision of the Boards of Governors by an 80% majority of the total voting power. Before November 1, 1992, there were 22 Executive Directors, 17 of whom were elected. In 1992, in view of the large number of new members that had joined the Bank, the number of elected Executive Directors increased to 20. The two new seats, Russia and a new group around Switzerland, brought the total number of Executive Directors to 24. With the term beginning November 1, 2010, the number of Executive Directors increased by one, totaling 25.

### **Voting Powers**

The World Bank and the IMF have adopted a weighted system of voting. According to the IBRD Articles of Agreement, membership in the Bank is open to all members of the IMF. A country applying for membership in the Fund is required to supply data on its economy, which are compared with data from other member countries whose economies are similar in size. A quota is then assigned, equivalent to the country's subscription to the Fund, and this determines its voting power in the Fund.



Each new member country of the Bank is allotted 250 votes plus one additional vote for each share it holds in the Bank's capital stock. The quota assigned by the Fund is used to determine the number of shares allotted to each new member country of the Bank.

Five Executive Directors are appointed by the members with the five largest numbers of shares (currently the United States, Japan, Germany, France and the United Kingdom). China, the Russian Federation, and Saudi Arabia each elect its own Executive Director. The other Executive Directors are elected by the other members. The voting power distribution differs from agency to agency within the World Bank Group.

The Corporate Secretariat is responsible for coordinating the process for members to complete their periodic capital increases in IBRD, IDA, IFC, and MIGA. It provides advice on the procedures for subscribing to additional shares as authorized under resolutions approved by the Boards of Governors, including required documentation and capital subscriptions payments.

### **Ethics Matters**

The Code of Conduct for Board Officials that took effect in November 1, 2007, supersedes the Code of Conduct and Ethics Committee Procedures approved in August 2003.

The Code of Conduct for Board Officials sets forth principles and ethical standards for the Executive Directors, the Presidents of each of the organizations, Executive Director Designates, Executive Director Post-Designates, Alternate Executive Directors, Alternate Executive Director Designates, Alternate Executive Director Post-Designates, Temporary Alternate Executive Directors, Senior Advisors, and Advisors to Executive Directors (collectively, "Board Officials") in connection with, or having a bearing upon, their status and responsibilities in the organizations of the World Bank Group.

The Code of Conduct provides that, as these officials are entrusted with responsibilities as prescribed in the Articles of Agreement, By-Laws, and related documents of the organizations, their personal and professional conduct must comply with the standards and procedures set forth in the Code of Conduct. Pursuant to the Code of Conduct, the Board has established an Ethics Committee to address ethics matters concerning Board Officials in order to ensure sound governance pursuant to the Code of Conduct. The Ethics Committee has the authority to advise Board Officials or the President on matters related to conflict of interests, annual disclosures, or other ethical aspects of conduct in respect of Board Officials or the President, and to investigate alleged misconduct by Board Officials or the President.

\*While the *IFC Articles of Agreement* and the *MIGA Convention* designate Boards of Directors, when referring to the World Bank Group Board members, they are collectively called Executive Directors.

### **Capital Structure of the World Bank**

The World Bank commenced with an authorised capital of US dollars 10 billion, divided into 1,00,000 shares of US dollars 100,000 each. Of this authorised capital, US dollars, 9,400 million were actually subscribed.

As in June 1985, the authorised capital stock of the World Bank comprises of 7,16,500 authorised shares of the par value of SDR 1,00,000 each. Of those 58,154 had been subscribed. Thus, the subscribed capital of the World Bank is SDR 51,315 each. Ten percent of the subscribed capital has been called and paid by member- countries. The remaining 90 per cent of the authorised capital is subject to call when the World Bank requires it to meet demand for loans or for guaranteeing loans to member-countries.

The World Bank's funding strategy or strategy for raising financial resources follow the four basic objectives: (1) To ensure availability of funds to the World Bank (by maintaining unutilised access of funds in markets in which the World Bank borrows); (2) To minimise the effective cost of loans to borrowers (through currency mix of the Bank's borrowings); (3) To have control over volatility in net income and overall loan charges (for which the Bank started in 1982 variable lending rates system that uniformly adjusts interest charges applicable to all outstanding balance on all loans); (4) To provide appropriate degree of maturity transformation between Bank's borrowing and lending.

### **Borrowing and Lending Activities of the World Bank**

The World Bank gives loans primarily from its own medium and long-term borrowings in the international capital markets and Currency Swap Agreements (CSA). Under the CSA, proceeds of a borrowing country are converted into a different currency and at the same time a forward exchange agreement is executed providing for a schedule of future exchanges of the two currencies in order to recover the currency converted. The World Bank can also borrow under the Discount-Note Programme, by placing bonds and notes directly with governments of member-countries, with government agencies and their central banks.

Also, the World Bank offers issues to investors and in public markets through investing banking firms, commercial banks and investment banks.

The total borrowing of the World Bank under its various schemes in the fiscal year 1984 amounted to US dollars 9.8 billion. Also, a substantial amount of the World Bank's resources accrue from the Bank's retained earnings and repayment of loans borrowed earlier from the World Bank.

### **Lending Operations of the World Bank**

Following are the ways in which the World Bank gives loans to its member-countries:-  
(i) By granting loans out of its own funds; (ii) By participating in loans out of funds raised in the market of a member-country or otherwise borrowed by the World Bank; and (iii) By providing guarantee in part or in full for loans made by private investors through the usual investment channels. It is stipulated that the total amount of outstanding loans or guarantees provided by the World Bank should not exceed 100 per cent of the Bank's unimpaired subscribed capital, reserves and surplus.

The World Bank gives loans or its guarantees on the following conditions:

(i) The World Bank is satisfied that in the prevailing market conditions, the borrower is unable to obtain loans under conditions which the Bank considers reasonable; (ii) The loans are for reconstruction or development (except in special circumstances); (iii) If the central bank of the member-country gives full guarantee for repayment of the principal, interest on loan and Other related charges; (iv) The project for which the loan from the World Bank is being sought is recommended by a competent committee after a careful study in its written report; and (v) The borrower is in a position to meet the Bank's obligations. The World Bank gives medium-term loans and long-term loans usually running up to the completion of the project for which the Bank has given the loan. Long-term loans are repayable over a period of 20 years or less, with a grace period of 5 years. It is observed that interest rate charged by the World Bank is calculated in accordance with guidelines related to its (i.e. Bank's) cost of borrowing. And, therefore, the World Bank loans carry different rates of interest. There is in addition an annual commitment charge of 0.75 per cent per year on the outstanding balances. The total World Bank lending during the fiscal year 1985 amounted to US dollars 11.4 billion.

### **The World Bank's Other Activities**

The World Bank's other activities include items such as training, technical assistance, inter-organisational cooperation, economic research and studies, evaluation operations and settlement of investment disputes among member-countries of the World Bank and the IMF.

The World Bank set up Staff College in 1958. It is known as the Economic Development Institute (EDI). The EDI is meant for training senior officials of developing countries. The training is in macro-economic planning, pricing and development policies, management of agricultural research, training in rural health care, industrial policy, and railway management and so on.

The World Bank renders technical assistance which is an integral part of the World Bank's programme of activities. This technical assistance is concerned with feasibility studies, engineering designs, construction supervision, management training, and diagnostic and institutional studies.

The World Bank also serves as executing agency in the case of projects financed by the United Nations Development Programme (UNDP). An important function of the World Bank concerns inter-organisational cooperation based on formal agreements such as cooperative programmes between the FAO, the UNESCO, the WHO, the UNCTAD, the GATT, the United Nations Environmental Programme, the ILO, the Asian Development Bank (the ADB), etc.

The World Bank sets aside roughly 3 per cent of its administrative budget for economic and social research. These research programmes started in 1971. About 165 research programmes have already been completed and about 180 were in progress in 1985. The World Bank also renders assistance to research programmes in developing member-countries.

The World Bank helps borrowers of the Bank in post-evaluation of the Bank-assisted projects through its Operation Evaluation Department.

The World Bank has also set up 'International Centre of Settlement of Investment Disputes' between member-countries. For example, the World Bank successfully solved the problem of river water dispute between India and Pakistan and the Suez Canal dispute between Egypt and the United Kingdom.

### **The World Bank and India**

India is one of the founder-members of the World Bank. In that capacity, India held a permanent seat on its Board of Executive Directors for a number of years. That position was threatened when China applied for membership of the World Bank.

The World Bank has been rendering substantial assistance to India in her efforts at planned economic development. This the World Bank does by granting loans, rendering

expert advice in various spheres, and training Indian personnel at the Economic Development Institute (which was established to train senior officials of member-developing countries).

The World Bank has a Chief Mission at New Delhi and it conducts on behalf of the World Bank monitoring and consultation in respect of Bank-aided projects in India.

It needs to be emphasised that since its establishment, India happens to be the largest recipient of the World Bank financial assistance. The Bank since 1949 was committed to 84 loans to India totalling US dollars.7274.7 million till June 1984. In 1984 India borrowed 1.7 billion US dollars from the World Bank, and 670 million US dollars from the IDA and about 2 billion US dollars from commercial sources.

The World Bank has been rendering assistance to India in respect of projects such as development of ports, oil exploration including Bombay High, gas-power projects, coal, iron, aluminium, railway modernisation, fertiliser plants, technical assistance and industrial development finance.

It was at the instance of the World Bank that the Aid India Consortium of 12 developed countries was established and it has been helping India substantially by granting loans and other assistance. The World Bank helped India to solve the almost intractable problem of the Indus Water dispute with Pakistan.

Thus, India has received substantial Financial and non-financial assistance from the World Bank for the development of industries, energy, transport, agriculture, etc.

## **European Investment Bank**

### **The EU's bank**

The EIB is the European Union's bank. We are the only bank owned by and representing the interests of the European Union Member States. We work closely with other EU institutions to implement EU policy.

### **A major player**

As the largest multilateral borrower and lender by volume, we provide finance and expertise for sound and sustainable investment projects which contribute to furthering EU policy objectives. More than 90% of our activity is focused on Europe but we also implement the financial aspects of the EU's external and development policies.

## Lending, blending and advising

- **Lending:** The vast majority of our financing is through loans, but we also offer guarantees, microfinance, equity investment, etc.
- **Blending:** Our support helps us unlock financing from other sources, particularly from the EU budget. This is blended together to form the full financing package.
- **Advising:** Lack of finance is often only one barrier to investment. We can help with administrative and project management capacity which facilitates investment implementation.

## African Development Bank

### Mission & Objective

The overarching objective of the African Development Bank (AfDB) Group is to spur sustainable economic development and social progress in its regional member countries (RMCs), thus contributing to poverty reduction.

The Bank Group achieves these objectives by:

- Mobilizing and allocating resources for investment in RMCs; and
- Providing policy advice and technical assistance to support development efforts.

In 2000, all multilateral development institutions have agreed on a same set of objectives, called the Millennium Development Goals (MDG). They are:

### Millennium Development Goals

- Eradicate extreme poverty and hunger
- Improve maternal health
- Achieve universal primary education
- Combat HIV/AIDS, malaria and other diseases
- Promote gender equality and empower women
- Ensure environmental sustainability
- Reduce child mortality
- Develop a global partnership for development

## History

Established to help development efforts on the continent, the African Development Bank (AfDB) Group comprises three distinct entities under one management: the African Development Bank (ADB) which is the flagship or parent institution, established on August 4, 1963 in Khartoum, Sudan, by the then 23 newly independent African countries; as well as two concessionary windows - the African Development Fund (ADF), established on November 29, 1972, by the African Development Bank and 13 non-African countries, and the Nigeria Trust Fund (NTF), set up in 1976 by the Federal Government of Nigeria.

The inaugural meeting of the Board of Governors of the Bank was held from November 4-7, 1964, in Lagos, Nigeria, and the headquarters was opened in Abidjan, Côte d'Ivoire, in March 1965. Its operations commenced on July 1, 1966.

Since early 2003, the Group operates from its Temporary Relocation Agency (TRA) in Tunis, Tunisia

## Membership

Membership of the AfDB Group, as at the end of December 2007, includes 53 independent African countries and 24 non-African countries. Turkey is finalizing procedures to become members of the Bank Group. To become an AfDB member, non-regional countries must first be ADF members.

## Resources

From an initial authorized capital of US\$ 250 million, AfDB resources increased over a 19-year period up to 1982 to US\$ 2.9 billion and jumped to US\$ 6.3 billion in 1983 as a result of the admission of non-regional countries on December 30, 1982. It further increased to US\$ 22.3 billion barely five years later following a 200% Fourth General Capital Increase achieved in Cairo, Egypt, in June 1987.

The Fifth General Capital Increase concluded in 1998 recorded a 35% capital increase and attributed 60% shareholding to regional countries and 40% to non-regional countries.

For the ADF, from the initial contributions of US\$ 101 million in 1974 by its first 13 member state-participants, the Fund has had eleven general replenishments on a 3-yearly basis. The current ADF XI replenishment of UA 5.76 billion or US\$ 8.9 billion for the 2008-2010 period, saw a record 52% increase on previous ADF-X figure.

The Nigeria Trust Fund, for its part, started operations with US\$ 80 million in 1976 and after one replenishment in 1981, it has been efficiently managed by the Bank to reach UA 233.5 million, equivalent to US\$ 0.432 billion.

Apart from capital subscriptions by member countries, other sources of Bank Group resources include borrowings from the international financial markets, as well as from incomes generated from loans.

The AfDB has also been instrumental in the establishment and promotion of other African development institutions such as Africa Re-insurance Corporation, Shelter Afrique, Association of African Development Finance Institutions (AADFI), Federation of African Consultants (FECA), the Africa Project Development Facility (APDF), the International Finance Company for Investments in Africa (SIFIDA), African Management Services Company (AMSCO), African Business Round Table (ABR), African Export-Import Bank (AFREXIMBANK), African Capacity Building Foundation, Joint Africa Institute, PTA Bank, the Network for Environment and Sustainable Development in Africa (NESDA).

The Bank has also been the lead agency for NEPAD infrastructure development, a respected guide in the development of banking and financial standards as well as the strategic partner of the African Peer Review Mechanism (APRM)

### **Asian Development Bank (ADB)**

The World Bank had been trying to set up regional development banks and some regional banks have been established for developing countries in Latin America, Africa and Asia.

The Economic Commission for Asia and Far East (ECAFE) had made in 1963 a suggestion for a regional development bank for Asian countries. Representatives of the major Asian countries met at Manila in December 1965 to finalise the proposal and the Asian Development Bank came to be formally established in December 1966.

### **Objective and Functions of the ADB**

The basic objective behind the establishment of the ADB is “to promote economic development of and mutual cooperation among the countries of Asia”. The ADB’s objective is to help accelerate the process of economic development of developing countries in the Asian region.



To realise the objective the ADB performs the following functions:

- To promote investment of public and private capital for economic development of Asian countries;
- To channelise investible funds of the ADB for the implementation of those projects which are important for the development of major sectors of the country's economies;
- To render assistance to member-countries in coordinating their programmes and policies of economic development and at the same time to promote inter-regional trade and cooperation among countries of the Asian region;
- To promote technical assistance for the execution of projects; and
- To mobilise funds for economic development of member-countries by extending cooperation to the world Bank, ECAFE and other United Nations bodies and public as also private institutions located among member-countries.

### **Membership, Capital Resources and Organisation**

The membership of the ADB is open to all countries in Asia, but for procuring additional and substantial financial and other resources, many developed countries of other regions are also admitted as members of the ADB.

By the end of June 1975, the ADB had 27 Asian members and 14 non-regional members, thus making a total of 41 members.

The authorised capital (in terms of US dollars) of the ADB was 3366 millions US dollars as on 31 December 1974. The subscribed capital on that date was 2770 million US dollars.

Besides subscribed capital, the ADB has also raised additional financial resources through borrowings. By December 1973 the total amount of outstanding borrowings by the ADB was 293 million US dollars, about 30% of this being borrowings from Japan in yens.

At the time of the establishment of the ADB, member-countries were asked to deposit only 50% of its subscribed capital in their national currencies.

The Board of members of the ADB are: United States, the United Kingdom, West Germany, and Canada. Japan is the principal subscriber to the ADB, apart from contributing substantial share capital Governors is free to call the remainder of the member-country's

subscribed capital, whenever the ADB needs additional funds for carrying on its lending activities.

### **Some of the Important Non-Regional of the ADB.**

Out of the total voting power, 20% has been allocated among member-countries equally, whereas the remaining 80% has been allocated on the basis of subscribed share capital by each member of ADB.

The management of the ADB is entrusted to the Board of Governors constituted by representatives of the member-countries of the ADB. The Board of Governors meets once a year, whereas for routine decision-making and carrying on the ADB's lending and other operations, a ten-member Board of Directors has been constituted.

In April 1974 there came to be established a fund known as the Asian Development Fund. It is a multi-purpose fund, the proceeds of which are to be utilised for providing concessional loans to the relatively poorer member-countries of the ADB. Ten member-countries had subscribed 245.4 million US dollars to the Asian Development Fund by December 1974.

### **Lending Operations of the ADB**

The ADB provides loans to its member-countries keeping in view the following considerations:

- (1) Larger portions of ADB loans should be given to relatively poorer among developing countries in Asia;
- (2) The government of the borrowing country has approved the loan by ADB being given to the private or public sector enterprise;
- (3) The Chairman of ADB has received a detailed report of the project for which the ADB is to provide loan;
- (4) The ADB while giving loan also takes into consideration prospects of loans which the applicant may receive from other than ADB source.
- (5) Generally the ADB loans are to be used within the markets of member-countries for purchase of essential goods, etc; but the Board of Directors with a two-third majority can allow the ADB loan to be used in markets of non-member countries; and
- (6) The ADB will function strictly keeping in view the sound principles of banking.

## **Islamic Development Bank**

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in Dhul Q'adah 1393H, corresponding to December 1973. The Inaugural Meeting of the Board of Governors took place in Rajab 1395H, corresponding to July 1975, and the Bank was formally opened on 15 Shawwal 1395H corresponding to 20 October 1975.

### **Purpose**

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah i.e., Islamic Law.

### **Functions**

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms for economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds. The Bank is authorized to accept deposits and to mobilize financial resources through Shari'ah compatible modes. It is also charged with the responsibility of assisting in the promotion of foreign trade especially in capital goods, among member countries; providing technical assistance to member countries; and extending training facilities for personnel engaged in development activities in Muslim countries to conform to the Shari'ah.

### **Membership**

The present membership of the Bank consists of 56 countries. The basic condition for membership is that the prospective member country should be a member of the Organisation of Islamic Cooperation (OIC), pay its contribution to the capital of the Bank and be willing to accept such terms and conditions as may be decided upon by the IDB Board of Governors.

### **Capital**

Up to the end of 1412H (June 1992), the authorized capital of the Bank was two billion Islamic Dinars (ID) {A unit of account of IDB which is equivalent to one Special

Drawing Right (SDR) of the International Monetary Fund (IMF)}. Since Muharram 1413H (July 1992), in accordance with a Resolution of the Board of Governors, it became six billion Islamic Dinars, divided into 600,000 shares having a par value of 10,000 Islamic Dinars (ID) each. Its subscribed capital also became four billion Islamic Dinars payable according to specific schedules and in freely convertible currency acceptable to the Bank. In 1422H, the board of governors at its annual meeting held in Algeria decided to increase the authorized capital of the Bank from ID 6 billion to ID 15 billion and the subscribed capital from ID 4.1 billion to ID 8.1 billion. According to the Directive of the Third Extra-Ordinary Session of the OIC Islamic Summit Conference held in Makkah Al-Mukarramah on 7- 8 December 2005, calling for a substantial increase in the capital stock of IDB in order to enable it to strengthen its role in providing financial support and technical assistance to its member countries, the Board of Governors of the IDB in its 31st Annual Meeting in Kuwait decided to increase the authorized capital stock of IDB by 15 billion Islamic Dinars to become 30 billion Islamic Dinars and the subscribed capital by 6.9 billion Islamic Dinars to become 15 billion Islamic Dinars.

### **Strategic Framework**

In 1424H, the Bank adopted a new strategy entitled IDB Group Strategic Framework. The Strategic Framework identified major elements of the IDB Group (ICD, ICIEC, IRTI and IDB as a flagship) to improve efficiency and services delivery to member countries.

Under the new strategy, the IDB envisions greater cooperation and coordination among the group members to ensure complementarities and optimum collective impact in the member countries.

To this end, the IDB has formulated its vision, mission statement and core values, and redefined its medium term strategic objectives and priority areas as briefly described below.

#### **Vision**

To be the leader in fostering socio-economic development in member countries and Muslim communities in non-member countries in conformity with Shariah.

#### **Mission**

The IDB Group is committed to alleviating poverty; promoting human development; science and technology; Islamic economics; banking and finance; and enhancing cooperation amongst member countries, in collaboration with our development partners.

The core values, referred to with the acronym **PRIDE**, are as follows:

- Performance excellence in all activities and in dealing with its clients and partners.
- Responsiveness (responding to clients' needs with focused and forward-looking approach based on review of performance, reflection on improvement and resolve to offer the best)
- Integrity (demonstrating a high level of sincerity, honesty and fairness)
- Dedication in serving clients with dignity and determination supported by creativity and initiative.
- Empowerment of staff and concerned entities with responsibility, authority and teamwork.

### Objectives

In this regard, the following three major strategic objectives have been identified to drive forward the Group actions.

- Promotion of Islamic financial industry and institutions
- Poverty alleviation
- Promotion of cooperation among member countries

### Priority Areas

To realize these objectives, the IDB Group will focus on the following six priority areas:

- Human development
- Agricultural development and food security
- Infrastructure development
- Intra-trade among member countries
- Private sector development
- Research and development (R & D) in Islamic economics, banking and finance

Mobilization of financial resources and quality manpower has been considered as two critical prerequisites for successful implementation of the Strategic Framework. While the Group will continue to strive to increase its resource base, it will also enhance the development impact of these resources.

## European Bank for Reconstruction and Development

The European Bank for Reconstruction and Development (EBRD) was established to help build a new, post-Cold War era in Central and Eastern Europe. It has since played a historic role and gained unique expertise in fostering change in the region - and beyond.

The EBRD is committed to furthering progress towards, in the words of its founding articles, 'market-oriented economies and the promotion of private and entrepreneurial initiative'. This has been its guiding principle since its creation at the beginning of the 1990s and, new challenges and the welcoming of new countries to the EBRD world notwithstanding, will continue to be its mission in years to come.

The EBRD was set up in haste to meet the challenge of an extraordinary moment in Europe's history, the collapse of communism in its East. In fact, a mere 18 months elapsed between the first mooted idea of a European bank, by President François Mitterrand of France, in October 1989 and its opening for business with headquarters in London in April 1991.

Urgency and the ability to respond to momentous events swiftly and decisively, whether it be the end of the Soviet Union, financial crises or the 'Arab Spring,' have been one of the bank's hallmarks from the start.

During the frenetic years of the early 1990s the Bank's emphasis on the private sector as the main motor for change in Central and Eastern Europe was vindicated many times over. This was the period that established the EBRD's reputation as an expert on transition to the open market.

It was heavily involved in areas such as banking systems reform, the liberalisation of prices, privatisation (legalisation and policy dialogue) and the creation of proper legal frameworks for property rights, all vital ingredients for change.

Such reforms were supported by sound advice, training and technical expertise, and supplemented by major investments in the private and public sectors. With domestic capital on its own insufficient to finance transition, the Bank helped to bring in external capital from both private and public sources.

Such experience has stood the Bank in good stead when it has expanded its original region of operations into new countries such as Mongolia (in 2006), Turkey (2009) and Jordan, Tunisia, Morocco, Egypt and Kosovo (in 2012). It is currently active in more than 30

countries from central Europe to central Asia and the southern and eastern Mediterranean. The Czech Republic is the only member to have 'graduated' from the EBRD and no longer receives investment from the Bank.

The EBRD's understanding of how a market economy works and engagement with other international financial institutions also allowed the Bank to play a crucial role in stabilising the region and planning for recovery after the shock of the global financial crisis in 2008.

Uniquely for a development bank, the EBRD has a political mandate in that it assists only those countries 'committed to and applying the principles of multi-party democracy [and] pluralism'. Safeguarding the environment and a commitment to sustainable energy are also central to the Bank's activity.

The EBRD serves the interests of all its shareholders - 64 countries plus the European Union and the European Investment Bank -, not just those countries which receive its investments (€9.1 billion in 2011). We all stand to gain from the EBRD region's closer and deeper integration into the global economy.

EBRD provide project financing for banks, industries and businesses, both new ventures and investments in existing companies. We also work with publicly owned companies.

Each of our projects is tailored to the needs of the client and to the specific situation of the country, region and sector. Direct investments generally range from €5 million to €230 million. We provide loan and equity finance, guarantees, leasing facilities and trade finance. Typically we fund up to 35 per cent of the total project cost.

The Bank invests only in projects that could not otherwise attract financing on similar terms. For each project we finance, we assign a dedicated team of specialists with specific sectoral, regional, legal and environmental skills.

Through donor funds we mobilise investment capital and expertise by giving local business access to consultant experts. Donor programmes are funded by governments and international institutions, and are managed by the EBRD.

We also manage six nuclear safety and decommissioning funds. The biggest of these is for the transformation of the destroyed reactor in Chernobyl into an environmentally safe state.

## Inter-American Development Bank

The idea of a development institution for Latin America was first floated during the earliest efforts to create an inter-American system, at the First Pan-American Conference in 1890. It would take nearly seven decades for the IDB to become a reality, under an initiative proposed by President Juscelino Kubitschek of Brazil.

The Bank was formally created in 1959, when the Organization of American States drafted the Articles of Agreement establishing the Inter-American Development Bank.

Throughout the years, the IDB has added new member countries and it increased its capital nine times. These actions have allowed the IDB to boost support for poverty alleviation and other development programs that have helped transform Latin America and the Caribbean. Although much remains to be done, the region's social indicators have improved significantly in such areas as literacy, nutrition and life expectancy.

Operations Policies of the IDB are divided into two parts for purposes of dissemination on the Bank's website: general operational policies common to all types of financing activities, and sector policies, which provide guidance in specific fields of activity.

The IDB's procurement policy governs the rules and procedures that apply to the purchase of goods and services for Bank-financed projects. The institution also has a Access to Information Policy that governs access to information on its operational activities.

In addition to these policies, the IDB's lending program is also guided by strategies, broader statements that seek to make operational the mandates given to the institution by its Board of Governors.

A third instrument used in the design and development of projects is "best practices." Best practice documents take the form of policy notes, technical notes and discussion papers incorporating «lessons learned» from a variety of sources, including projects financed by the IDB.

Partnering with clients, the IDB seeks to eliminate poverty and inequality, and promotes sustainable economic growth.

The Bank supports clients in the design of projects, and provides financing, technical assistance and knowledge services to support development interventions. The IDB focuses on empirical evidence for making decisions and measuring the impact of this projects to increase its development effectiveness.



## Clients of IDB

The IDB lends to national, provincial, state and municipal governments as well as autonomous public institutions. Civil society organizations and private sector companies are also eligible for IDB financing.

## Products Offered:

- Lending and Grants (**Financial Instruments:** Rates, Loans, Grants, Guarantees, Equity Investments, Technical Cooperation, Financing Solutions, Funds under Administration)
- Knowledge Generation
- Project Preparation Facilities

## Self Assessment Questions

1. Discuss the role of the world Bank.
2. Write a short note about the European Development Bank.
3. Explain the objectives and functions of Asian Development Bank.
4. What is EBRD. State its functions.

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## Lesson 3.3 - Global Financial Instrument

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### Learning Objectives

*After reading this chapter you will be able to.*

- ▶ Elucidate and explain security Market instrument of international financial markets.
- ▶ Focus and discuss International equities, GDRs, ADRs, International Money Market and Bond Market Instruments, Eurobonds, Repos, Euro CPs, MTN, FRN, Loan Syndicates and Euro Deposits.
- ▶ Evaluate the Euro Issues in India.

### Introduction

There are different types of equity investment instruments in international market. International equity offering generally takes any one of the two forms, viz, i) dual syndicate equity offering, where the equity offering is split into overseas and domestic tranches and each is handled by separate lead manager and ii) euro equity offering where one tranche is placed overseas and managed by one lead manager. GDRs, ADR AND IDRS (Global, American and international depository Receipts) are the prime modes of Euro-equity offerings.

### Global Depository Receipt (GDR)

A Global Depository Receipt (GDR) is a dollar denominated instrument traded on a stock exchange in Europe or the US or both. It represents a certain number of underlying equity shares.

The shares are issued by the company to an intermediary called depository in whose name the shares are registered. It is the depository which subsequently issues the GDRs. The physical possession of the equity shares is with another intermediary called the custodian who is an agent of the depository. Thus while a GDR represents the issuing company's shares, it has a distinct identity and in fact does not figure in the books of issuer.

The concept of GDRs has been in use since 1927 in Western capital markets. Originally they were designed as an instrument to enable US investors to trade in securities that were not listed in US exchanged in the form of American depository receipts (ADRs). Issue traded outside the US were called International Depository Receipt (IDR) issues.

Thus, a global depository receipt or global depository receipt (GDR) is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account. GDRs represent ownership of an underlying number of shares. Global depository receipts facilitate trade of shares, and are commonly used to invest in companies from developing or emerging markets.

Prices of global depository receipt are often close to values of related shares, but they are traded and settled independently of the underlying share.

### **Characteristics of GDRs**

1. It is an unsecured security
2. A fixed rate of interest is paid on it
3. It may be converted into number of shares
4. Interest and redemption price is public in foreign agency
5. It is listed and traded in the share market

Until 1983, the market for depository receipts was largely investor driven and depository banks often issued them without the consent of the company concerned. In 1983, the securities and exchanged commission (SEC) of the US made it mandatory for certain amount of information to be provide by the companies.

Till 1990, the companies had to issue separate receipts in the United states (ADRs) and in Europe (IDRs). Its inherent weakness was that there was no cross border trading possible as ADRs had to be traded, settled and charged through DTC (an international settlement systems in the US) while the IDRs could only be traded and settled via Euro clear in Europe.

In 1990, changes in Rule 144A and regulation 5 of the SEC allowed companies to raise capital without having to register the securities within the SEC or changing financial statements to reflect US accounting principles. The GDR evolved out of these changes.

Depository Receipts (DRs) are offered for subscription as under:

- a) **Unsponsored:** Issued by one or more depositories in response to market demand. Today this is obsolete.
- b) **Sponsored:** This is prominent today thanks to flexibility to list on a national exchange in the US and the ability to raise capital.
  - 1) **Private Placement (!\$\$A) DRs:** A company can access the US and other markets through a private placement of sponsored DRs. In this a company can raise capital by placing DRs with large institutional investors and avoid registering with the SEC. The National Association Of Securities Deal (NASD) of the US has established an Electronic Trading System similar to NASDAQ, called PORTAL within which Rule 144A eligible securities approved by NASD for deposit may traded by QIBs.
  - 2) **Sponsored Level DRs:** This is the simplest method for companies to access the US and non-US capital markets. Level-I DRs trade on the OTC market and as a result the company does not have to comply with US generally accepted accounting principles (US GAAP) or full Securities and Exchange Commission (SEC) disclosures. Under this, companies enjoy the benefits of a publicly traded security without changing the current reporting process.
  - 3) **Sponsored Level II and III DRs:** Companies that wish to either list their securities on an exchange in the US or raise capital, use sponsored level II and III DRs respectively. Each level requires different SEC registration and reporting plus adherence to US GAAP. The companies must also meet the listing requirements of the National Exchange or NASDAQ whichever it chooses.

### **Need for GDR issues by Indian Companies**

The specific needs of Indian companies to issue GDRs are as follows.

- i) To raise valuable foreign exchange, ii) to meet the expansion and diversification needs of these companies, iii) to globalize the demand for the scripts of these companies, iv) to leverage the corporate names of these companies in the global capital market, v) to mitigate the rising cost of domestic capital due to stringent monetary conditions at home and vi) to broad-base share holdings in these companies are the specific needs that were sought to be fulfilled by these GDR companies.

## Requirements for Issuing GDRs

In a directive issued on November 12, 1993, the Government of India laid down certain provision governing issues of GDRs and foreign currency bonds. The key provisions are as follows:

- Prior permission from the department of Economic Affairs, ministry of Finance is mandatory.
- Company seeking such approval must have a consists track record of good performance.
- The custodian shall be a Domestic Custodian Bank.
- The aggregate of the foreign investment in the company, direct or indirect, shall not exceed 51% of the issued and subscribed capital of the issuing company ( This is exclusive of general permission of offshore funds or FIIs to invest upto 24% or 30% as the case may be.

In addition the notification contains details of taxation are mentioned in the text. Dividends are subject to a 10% withholding tax and capital gains (if the underlying shares are sold in India or to an India resident) at maximum marginal rate if short term (holding period less than 12 months) and 10% if long term are provided for.

Subsequently, in may 1994, the Government of India issued further guidelines intended to further regulate the access and the use of funds. The May 1994 guidelines specify inter alia:

- 1) A company can make a GDR issue only once in a period of 12 months. A group of companies can make no more than two issues.
- 2) The funds mobilized must be used within a year of the issue date for one or more of the following purposes:
  - a. Import of capital equipment.
  - b. Purchase of domestic plant, equipment and buildings.
  - c. Prepayment or scheduled repayment of an existing foreign currency liability.
  - d. Funds a joint venture or a project abroad provided the same has been approved by the Government.
  - e. Up to 15% of the issue proceeds can be utilized for “general corporate restructuring purposes”.

- 3) On a case-by-case the Government may approve retention of the proceeds abroad to be used as prescribed. Otherwise the funds must be repatriated to India within two weeks of the issue.
- 4) In certain cases, GDR investment will be treated on par with foreign direct investment and hence will require prior clearance by the Foreign Investment Promotion Board (FIPB).

The guidelines are subject to review and revision every three months. GDR can be offered to US investors only if very stringent requirements of registration with the SEC are complied with. However, under an exemption granted by Rule 144A of the securities Act, securities can be offered to Qualified Institutional Buyers (QIBs) without going through the registration process.

### Parties to GDRs

The key involved in a GDR issue apart from the issuing company are:

- i) **The lead manager:** An investment bank which has the primary responsibility for assessing the market and successfully marketing the issue. It helps the company at all stages from preparing the documentation, making investor presentation, selection of other manager (subscribers) and post-issue support. It also owes a responsibility to investors or presenting an accurate picture of the company's present status and future prospects, to the best of its knowledge. This means that it must exercise due diligence in collecting and evaluating all possible information which may have a bearing on the issue.
- ii) **Others managers** or managers or subscribers to the issue agree to take and market parts of the issue as negotiated with the lead manager.
- iii) **Depository:** A bank or financial institution, appointed by the issuing company which has certain duties and functions to be discharged vis-à-vis the GDR holders and the company. For this it receives compensation both from the company as well as the GDR holders.
- iv) **Custodian:** A bank appointed by the depository, generally in consultation with the issuing company which keeps custody of all deposited property such as share certificates, dividends, right and bonus shares etc. It receives its fees from the depository.
- v) **Clearing systems:** EUROCLEAR (Brussels), CEDEL (London) are the registrars in Europe and Depository Trust Company (DTC) is the registrar in USA who keeps records of all particulars of GDRs and GDR holders.

## Steps in Issue of GDRs

The steps involved in the GDR mechanism can be summarized as follows:

- i) The amount of issue is finalized in US dollars. The company considers factors such as gearing, dilution effect on future earnings per share etc. The lead manager assesses the market conditions.
- ii) The lead manager and other managers agree to subscribe to the issue at a price to be determined on the issue date. These agreements are embodied in a subscription agreement signed on the issue date.
- iii) Usually, the lead manager has an option to subscribe to specified additional quantity of GDRs. This option called green shoe has to be exercised within a certain number of days.
- iv) Simultaneously, the Depository and the Custodian are appointed and the issuer is ready to launch the issue.
- v) The company issues a share certificate equal to the number of GDRs to be sold. This certificate is in the name of the Depository, kept in custody of the custodian. Before receipts of the proceeds of the issue, the certificate is kept in escrow.
- vi) Investors pay money to the subscribers.
- vii) The subscribers (i.e. the lead managers and other managers to the issue) deposit the funds with the Depository after deducting their commissions and expenses.
- viii) The company registers the depository or its nominee as holder of shares in its register of shareholders.
- ix) The Depository delivers the European Master GDR to a common depository for CEDEL and EUROCLER and holds an American Master GDR registered in the name of DTC or its nominee.
- x) CEDEL, EUROVLRAR and DTC allot GDRs to each ultimate investors based on the data provided by the managers through the depository.
- xi) The GDR holders pick up their GDR certificates. Anytime after a specified “cooling off” period after close of the issue they can convert their GDRs into the underlying shares by surrendering the GDR to the depository. The Custodian will issue the share certificates in exchange for the GDR.
- xii) Once surrendered in exchange for shares, such shares can not be reconverted into GDRs. That is there is no fungibility.

- xiii) The GDRs are listed on stock exchanges in Europe such as Luxembourg and London.
- Xiv) Dividends paid will be collected by the custodian converted into local currency and distributed to GDR holders.

The costs of the issue consist of various fees, commission and expenses paid to the lead manager and other managers, fees and expenses paid to the depository, preparation of documents, legal fees, expenses involved in investor presentation (road shows etc.) listing fees for the stock exchanges, stamp duties etc.

Fees and commissions paid to managers vary but are generally in the neighborhood of 3-4% of the issue amount. This is for less than issue costs in India which range between 8% to 15% of the issue size. GDR holders have the right to dividends, the right to subscribe to new shares and the rights to bonus shares. All these rights are exercised through the depository. The depositories convert the dividends from rupees to foreign currency. GDR holders have no voting rights. The depository may vote if necessary as per the Depository Agreement.

### **American Depositary Receipt (ADR)**

ADRs are financial assets that are issued by U.S. banks and represent indirect ownership of a certain number of shares of a specific foreign firm that are held on deposit in a bank in the firm's home country. The advantage of ADRs over direct ownership is that the investor need not worry about the delivery of the stock certificates or converting dividend payments from a foreign currency into U.S. dollars. The depository bank automatically does the converting for the investor and also forwards all financial reports from the firm. The investor pays the bank a relatively small fee for these services. Typically non-Canadian firms utilize ADRs. For example, Mexican firms are traded in this manner in the United States – at yearend 1993, all 13 Mexican firms with their stock listed on the NYSE utilized ADRs. In March 1999, the first even ADR issue by an Indian firm took off. The Information Technology Ltd., floated ADRs which were received very well.

This is an excellent way to buy shares in a foreign company while realizing any dividends and capital gains in U.S. dollars. However, ADRs do not eliminate the currency and economic risks for the underlying shares in another country. For example, dividend payments in Euros would be converted to U.S. dollars, net of conversion expenses and foreign taxes and in accordance with the deposit agreement. ADRs are listed on NYSE, AMEX or Nasdaq as well as OTC.



## **Debt Instruments**

Debt instruments ADR: Global debt market is much older than global equity market. Earlier the multilateral and bilateral debt instruments are in full form. Debt instruments took several forms viz. straight bonds, Syndicated loans, floating rate bonds, Convertible bonds etc.

### **Varieties of Global Market Debt Instruments**

Debt investment guarantees periodic current return and priority repayment of capital over equity investment in the event of winding up. Of course, debt investments are redeemable after a fixed time period, usually 7 years or so. Security is there.

Risk averse investors go for this investment. A brief description of debt instruments are available in the Euro-market.

### **Bonds**

For starters, there is a veritable plethora of securities, such as Euro-bonds, Yankee bonds, Samurai bonds, and Dragon bonds which tap the European, US, Japanese, and Asia-Pacific markets, respectively. More specifically, Eurobonds are unsecured debt securities maturing at least a year after the launch. Usually fixed-rate instruments, with bullet repayments-one-shot redemption-these bonds are listed on stock exchanges abroad. And borrowers access global investors with deep pockets: individuals with high net worth as well as institutions.

The volume of Eurobonds issues from the world's emerging markets hovered around the \$29-billion mark, with the average size of an issue being \$127 million some five years ago. The most popular instrument among emerging market borrowers: a Eurobond with a 144-A tranche. That is, a public offering in the Euro-market and a private offering in the US.

### **Foreign Commercial Paper**

Commercial papers are continuously offered unsecured debt by the borrower. Most FCPs mature in 30, 60, or 90 days and are sold at a discount to their face value. That reflects the interest on the instrument as well as the overall yield to the investor. It's extremely flexible, since commercial papers can be structured according to different maturities, amounts and rates according to the issuer's needs for funds.

### **Fixed/Floating Rate Notes**

This debt instrument matures in 90 days' time but it can be extended at the issuer's option for an additional period at each maturity date; simultaneously, the interest rate also increases. Several variations are possible; extendable bonds and stepped-up coupon put table bonds. As the term suggests, hold on to the bonds for some more time usually at a higher coupon rate.

As for stepped-up coupon put table bonds, they are a hybrid between debt with warrants and extendable bonds or notes. After a specified period of time, investors can either put the bonds back up to the issuer or hold on to the bonds for a stated period at a higher-stepped-up-coupon rate.

### **Flip-Flop Notes**

A bond with reverse flexibility, a flip-flop note offers investors the option to convert to another debt instrument. And in some cases, investors can even go back to the original bond at a later date.

The option changes the maturity of the issue and the interest rate profile. It gives issuers the opportunity to persuade investors to accept lower interest rates, thus reducing their costs. Conversely, investors have options which come in handy when interest rates fluctuate sharply.

### **Dutch Auction Notes**

Here, investors bid for seven-year notes on which the coupon rate is re priced every 35 days. As a result, the notes are sold at the lowest yield possible. Bids are conducted through a real auction by dealers in the US markets. The main advantage is that these notes provide money for longer periods than commercial paper, since they are re priced only once every 35 days and, unlike commercial paper, are not redeemed and resold.

### **Bunny Bonds**

These bonds permit investors to deploy their interest income from a host bond into more bonds with the same terms and conditions. Since the option to reinvest interest at the original yield is attractive to long-term investors, like the pension funds, companies find it a cheap source of finance.

## **Euro-Rupee Bonds**

It doesn't exist yet, but several foreign institutions are toying with the idea of gobbling together such a tool for wary companies. Denominated in rupees, Euro-rupee bonds can be listed in, say, Luxembourg. Interest will be paid out in rupees, and investors play the risks of currency fluctuations.

## **Euro-Convertible Bonds**

It's the most exciting Euro-option available. Equity-linked debt instruments, which can be converted into GDRs. ECBs represent the best of both worlds. And they may soon overtake GDRs in terms of their popularity in this country.

Traditionally, investors have the option to convert any such bonds into equity according to a pre-determined formula-and, appropriately, even at a pre-determined exchange rate. Such bonds allow investors the flexibility to remain with the debt instrument if the share price refuses to rise. These bonds have also spawned subtle variations like those with call and put options, which allow the issuer to insist on conversion beyond certain limits or permit investors to sell the bonds back to the issuer. What's more significant are the structural variations that the Euro-market is becoming famous for.

## **Deep Discount Convertibles**

Such a bond is usually at a price which is 70 to 80 per cent of its face value. And the initial conversion prices and the coupon rate levels, are lower than that of a conventional Eurobond.

## **ECBs with Warrants**

Strictly speaking, these financial instruments are nothing but derivatives of Euro-bonds. They are combination of debt, with the investor getting an option on the issuer's equity. The equity, or warrant, is detachable from the host bond and it can be cased after specific points of time. However, the bonds, which have a debt life of seven to 10 year, remain outstanding until they mature.

“There can be expectations of the issuer and the lender”. For instance, they could be zero coupon which carry a conversion option as a predetermined price, which are called liquid yield option notes.

## **Bell Spread Warrants**

These warrants offer an investor exposure to the underlying share between a lower level, L, and an upper level, U. The lower level is set to provide a return to investor above and divided yield on the share. After maturity- usually three years – if the share is below the level L, then the investor receives the difference from the company.

Compensating for the downside protection, the issuer can cap the up-side potential on the share. When it matures, if the issuer's share price is above the level U, the issuer has to pay out only the amount U. If the stock is between L and U on maturity, the issuer has a choice of either paying the investor cash or delivering shares. As the minimum return is set above the dividend yield on shares, the structure works best for companies with a low dividend yield.

Money-back Warrants (MBWs): MBWs entitle an investor to receive a certain predetermined sum from the issuer provided the investor holds the warrant until it matures, and does not convert it into shares. To the investor, the cost of doing so is not only the cash he loses, but also the interest foregone on the sum of the money. This means that companies must offer a higher premium than they normally do.

## **Syndicated Loan**

The earlier to be evolved and, for a time, the most dominant form of cross border lending was the syndicated bank loan. Throughout the late seventies and early eighties most of the developing country borrowers relied on this source since their credit rating and reputation were not good enough for them to avail of other avenues such as bond issues. A large bank loan could be arranged in a reasonably short time and with few formalities.

This was also a period during which banks found themselves being flooded with inflows of short term funds and a relatively repressed demand for loans from their traditional developed country borrowers.

## **Euro Market Instruments**

Today instruments market is integrated and globalized one. The euro market speaks of the integrated nature of the global investment market. It is mainly interbank market dealing in euro currency deposit and euro currency loans. Some of the instruments dealt in the market are; euro bonds. Commercial papers, certificate of deposits. Floating rate notes etc. a brief description of these instruments are given here.

## **Eurocurrency Deposits**

Eurocurrency deposit refers to the deposit of a currency with the banks outside the country where the currency is legal tender. Hence Eurocurrency deposit consists of all deposits of currencies placed with banks outside their home currency. Deposits are placed at call or for fixed periods as time deposits. Call deposits may be made for overnight, two days or seven days notices. Time deposits are accepted in the periods of 1,3,6, and 12 months. In general the deposits are accepted in the Eurocurrency market for a minimum of U. S. dollar 50,000/- or its equivalent in other currencies.

## **Certificate of Deposit**

Certificate of deposit is a certificate issued by a bank evidencing receipt of money and carries the bank's guarantee for the repayment of principal and interest.

Certificate of deposits are negotiable instruments and are issued payable to bearer and are traded in the secondary market. The certificate of deposits are issued for a minimum denomination of U.S dollar 50,000/- and for a maximum period, generally, of 1 year.

Certificates of deposits provided an excellent avenue to the investors in Eurocurrency market who would like to park their surplus in the high interest instrument with liquidity. For example if an investor say bank has surplus fund which it would like to invest for a period of say 3 months it can buy a C.D. for 3 months. If need be, the bank can sell the C.D. in the secondary market and liquidate it.

## **Types of Certificates of Deposits**

1. Straight or Top CDs: These are certificates of deposits with a fixed rate of interest and a fixed date of maturity (Generally 1-12 months). The interest is fixed in term of LIBOR and interest rate depends on the issuing bank and liquidity position in the market.
2. Floating Rate CDs: These are certificates of deposits which are issued with the interest rate linked to the LIBOR rate and are normally issued for a period of maximum of 3 years. Interest rate is reviewed at predetermined periodicity say every six months and adjusted in line with the base rate LIBOR rate.
3. Discount CDs: These are issued at a discount and are paid at maturity for the face value, the difference between the issue price and face value represents the interest.

4. Trenches CDs: A Tranche CD is a share in a programme of CD issues by a bank upto predetermined level. Each Tranche CD carries the same rate of interest and matures on the same date.

They are normally placed directly with the investors and they represent short term bonds. These CDs are issued with maturities upto 5 years.

### **Eurocredits**

In THE Eurocurrency market, most of the lending takes places in the form of Euro credit. Euro credits are medium and long term loans given by the banks in currencies which need not necessarily be those of the lenders or borrowers.

### **Security Aspects of Euro Credit**

Euro credits are provided mostly without any collateral security but the emphasis is on the credit rating of the borrower. In view of the difficulties experienced in enforcing securities the lending is made on strength of the standing of the borrower in the market.

### **Nature of Facility**

Euro credits are extended either as revolving credits or as ten credits. Under revolving credit, a limit is fixed for a borrower and he can draw whenever he needs and interest will be levied only on the amount drawn. On the unutilized portion of the sanctioned limit, a commitment fee may be charged.

Under the term credit facilities, the credit is extended for a specified term like say 3 year, the amounts disbursed as per the term of the contract. The repayment takes place over a period of time as per the agreed schedule.

Euro credits are extended generally for a period of 5 to 8 years. In some cases it may go upto 15 years.

### **Interest**

A special feature of Euro credit is the method of fixing the interest rate. Interest rates are tied to bench mark of references rate. The bench mark is the London interbank Offered Rate. For dollar credits LIBOR is used as benchmark while LUXIBOR (LUXEM boung Interbank Offered Rate) is used as benchmark rate for credits extended in Deutschemark

and for credits in Pound Sterling Paris Interbank offered rate(PIBOR) is taken as the base rate. The interest is quoted as so many basic points above the reference rate like 100 basic points above LIBOR above LUXIBOR etc. This is known as margin and the margin depends on the credit rating of the borrowing, and his bargaining power. The interest is reviewed every six months and changed in tune with the reference rate.

## Currency

The credits are generally extended in U.S. dollar but other currencies are also used for lending. IN some cases, the credit agreement provides for currency option. Under the arrangement the loan is originally given is one currency with the option to the borrower to roll the loan is a different currency if need be. This helps the borrower to protect against exchange risk.

## Loan Syndication

It is the process of involving several different lenders in providing various portions of a loan. Loan syndication most often occurs in situations where a borrower requires a large sum of capital that may either be too much for a single lender to provide, or may be outside the scope of a lender's risk exposure levels. Thus, multiple lenders will work together to provide the borrower with the capital needed, at an appropriate rate agreed upon by all the lenders.

Mainly used in extremely large loan situations, syndication allows any one lender to provide a large loan while maintaining a more prudent and manageable credit exposure, because the lender isn't the only creditor. Loan syndication is common in mergers, acquisitions and buyouts, where borrowers often need very large sums of capital to complete a transaction, often more than a single lender is able or willing to provide.

### Unique features of syndicated loans:

1. Access to Euro-currency markets
  - a) Free from Regulatory Control
  - b) Offshore banking- global converge
  - c) Flexibility to suit the borrower's and lender's changing needs.
2. Recycling of Euro deposits from surplus to deficit areas.
3. Transform short term Euro deposits to medium/long term euro credits.

## Concepts of Loan Syndication

1. Agreement between two or more lenders
2. Common borrower.
3. Common documentation.
4. Different from unsyndicated or independent borrowings from multiple banks.

## Advantages to Lenders

1. Spreading of risk.
2. Access to big borrowers.
3. Access to credit judgments/ marketing skills of sophisticated banks.
4. Sources of fees i.e non interest income.
5. Advertisement.

## Advantages to the Borrower

1. Ability to raise Jumbo loans in one stroke.
2. Single tap funding.
3. One set documentation. Hence less hassle.
4. Flexibility in the borrowing and speed which ensures timely delivery of credit.

## Protection to the Lenders

To protect their interest the lending bank lays down certain financial covenants which are included in the agreement. The covenants are financial values or ratios to be maintained by the borrower and the following are the few.

- a) Debt-equity ratio
- b) Dividend payout ration
- c) Debt service coverage ration

Normally the lending banks analysis before sanction the credit standing of the borrower, his country's credit standing, and his country's economic and political situation.

Even though all members of a syndicate sign a common loan agreement each lending bank is responsible for its own decision.



Any misrepresentation of fact by the borrower or failure to perform the covenants is defaults by the borrower. Default with any single lending bank will be construed as default with all banks. Since the credits fall outside the jurisdiction of any court the legal recourse is difficult and hence settlement through political negotiation is normally resorted to in care of defaults.

## **Euro Loan Syndication**

Euro Loan syndication was one of the earlier forms of lending evolved and remains to be one of the dominant form of crossborder lending. When the size of the lending is huge running into a few hundred million or billions, a few banks join together and provide the loan. This is loan syndication in simple term. It owes its evolution to U.S. Laws which fixed certain limits on lending exposure of a single bank on a single borrower.

A syndicated credit is the agreement between two or more lending institutions to provide a borrower a credit facility utilizing common loan documentation.

An appropriate definition will be.

“International syndicated credits are managed and underwritten by one or more financial institution normally from a location other than domicile of the borrower to include lender from differing banking geographic which provides the borrower access to more than its own currency of domicile.

In arranging a syndicated loan the following player take a major role.

1. **Managing Bank:** Managing bank is appointed by the borrower to arrange the credit. The managing bank helps the borrower to draw up the loan application, it negotiates the term and conditions with other banks and arranges the syndicate. The managing bank's role comes to an end with the signing of loan agreement by the borrower and the participating banks
2. **Lead Bank:** Lead Bank is the bank which provides the major chunk of the loan.
3. **Agent Bank:** Agent Bank is the bank appointed by the lenders to look after their interest once the loan agreement is signed. They take over from the managing bank.
4. **Participating Bank:** The participants in a syndicated loan fall into the following segments.
  1. The wholesale large commercial banks who arrange the credits, take lion's shares.

2. The retail sector small banks take whatever share is given to them and take a participation in the loan syndication.

Loan syndication is the most popular method of raising short term and medium term loans. Most of the developing country borrowers rely on this source of credits since their ratings and market standing are not good enough to avail of other avenues like bond issues etc. A large bank loan could be arranged in a reasonably short time and with few formalities. Minimum amount of syndicated loan raised is normally 50 million US dollar and the maximum amount is normally 5 billion US dollar and are given for a period ranging from 365 days to 20 years.

**Apart from interest the following fees are payable in a syndicated loan:**

1. **Management Fee** is the fees payable to managing bank which arranges the credit. It is payable upfront and is fixed as a percentage of the loan arranged
2. **Participation Fee** is the fee payable to the participants in the syndicate. A part of the management fee is passed on to the participant banks in proportion to their share as participation fee.
3. **Commitment fee** is the charge paid on undrawn balances of the credit. This is also known as facility fee and is levied to compensate the banks for keeping funds ready.
4. **Agency Fee** is the fee payable to the agent bank which takes care of disbursement of the credit after sanction, recovery of loan instalments and distribution of principal plus interest to the participants and this is an annual fee.

**Eurobonds**

A bond issued in a currency other than the currency of the country or market in which it is issued. Usually, a eurobond is issued by an international syndicate and categorized according to the currency in which it is denominated. A euro dollar bond that is denominated in U.S. dollars and issued in Japan by an Australian company would be an example of a euro bond.

The Australian company in this example could issue the euro dollar bond in any country other than the U.S. Eurobonds are attractive financing tools as they give issuers the flexibility to choose the country in which to offer their bond according to the country's regulatory constraints. They may also denominate their euro bond in their preferred currency. Eurobonds are attractive to investors as they have small par values and high liquidity.

Eurobonds constitute a major source of borrowing in the Eurocurrency market. A bond is a debt security issued by the borrower which is purchased by the investor and it involves the process of some intermediaries like underwriters, merchant bankers etc. Eurobonds are bonds of international borrower's sole in different markets simultaneously by a group of international banks. The bonds are issued on behalf of governments, big multinational corporations, etc

Euro bonds are unsecured securities and hence normally issued by Governments, Governmental Corporations, local bodies which are generally guaranteed by the Governments of the countries concerned and big multinational borrowers of good credit rating. The bonds are sold by a group of international banks which form a syndicate. The lead bank in the syndicate, advises the issuer of the bond on the size of the issue, terms and conditions, timing of the issue etc., and take up the responsibility of coordinating the issue. Lead managers take the assistance of co-managing banks. Each issue is underwritten by a group of underwriters and then are sold.

### **Feature of Eurobonds**

Eurobonds are mostly bearer bonds and are generally denominated in U.S. dollar, issued in the denominations of U.S. dollar 10,000/- The bonds are issued for a period of about 5 to 7 years though in some cases they are issued for a longer duration.

### **Types of bonds**

The following are the types of bonds:

1. Straight or fixed rate bonds
2. Convertible bonds
3. Currency option bonds
4. Floating rate bonds/Notes
5. Zero coupon bonds

#### ***(i) Straight or Fixed Rate Bonds***

These are the traditional bonds which are debt instruments carrying a fixed interest with a fixed maturity period with interest payable at a fixed predetermined interval, say 6 months or 1 year. The period of such bonds vary from 5 to 25 years but commonly bonds are issued by a period of 15 years.

These are issued for a face value with a certain percentage of interest payable at a certain periodicity and are redeemable after the expiry of the period specified.

These bonds are traded in the secondary markets which provide liquidity to the bonds.

Though the bonds are issued for a fixed maturity, some bonds are issued with a clause that the bonds are redeemable by the issuer, at issuer's choice, prior to its maturity at a price which is above the face value (call price). There are known as callable bonds and are a simple variant of straight bond. This feature of the bond allows the issuers to restructure their liability and provides flexibility.

A puttable bond is another variant of straight bonds and is opposite to callable bond. It allows the investor to surrender the bonds to the issuer of the bond prior to maturity of the bonds, at the discretion of the investor, after a certain period after issue. This provides liquidity to the investor and may have to pay for this privilege in the form of lower interest.

Though the interest is fixed on the bonds, the yield varies with the purchase price of the bonds. The market price at which the bond is bought by the investor either in the primary market (new issue market) or in the secondary market (an existing issue made sometime in the past) is its purchase price which may be same as the face value of the bond or may be lower or higher than the face value depending upon whether the bond was purchased at a discount or at a premium. The yield varies with the purchase price of the bond.

#### **(ii) Euro Convertible Bonds**

These are similar to fixed or straight bonds with an option to convert them at the discretion of the investor into the equity shares of the issuing company. The conversion will be done at a price (which determines the number of shares for which the bond will be exchanged) after expiry of a certain period of time. These convertible bonds are similar in nature to the convertible debentures in our country. Conversion of the bond into equity shares is done at the discretion of the bond holder and he can opt for it if the market prices of the shares are higher than the conversion price.

Convertible bonds are attractive from investment perspective because it gives the investor an opportunity to participate in the company's growth. Additionally, the bonds are normally issued in a currency other than the currency in which the shares are denominated and hence conversion into shares in a different currency provides the investor much needed currency diversification in investments.

This instrument is preferred by those who find the domestic (their country) debt market to be restrictive for short maturities, high rates of interest and various covenants of commercial loans in foreign currency unacceptable. This also favoured by those who wish to prevent immediate dilution of equity and possible loss of control over management.

Hence Euro convertible bonds are equity linked debt security instruments that can be converted into shares.

### **Warrants**

This is a variant of the convertible bonds. The bond is issued with warrants which are detachable. The warrant gives the holder the right to purchase a financial asset say shares at a stated price. The warrants are tradable. The investor can keep the bond and trade the warrant for the shares.

### **(iii) Currency Option Bonds**

These bonds are similar in nature to the straight bonds with a difference that it is issued in one currency with an option to take interest and principal in another currency. The rate at which the conversion takes place from one currency into another depends upon the terms of the issue. The rate may be fixed at the time of issue of bonds or at floating rates.

Due to fluctuations observed in foreign exchange market the later option of floating rates are more popular and under this the rate of conversion is the spot rate quoted in the market three business days before the due date of payment of principal and interest.

### **(iv) Floating Rate Bonds/Notes**

These are similar to the straight or fixed rate bonds as far as maturity and denomination are concerned but the difference is that unlike the fixed rate bond where the interest rate is fixed, in this the interest rate is varying in nature.

The interest rate is linked to a base rate like LIBOR and the interest payable on the bond for the next six months or one year is set with reference to the base rate. The rate of interest is adjusted every six months or one year depending on the terms for the issue.

In some cases, a ceiling is put on the interest rate on the bond and in some cases a floor rate is fixed.

The floating rate bonds offer flexibility to the investors who can block their funds for a long term with benefits of the short term interest movements, i.e. if an investor invests for a period of say 10 years and if the money market shows gradual increase in the interest rates his funds do not get blocked at lower rates but interest keep changing with the changes in the interest rates in the market FRNs are normally issued by bankers.

#### **(v) Zero Coupon Bonds**

These bonds are purchased at a substantial discount from the face value of the bond and are redeemed at face value on maturity. There are no interim interest payments. The difference between the purchase price and face value is the return on the investment.

These bonds are similar to cumulative deposits or cash certificates of banks in our country.

#### **Distinction between Eurobonds, domestic bonds and foreign bonds**

**Domestic bonds** are bonds issued by a resident issuer in the country of its residence, denominated in the currency of the country.

**Example:** State Bank of India bonds sold in India to Indian residents denominated in Indian rupees is domestic bond.

**Foreign bonds** are bonds issued by a non resident entity denominated in the currency of the country where the bond is issued.

**Example:** India Development Bonds issued by State Bank of India in U.S.A. denominated in U.S. dollars are foreign bonds.

**Eurobonds** are bonds denominated in a currency other than the currency of the country in which they are issued.

**Example:** A German multinational issuing bonds in London denominated in U.S. dollar qualifies for a Eurobond.

The foreign bonds and domestic bonds are subject to regulations by regulatory authorities and disclosure norms while Eurobonds are not governed by any such regulation or disclosure norms.

Many Eurobonds are listed on stock exchanges in Europe and this require filing of certain financial reports by the issuers to the exchange on a regular basis.

### **Other Euro-Instruments**

Note Issuance Facility and Euro Commercial Paper are dealt her.

### **Note Issuance Facility**

This is an innovation of early 80's. It combines the features of syndicated banks loans and floating rate notes issued to the investors. This instrument satisfies the investors' need for short term investment and borrowers' need for medium term funding.

In this instrument the issuer obtains medium term funding by issuing short term notes to the investor directly and keep them rolling over repeatedly. Thus every six months or one year, the previous issue would be redeemed and a fresh issue will be made. In order to ensure that the issuer gets the fund whether or not the notes are taken up by the market, a group of underwriters (syndicate of banks) underwrite the issues and thereby undertake an obligation to take up the part of issue which is not subscribed to by the market. The issuer of the bond pays a fee for this underwriting facility.

Note issuance facility represents a combination that best suits all parties. Parties with good rating can raise funds at a rate lower than the rate at which banks lend. Investors who generally prefer short term investments find this attractive as they are redeemed in a short time by the issuer and reissued. Underwriting facility ensures smooth flow of funds to the borrower. This ensures income to the banks by way of underwriting fees.

### **Commercial Papers**

Commercial Paper (CP) is a short term unsecured promissory note that is generally sold by large corporations on discount basis to institutional investors and other corporates for maturities ranging from 7 to 365 days. Commercial paper is cheap and flexible source of fund for highly rated borrowers as it works out cheaper than bank loans. For an investor it is an attractive short term investment which offers higher interest than bank accounts.

In U.S.A. the commercial paper is in existence for more than 100 years and accounts more than 400 billion US dollars. U.S.A. is the largest commercial paper market. It is used extensively by U.S. and non U.S. corporations. Any issuer who wants to launch a C.P. in U.S.A. has to get it rated by Moody's or by Standard and Poor's Corporation, the credit

rating agencies. The commercial papers then can be placed either directly or through C.P. dealers. The major investors are Corporates, Trusts, Insurance Companies, Pension Funds and other funds, banks etc.

Commercial papers can be issued either directly in their own name or with third party support in the form of standby letters. Most C.P. programs have a back-up credit line of a commercial bank covering at least 50% of the issue.

In Europe, commercial paper evolved out of Euro notes like Note issuance facility, which are under-written facilities. As the underwriting facility is expensive, in 1984, Saint Gobain, an issuer and Banque Indo-Suez dealer issued Euronotes without underwriting facility and thus became the first Euro-CP issuer. The commercial paper issues in the Euromarkets developed rapidly in an environment of securitisation and disintermediation of traditional banking.

Euro CPs are not rated by rating agencies as the Euro investors are not keen about the ratings of issuers.

#### Advantages of Euro CP's to Borrowers

1. Cheaper source of funds.
2. Simplicity in documentation, low cost of arrangement, absence of rating requirements.
3. Flexible maturity.
4. Diversification of short term funding through market that is found attractive by wide variety of investors.
5. Flexibility in limits determined by the issuer's cash flow requirements at any point of time.
6. A successful Euro CP programme will enhance the reputation of the issuer worldwide among the investing community.

#### Different between Euro & U.S. CP Programmes

	Euro CP Programme	U.S. CP Programme
1.	Do not distinguish the issuer's nationalities	U.S. investors expect higher returns from foreign issuers of comparable rating with U.S. issuers
2.	Low rated CPs are issued by U.S. issuers	Better rated CPs are issued by issuers



3.	Central Banks, Corporate funds are the investors	Money market funds are the investors
4.	Euro CP is traded in secondary market	Held by the investor until maturity
5.	Very competitive	Less competitive
6.	No credit rating required	Credit rating required
7.	Priced in relation to Bank rate	Priced in relation to treasury bill, Bank CD rates
8.	Time consuming process	Simple process

In recent years, the growth in the number of new issues and volume has slowed down in Euro commercial paper markets. As a result of some defaults, investors' concern about credit worthiness has increased dramatically.

### **International Money Market Instrument**

#### **a. Euro Notes**

Legal tender in the form of a banknote that can be used in exchange for goods and services in the eurozone. Euro notes come in 5, 10, 15, 20, 50, 100, 200 and 500 euro denominations. The supply of euro notes is controlled by the European Central Bank, which controls the monetary policy in order to maintain price stability in the European Union.

#### **b. Banker's Acceptance - BA**

A short-term debt instrument issued by a firm that is guaranteed by a commercial bank. Banker's acceptances are issued by firms as part of a commercial transaction. These instruments are similar to T-Bills and are frequently used in money market funds. Banker's acceptances are traded at a discount from face value on the secondary market, which can be an advantage because the banker's acceptance does not need to be held until maturity. Banker's acceptances are regularly used financial instruments in international trade.

#### **c. Letter of Credit**

It is a document issued by a financial institution, or a similar party, assuring payment to a seller of goods and/or services provided certain documents have been presented to the bank. These are documents that prove that the seller has performed the duties under an underlying contract (e.g., sale of goods contract) and the goods (or services) have been supplied as agreed. In return for these documents, the beneficiary receives payment from the financial institution that issued the letter of credit. The letter of credit serves as a

guarantee to the seller that it will be paid regardless of whether the buyer ultimately fails to pay. In this way, the risk that the buyer will fail to pay is transferred from the seller to the letter of credit's issuer. The letter of credit can also be used to ensure that all the agreed upon standards and quality of goods are met by the supplier, provided that these requirements are reflected in the documents described in the letter of credit.

#### **d. Repurchase Agreement - Repo'**

A form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, and buys them back the following day. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the party on the other end of the transaction, (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement.

#### **Eurodollar**

Originally, dollar-denominated deposits not subject to U.S. banking regulations were held almost exclusively in Europe; hence the name eurodollars. These deposits are still mostly held in Europe, but they're also held in such countries as the Bahamas, Canada, the Cayman Islands, Hong Kong, Japan, the Netherlands Antilles, Panama and Singapore. Regardless of where they are held, such deposits are referred to as euro dollars. Since the eurodollar market is relatively free of regulation, banks in the eurodollar market can operate on narrower margins than banks in the United States. Thus, the eurodollar market has expanded largely as a means of avoiding the regulatory costs involved in dollar-denominated financial intermediation.

#### **Federal Funds**

Excess reserves that commercial banks deposit at regional Federal Reserve banks. Federal funds can then be lent to other commercial banks with insufficient reserves. These loans are made at a relatively low interest rate, called the federal funds rate or overnight rate, and they typically have an extremely short duration: overnight. Federal funds help commercial banks meet their daily reserve requirements. Banks are required to maintain a certain level of reserves based on the amount of customer deposits they are responsible for.

#### **Eurocommercial Paper**

An unsecured, short-term loan issued by a bank or corporation in the international money market, denominated in a currency that differs from the corporation's domestic

currency. For example, if a U.S. corporation issues a short-term bond denominated in Canadian dollars to finance its inventory through the international money market, it has issued euro commercial paper.

### **Money Market Fund'**

An investment fund holds the objective to earn interest for shareholders while maintaining a net asset value (NAV) of \$1 per share. Mutual funds, brokerage firms and banks offer these funds. Portfolios are comprised of short-term (less than one year) securities representing high-quality, liquid debt and monetary instruments.

### **Certificate Of Deposit - CD'**

CD is a savings certificate entitling the bearer to receive interest. A CD bears a maturity date, a specified fixed interest rate and can be issued in any denomination. CDs are generally issued by commercial banks and are insured by the FDIC. The term of a CD generally ranges from one month to five years.

### **Floating-Rate Note - FRN'**

FRN is a note with a variable interest rate. The adjustments to the interest rate are usually made every six months and are tied to a certain money-market index. It is also known as a "floater."

These protect investors against a rise in interest rates (which have an inverse relationship with bond prices), but also carry lower yields than fixed notes of the same maturity. It's essentially the same concept as an adjustable-rate mortgage, except FRNs are investments (not debt).

### **Medium Term Note - MTN'**

1. A note that usually matures in five to 10 years.
  2. A corporate note continuously offered by a company to investors through a dealer. Investors can choose from differing maturities, ranging from nine months to 30 years.
1. Notes range in maturity from one to 10 years. By knowing that a note is medium term, investors have an idea of what its maturity will be when they compare its price to that of other fixed-income securities. All else being equal, the coupon rate on medium-term notes will be higher than those achieved on short-term notes.

2. This type of debt program is used by a company so it can have constant cash flows coming in from its debt issuance; it allows a company to tailor its debt issuance to meet its financing needs. Medium-term notes allow a company to register with the SEC only once, instead of every time for differing maturities.

### **Euro Deposit**

The equivalent of a money market rate on cash deposits made in the euro currency. Euro deposit rates will usually be quoted as “money market euro deposit rates” and are typically only offered to U.S. investors with minimum investments of greater than 10,000 euros.

Euro deposits pay a floating interest rate (like a money market account) and offer the chance for capital appreciation if the euro appreciates against the investor’s home currency (presumably the dollar). Euro deposit rates are based on the euro interbank offer rate, which is set by the European Central Bank.

There has been increased investor demand for cash equivalents in currencies outside of the U.S. dollar. If the dollar decreases in value compared to other currencies, there is little recourse for the investor’s loss of global purchasing power, but by holding a euro-denominated asset, the investor can diversify some of his currency risk and possibly reduce overall portfolio risk in the process.

### **Euro Issues in India**

From May 1992 onwards, Indian companies have been issuing Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds/Euro Currency Bonds (FCCBs/ECBs) on the Euro market on a large scale. In the year 1993-94, the Euro dollar markets were enthusiastically explored by the Indian firms. Most issues have been for Global Depository Receipts, held in trust, by offshore managers on behalf of individual investors. During 1995-96, seven Euro issues, all in the form of GDRs, were made which together raised \$652 million.

In November 1995, the Government relaxed the Euro issue guidelines permitting companies to remit funds into India in anticipation of the use of funds for approved end uses. The earlier guidelines issued in October 1994 provided that the Euro issue proceeds were to be mandatorily retained abroad by the issuer companies to be repatriated as and when expenditure on approved project/end uses were incurred.

Guidelines issued by the Finance Ministry in July 1996. It laid down that an issuing company seeking permission for raising foreign funds by Euro-issues having a consistent track record of good performance (financial or otherwise) for a period of three years shall be allowed to issue GDRs/FCCBs. This requirement would be relaxed in view of the importance of the infrastructure projects, and the need to encourage equity financing of such projects. Euro-issues shall be treated as direct foreign investment (subject to extant policies governing direct foreign investments) in the issuing company.

Some restrictions had been imposed previously on the number of issues that could be floated by an individual company or a group of companies during a financial year. There will henceforth be no restrictions on the number of Euro-Issues to be floated by a company or a group of companies in a financial year.

GDR end-users will include- financing capital goods imports; - capital expenditure including domestic purchase/installation of plant, equipment and buildings and investments in software development; - prepayment or scheduled repayment of earlier external borrowings; - investments abroad where these have been approved by competent authorities; - equity investment in JVs/WOSs in India.

However, investments in stock markets and real estate will not be permitted. Up to a maximum of 25 per cent of the total proceeds may be used for general corporate restructuring, including working capital requirements of the company raising the GDR.

Currently, companies are permitted to access foreign capital market through Foreign Currency Convertible Bonds for restructuring of external debt which helps to lengthen maturity and soften terms, and for end-use of funds which conform to the norms prescribed by the Government for External Commercial Borrowings (ECB) from time to time. In addition to these, not more than 25 per cent of FCCB issue proceeds may be used for general corporate restructuring including working capital requirements.

FCCBs are available and accessible more freely as compared to external debt, and the expectation of the Government is that FCCBs should have a substantially finer spread than ECBs. Accordingly, the all-in costs for FCCBs should be significantly better than the corresponding debt instruments (ECBs). Companies will not be permitted to issue warrants along with their Euro-issue.

The policy and guidelines for Euro-issues will be subject to review periodically.

### Self Assessment Questions

1. What is GDR? State its characteristics and issue requirements.
2. Who are parties in GDR. Explain the steps in issue of GDR.
3. Write a short note about ADR.
4. What is loan syndication? Explain the features of syndicated loan.
5. Define Euro Bond. Explain the different types of Euro Bond.
6. What is Commercial paper? Explain its advantage.
7. Describe briefly different types of International money market instruments.

### CASE STUDY

During the last two months the Indian rupee has been appreciating steadily against U.S.Dollar. Does this necessarily mean that Indian exports most have experienced fall into profits on their efforts? Why or Why not?

### CASE STUDY

You are just one week 'young' in your job as a treasury executive in a leading laptop trader/supplier in India. Earlier you company was sourcing assembled laptops from China, but with the incentives provided in the Budget of 2006 by the Finance Minister of India, your company is planning to enter assembly/manufacturing market in India.

Now, your company is planning to source components and sub assemblies from Taiwanese firms. This will involve a lot of foreign exchange trading and contracts.

Since you are from a leading business school in India, your CFO has asked you to make a presentation to the top management on various possibilities relating to forex market in India.

### Question

1. What is all that you would like to tell the top management so as to establish your creadibility?

## CASE STUDY

Apex Corp. is a US based MNC that has been in international business for the last several years. It has been conducting business with all the major countries of the world. One of the countries has allowed for its currency value to be market determined. The spot rate of currency is \$ 85. In addition the one year forward rate being quoted in the market is \$ 82. As a step to build the economy, the country is also allowing foreign investors to make investments. Various incentives are being offered by the country to attract foreign funds. The rate of interest on one year government securities is presently 16%. This is substantially higher than the 10% rate which is presently offered on one year US government securities.

Apex Corp. has asked you, as an employee in their international money market division, to assess the feasibility of making a short term investment in this country. The amount available for making the investment for the next year is \$ 12 million.

The Apex Corp. has also come to know that the exchange rate in this country will be market determined for the next few years. Financial managers in Apex Corp. are hence apprehensive about the high volatility of the currency till an equilibrium is reached. It is expected that the value of currency in one year will be approx. \$ 85. However, there is a high degree of uncertainty attached with this value and predictions are being made that the actual value may be 30% above or below this expected value.

### Questions

- (a) Would you be willing to invest funds in this country without covering your position? If yes, then answer, why?
- (b) Would covered interest arbitrage be worth considering? Show your calculations.
- (c) Are there any risks involved in using interest arbitrage? Elucidate.

## CASE STUDY

What are the likely consequences of Permitting foreign industrial Partners in the field of banking in India?

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## UNIT - IV

### Unit Structure

Lesson 4.1 - Currency Risk management

Lesson 4.2 - Translation Exposure

Lesson 4.3 - Operating /Economic Exposure

### Learning Objectives

*After reading this chapter you will be able to:*

- Understand meaning of Currency risk and Exposure.
- Recognize types of currency risk.
- Explain concept and Measurement of transition exposure.
- Understand the techniques and methods transaction exposure management.
- Differentiate transaction exposure and Translation exposure.
- Evaluate the Exchange Risk Management.
- Understand operating exposure and its measurement.



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## Lesson 4.1 - Currency Risk Management

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### Learning Objectives

*After reading this chapter you will be able to:*

- Understand meaning of Currency risk and Exposure.
- Recognise types of currency risk.
- Explain concept and Measurement of transition exposure.
- Understand the techniques and methods transaction exposure management.

### Introduction

Currency risk is a form of risk that originates from changes in the relative valuation of currencies. These changes can result in unpredictable gains and losses when the profits or dividends from an investment are converted from the foreign currency into U.S. dollars. Investors can reduce currency risk by using hedges and other techniques designed to offset any currency-related gains or losses.

For example, suppose that a U.S.-based investor purchases a German stock for 100 euros. While holding this bond, the euro exchange rate falls from 1.5 to 1.3 euros per U.S. dollar. When the investor sells the bonds, he or she will realize a 13% loss upon conversion of the profits from Euros to U.S. dollars.

However, if that investor hedged his or her position by simultaneously short-selling the euro, then the profit from the euro's decline would offset the 13% loss upon conversion.

### Types of Currency Risks

- Transaction exposure
- Translation exposure
- Economic exposure

## **Transaction Exposure**

Transaction Exposure is the risk of gains or losses that occurs when a firm engages in commercial transactions in which the currency of the transaction is foreign to the firm; i.e., it is denominated in a foreign currency. This is the type of exchange rate risk that we have looked at the various ways of managing via futures, forward contracts, options and money market hedges.

## **Financial Techniques of Managing Transaction Exposure**

We will briefly go over the standard financial methods available for hedging this exposure. The main distinction between transaction exposure and operating exposure is the ease with which one can identify the size of a transaction exposure. This, combined with the fact that it has a well-defined time interval associated with it makes it extremely suitable for hedging with financial instruments. Among the more standard methods for hedging transaction exposure are:

### **i) Forward Contracts**

When a firm has an agreement to pay (receive) a fixed amount of foreign currency at some date in the future, in most currencies it can obtain a contract today that specifies a price at which it can buy (sell) the foreign currency at the specified date in the future. This essentially converts the uncertain future home currency value of this liability (asset) into a certain home currency value to be received on the specified date, independent of the change in the exchange rate over the remaining life of the contract.

### **ii) Futures Contracts**

These are equivalent to forward contracts in function, although they differ in several important features. Futures contracts are exchange traded and therefore have standardized and limited contract sizes, maturity dates, initial collateral, and several other features. Given that futures contracts are available in only certain sizes, maturities and currencies, it is generally not possible to get an exactly offsetting position to totally eliminate the exposure. The futures contracts, unlike forward contracts, are traded on an exchange and have a liquid secondary market that make them easier to unwind or close out in case the contract timing does not match the exposure timing. In addition, the exchange requires position taker to post a bond (margins) based upon the value of their positions. This virtually eliminates the credit risk involved in trading in futures.

### iii) Money Market Hedge

Also known as a synthetic forward contract, this method utilizes the fact from covered interest parity, that the forward price must be exactly equal to the current spot exchange rate times the ratio of the two currencies' riskless returns. It can also be thought of as a form of financing for the foreign currency transaction. A firm that has an agreement to pay foreign currency at a specified date in the future can determine the present value of the foreign currency obligation at the foreign currency lending rate and convert the appropriate amount of home currency given the current spot exchange rate. This converts the obligation into a home currency payable and eliminates all exchange risk. Similarly a firm that has an agreement to receive foreign currency at a specified date in the future can determine the present value of the foreign currency receipt at the foreign currency borrowing rate and borrow this amount of foreign currency and convert it into home currency at the current spot exchange rate. Since as a pure hedging need, this transaction replicates a forward, except with an additional transaction, it will usually be dominated by a forward (or futures) for such purposes; however, if the firm needs to hedge and also needs some short term debt financing, wants to pay off some previously higher rate borrowing early, or has the home currency cash sitting around, this route may be more attractive than a forward contract.

### iv) Options

Foreign currency options are contracts that have an up front fee, and give the owner the right, but not the obligation to trade domestic currency for foreign currency (or vice versa) in a specified quantity at a specified price over a specified time period. There are many different variations on options: puts and calls, European style, American style, and future-style etc. The key difference between an option and the three hedging techniques above is that an option has a nonlinear payoff profile. They allow the removal of downside risk without cutting off the benefit from upside risk.

There are different kinds of options depending on the exercise time the determination of the payoff price or the possibility of a payoff. While many different varieties exist, there are a few that corporations have found useful for the purposes of hedging transaction exposures.

One of these is the average rate (or Asian or Look back) option. This option has as its payoff price, not the spot price but the average spot price over the life of the contract. Thus these options can be useful to a firm that has a steady stream on inflows or outflows in a particular currency over time. One large average rate option will basically act as a hedge for the entire stream of transaction. Moreover, the firms will lock in an average exchange

rate over the period no worse than that of the strike price of this option. Finally, because the average rate is less volatile than the end of period rate (remember the average smoothes volatility this option will be cheaper than equivalent standard options. Thus the firms obtains in a single instrument hedging for a stream of transaction so reduces transaction costs plus benefits from the “hedging” over time of the averaging effect.

Another popular exotic option for corporations is the basket rate option. Rather than buy options on a bunch of currencies individually, the firms can buy an option based upon some weighted average of currencies that match its transaction pattern. Here again since currencies are not perfectly correlated the average exchange rate will be less volatile and this option will therefore be less expensive. There firm can take advantage of its own natural diversification of currency risk and hedge only the remaining risk.

### **Transaction Hedging Under Uncertainty**

Uncertainty about either the timing or the existence of an exposure does not provide valid arguments against hedging.

#### *Uncertainty about Transaction Date:*

Many corporate treasurers loath to commit themselves to the early protection of foreign currency cash flow.

Often the reason is that, although they are sure a foreign currency transaction will occur, they are unsure as of the exact date that the transaction will occur. These fears arising from a possible mismatch of maturities of transaction and hedge are unfounded. Through the mechanism of rolling or early unwinding, financial contracts leave open the possibility of adjusting the maturity at a later date, when more precise information is available. The resulting risk borne from the maturity mismatch is usually quite small relative to the total risk of leaving a transaction exposed until better information becomes available. Consider the example of a French exporter who had been expecting to receive, from a foreign purchaser, a payment of \$1 million at a future date  $t$ . Early on, he had hedged himself by selling forward the \$1m at a forward price of  $\$1 = \text{FF}6.200$ . Come date  $t$ , he is informed that his foreign customer will pay one month later at date  $t+1$ . Thus, at date  $t$  the French producer must roll over his forward contract on the basis of the then prevailing rates:

Spot rate at  $t$  (FF/\$): 5.9375 / 405

One-Month Franc Discount 74 / 100 (Outright Forward 5.9449 / 5.9505)

### **Uncertainty about Existence of Exposure:**

Another form of uncertainty that arises regarding transaction exposure is in submitting bids with prices fixed in foreign currency for future contracts. If and when a bid is accepted, the firm will either pay or receive foreign currency denominated cash flows. This is a special source of exchange rate risk as it is a contingent transaction exposure. In such cases, an option is ideally suited. As mentioned above, the firm is really interested in insurance against adverse exchange rate movements between the time the bid is submitted and the time it may be accepted. Thus an option can be used to protect the value of the foreign currency cash flows associated with the bid against adverse currency movements. The cost of the option, which can be included in the bid, protects the value of the expected cash flows from falling below a predetermined level and represents the most the firm can lose due to currency risk. Under such a situation there are four possible outcomes: the bid is either accepted or rejected and the option is either exercised or let to expire.

### **Operational Techniques for Managing Transaction Exposure**

Transaction exposures can also be managed by adopting operational strategies that have the virtue of offsetting existing foreign currency exposure. These techniques are especially important when well functioning forward and derivative market do not exist for the contracted foreign currencies.

#### **These strategies include:**

- i) Risk Shifting- The most obvious way to reduce the exposure is to not have an exposure. By invoicing all transactions in the home currency a firm can avoid transaction exposure all together. However, this technique can not work for every one since someone must bear transaction exposure for a foreign currency transaction. Generally the firm that will bear the risk is the one that can do so at the lowest cost. Of course, the decision on who bears the currency risk may also impact the final price at which the contract is set.
- ii) Currency risk sharing - An alternative to trying to avoid the currency risk is to have the two parties to the transaction share the risk. Since short terms transaction exposure is roughly a zero sum game, one party's loss is the other party's gain. Thus, the contract may be written in such a way that any change in the exchange rate from an agreed upon rate for the date for the transaction will be split between the two parties. For example a U.S. firm A contracts to pay a foreign firm B FC100 in 6 months based upon an agreed on spot rate for six months from now of

$\$1 = \text{FC}10$ , thus costing the U.S. firm \$10. However, under risk sharing the U.S. firm and the foreign firm agree to share the exchange rate gain or loss faced by the U.S. firm by adjusting the FC price of the good accordingly. Thus, if the rate in 6 months turns out to be  $\$1 = \text{FC}12$ , then rather than only costing the U.S. firm  $\$100/12 = \$8.50$ , the \$1.50 gain over the agreed upon rate is split between the firms resulting in the U.S. firm paying \$9.25 and the foreign firm receiving FC 111. Alternatively if the exchange rate had fallen to  $\$1 = \text{FC}8$ , then instead of paying \$12.50 for the good, the exchange rate loss to the U.S. firm is shared and it only pays \$11.25 and the foreign firm accepts FC90. Note that this does not eliminate the transaction exposure, it simply splits it.

- iii) Leading and Lagging - Another operating strategy to reduce transaction gains and losses involves playing with the timing of foreign currency cash flows. When the foreign currency in which an existing nominal contract is denominated is appreciating, you would like to pay off the liabilities early and take the receivables later. The former is known as leading and the latter is known as lagging. Of course when the foreign currency in which a nominal contract is denominated is depreciating, you would like to take the receivables early and pay off the liabilities later.
- iv) Re invoicing Centers - A re invoicing center is a separate corporate subsidiary that manages in one location all transaction exposure from intra company trade. The manufacturing affiliate sells the goods to the foreign distribution affiliates only by selling to the re invoicing center. The re invoicing center then sells the good to the foreign distribution affiliate. The importance of the re invoicing center is that the transactions with each affiliate are carried out in the affiliates local currency, and the re invoicing center absorbs all the transaction exposure. Three main advantages exist to re invoicing centers: the gains associated with centralized management of transaction exposures from within company sales, the ability to set foreign currency prices in advance to assist foreign affiliates budgeting processes, and an improved ability to manage intra affiliate cash flows as all affiliates settle their intra company accounts in their local currency. Re invoicing centers are usually an offshore (third country) affiliate in order to qualify for local non resident status and gain from the potential tax and currency market access benefits that arise with that distinction.

### **Information System for Exposure Management**

Effective exposure management requires a well designed management information system (MIS). Exposure above a certain minimum size must be immediately reported to the executive or department responsible for exposure management. The three types of exposure transactions, translation and operating must be clearly separated. In the case

of cash flow exposures, the report must state the timing and amount of foreign currency cash flows, whether either or both are known with certainty or, if uncertain the degree of uncertainty associated with the timing or amount. The exposure management team must evolve a procedure of assessing the risk associated with these exposures by adopting a clearly articulated forecasting method scenario approach. The benchmark for comparing the alternative scenarios must be clearly stated. As argued above, the appropriate benchmark for short term transactions exposures is the relevant forward rate.

If a discretionary hedging posture is to be adopted, stop loss guidelines must be clearly articulated. These can take the form of specified levels of forward rate or specified changes in the spot rate which when crossed would automatically trigger appropriate hedging actions.

All exposed positions including their hedges if any should be monitored at frequent intervals to estimate mark-to-market value of the entire portfolio consisting of the underlying exposures and their corresponding hedges.

When a particular exposure is extinguished, a performance assessment must be carried out by comparing the actual all in rate achieved with the benchmark. This should be done at regular intervals with the frequency of assessment being determined by the size of exposures and their time profiles. Periodic reviews must be carried out to ensure that the risk scenarios being considered are not far removed from actual developments in exchange rates due to large forecasting errors.

Effective management of operating exposures requires far more information and judgmental inputs from operating managers. Pricing and sourcing decisions must involve the exchange rate dimension and its likely impact on future operating cash flows. A strategic review of the entire business model must incorporate realistic assessment of the impact of exchange rate fluctuations on the firm's entire operations in the medium to long term

### **Self Assessment Questions**

1. What is currency risk? State the causes of currency risk.
2. Explain different types of currency risk.
3. What is transaction exposure? Explain the financial techniques of managing transaction exposure.

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## Lesson 4.2 - Translation Exposure

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### Learning Objectives

*After reading this chapter you will be able to:*

- Explain concept and Measurement of translation exposure.
- Understand the techniques and methods transaction exposure management.
- Differentiate transaction exposure and Translation exposure.
- Evaluate the Exchange Risk Management.
- Understand operating exposure and its measurement.

### Translation Exposure

Translation exposure is also referred to as accounting exposure or balance sheet exposure. The restatement of foreign currency financial statements in terms of a reporting currency is termed translation. The exposure arises from the periodic need to report consolidated worldwide operations of a group in one reporting currency and to give some indication of the financial position of that group at those times in that currency.

Translation exposure is measured at the time of translating foreign financial statements for reporting purposes and indicates or exposes the possibility that the foreign currency denominated financial statement elements can change and give rise to further translation gains or losses, depending on the movement that takes place in the currencies concerned after the reporting date. Such translation gains and losses may well reverse in future accounting periods but do not, in themselves, represent realized cash flows unless, and until, the assets and liabilities are settled or liquidated in whole or in part.

This type of exposure does not, therefore, require management action unless there are particular covenants, e.g., regarding gearing profiles in a loan agreement, that may be breached by the translated domestic currency position, or if management believes that translation gains or losses will materially affect the value of the business. International Accounting Standards set out best practice.



A firm which has subsidiaries and assets in another country is subject to translation exposure. Translation exposure results as a consequence of the fact that a parent company must consolidate all of the operations of its subsidiaries into its own financial statements.

Since a foreign subsidiary's assets are carried on its books in a foreign currency, it is necessary to convert the foreign values into domestic currency for combining with the parent's assets.

Fluctuating exchange rates, results in gains and losses occurring during the translation process. Since this type of exposure is related to balance sheet assets and liabilities, it is often referred to as accounting exposure.

The primary issue related to the translation of foreign asset values has to do with whether the proper exchange rate to use is the current rate of exchange or the historic rate of exchange that existed at the time that an asset was acquired. In order to see the possible gains and losses that can occur, let's consider the following:

A U.S. company has a Mexican subsidiary that buys an asset for 12 million pesos in 20x1 when the exchange rate is 12 pesos per USD. Over the following year, inflation in Mexico is 50% while in the U.S. it is 0%. Of course, if purchasing power parity holds, then the exchange rate in one year should be 18 pesos per dollar.

If we use historical cost accounting, the asset will have a value of 12 million pesos on the Mexican subsidiary's books. Translating this at the current exchange rate of 18 pesos/USD yields a US dollar value of

$$= \frac{12,000,000 \text{ pesos}}{18 \text{ pesos/USD}} = \text{USD } 666,667$$

If we translate the historical cost of 12 million pesos at the historical exchange rate at the time of acquisition of 12 pesos/USD we get a US dollar value of

$$= \frac{12,000,000 \text{ pesos}}{12 \text{ pesos/USD}} = \text{USD } 1,000,000$$

Thus, the correct value would be to use the historical exchange rate when the books are kept on an historical cost basis.

On the other hand, Mexico is a country that utilizes an inflation-adjusted (or current) accounting system where assets are indexed for inflation. Thus, the Mexican subsidiary

would carry the asset on the books at 18 million pesos (12 million pesos \* (1+50%) = 18 million pesos). Translating this using the current exchange rate of 18 pesos/USD yields

$$= \frac{18,000,000 \text{ pesos}}{18 \text{ pesos/USD}} = \text{USD } 1,000,000$$

If the historical exchange rate were used, we would obtain the following value:

$$= \frac{18,000,000 \text{ pesos}}{12 \text{ pesos/USD}} = \text{USD } 1,500,000$$

For the proper translation of value, we should either use the historic exchange rate with historical cost accounting or the current exchange rate with current accounting practices. For a foreign currency that has depreciated, we get the following general results (an appreciating currency would yield the opposite results)

In 1981, FASB 52 set the rules for U.S. GAAP accounting in which it stated that all asset and liability accounts must be translated at the *current* rate of exchange. Equity accounts are translated at *historical* rates of exchange. A separate account, "Equity Adjustment from Translation", is used to reflect translation gains and losses. The only exception to this is for assets in countries experiencing *hyperinflation* which is defined as cumulative inflation greater than 100% over a three-year period. In that case, historical exchange rates are allowed for *non-monetary* items (inventory/cost of goods sold, plant & equipment/depreciation).

In any event, translation exposure is not a **real** gain or loss in terms of making or losing money. The *value* of the asset is the value of the asset. The gain or loss results simply from translating from one currency to another. In that sense, one should not really worry about translation exposure (except to the extent that there is a *perceived* gain or loss from unsophisticated users of the financial statements).

This is also referred to as conversion exposure or cash flow exposure. It concerns the actual cash flows involved in setting transactions denominated in a foreign currency. These could include, for example:

- Sales receipts
- Payments for goods and services
- Receipt and/or payment of dividends
- Servicing loan arrangements as regards interest and capital

The existence of an exposure alerts one to the fact that any change in currency rates, between the time the transaction is initiated and the time it is settled, will most likely alter the originally perceived financial result of the transaction.

It is, for example, important to commence monitoring the exposure from the time a foreign currency commitment becomes a possibility, not merely when an order is initiated or when delivery takes place.

The financial or conversion gain or loss is the difference between the actual cash flow in the domestic currency and the cash flow as calculated at the time the transaction was initiated, i.e., the date when the transaction clearly transferred the risks and rewards of ownership. Where financing of a transaction takes place, such as a loan obligation, there are also gains/losses which may result.

### **Measurement of Translation Exposure**

Translation exposure measures the effect of an exchange rate change on published financial statements of a firm.

- Assets & liabilities that are translated at the current exchange rate are considered to be exposed (uncovered) as the balance sheet will be affected by fluctuations in currency values over time.
- Assets & liabilities that are translated at a historical exchange rate will be regarded as not exposed as they will not be affected by exchange rate fluctuations.
- So, the difference between exposed assets & exposed liabilities is called translation exposure.

**Translation Exposure = Exposed Assets - Exposed Liabilities**  
**(Change in the Exchange Rate)**

Under the generally accepted US accounting principles, the net monetary asset position of a subsidiary is used to measure its parent's foreign exchange exposure. The net monetary asset position is monetary assets such as cash & accounts receivable minus monetary liabilities such as accounts payable & long-term debt.

The translation of gains & losses does not involve actual cash flows – these gains or losses are purely on paper i.e. they are of an accounting nature.

### **STEPS for Measuring Translation Exposure are:**

1. Determine functional currency.
2. Translate using temporal method recording gains/losses in the income statement as realized
3. Translate using current method recording gains/losses in the balance sheet & as realized
4. Consolidate into parent company financial statements.

### ***Economic Exposure***

*Economic exposure* or operational exposure moves outside of the accounting context and has to do with the strategic evaluation of foreign transactions and relationships. It concerns the implications of any changes in future cash flows which may arise on particular transactions of an enterprise because of changes in exchange rates, or on its operating position within its chosen markets. Its determination requires an understanding of the structure of the markets in which an enterprise and its competitors obtain capital, labour, materials, services and customers. Identification of this exposure focuses attention on that component of an enterprise's value that is dependent on or vulnerable to future exchange rate movements. This has bearing on a corporation's commitment, competitiveness and viability in its involvement in both foreign and domestic markets.

Thus, economic exposure refers to the possibility that the value of the enterprise, defined as the net present value of future after tax cash flows, will change when exchange rates change.

*Economic exposure* will almost certainly be many times more significant than either transaction or translation exposure for the long term well-being of the enterprise. By its very nature, it is subjective and variable, due *in part* to the need to estimate future cash flows in foreign currencies. The enterprise needs to plan its strategy, and to make operational decisions in the best way possible, to optimize its position in anticipation of changes in economic conditions.

### **Identification of Exposure**

The three types of exposure mentioned earlier require to be identified, classified and collated in terms of the foreign currencies involved and their related time frame. This is crucial for management reporting within an enterprise. At no time should the enterprise lose sight of the overall position in the process of managing any one particular type of exposure.

### Self Assessment Questions

1. What is translation exposure?
2. Distinguish between transaction and translation exposure?
3. How do you measure translation exposure?

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## Lesson 4.3 - Operating /Economic Exposure

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### Learning Objectives

After reading this chapter you will be able to:

- Evaluate the Exchange Risk Management.
- Understand operating exposure
- Know the Measurement of operating exposure
- Understand the management of operating exposure

### Operating Exposure

Operating exposure is known as **economic exposure**. The extent to which the value of the firm changes when the exchange rate changes (value is measured as the present value of expected future cash flows)

Suppose

PV = present value of the firm

$\Delta PV$  = change in present value of the firm

$\Delta S$  = change in exchange rate

If  $\Delta PV/\Delta S \neq 0$ , then the firm is exposed to currency risk (i.e., operating exposure)

Operating exposure arises because currency fluctuations can alter a firm's future revenues and costs (i.e., its operating cash flows).

### Managing Operating Exposure

Long-term; Techniques involve:

## Marketing Management

### A. Market Selection

To examine which markets to sell products (strong currency market vs. weak currency market). Sell in multiple markets to take advantage of economies of scale and diversification of exchange rate risk.

(Example: Mexican peso devalued in December 1994. The sale of Goodyear tires of Mexican plant plunged more than 20% (i.e., a drop of 3,500 tires per day) in Mexico. The plant changed its sale strategy quickly and exported tires to U.S., South America, and Europe.)

### B. Pricing Strategy

Emphasize on market share or profit margin. Exporters will benefit from a weak home currency and can either increase price or increase market share.

### C. Product Strategy

New products, product line decisions, and product innovation (through R&D), VW sold very inexpensive vehicles in the early 1970s, but the appreciation of the DM caused VW to keep lowering prices to maintain market share. VW lost over \$300 million in 1974. VW altered their strategy to sell more expensive cars with higher quality. Successful R&D allows for cost cutting, enhanced productivity, and product differentiation

## Production Management

A. **Product Sourcing:** purchase components overseas (outsource components)

B. **Plant Location:** shift production to lower cost sites. Increase production in a country with a weaker currency, and decrease production in a country with a stronger currency (e.g., Honda built North American factories in response to strong yen, but later Honda imported the cars from Japan because of a weak yen).

C. **Increase Productivity:** close inefficient plants, high automation

## Financial Hedging

It involves the use of currency swaps, currency futures, currency forwards, and currency options.

### ***Proactive Management***

Six of the most commonly employed proactive policies are

- Matching currency cash flows
- Risk-sharing agreements
- Back-to-back loans
- Currency swaps
- Leads and lags (pay early and pay late)
- Re invoicing centers

### ***Matching Currency Cash Flows***

- One way to offset an anticipated continuous exposure to a particular currency is to acquire debt denominated in that currency
- This policy results in a continuous receipt of payment and a continuous outflow in the same currency
- This can sometimes occur through the conduct of regular operations and is referred to as a ***natural hedge***

### ***Risk-Sharing Agreements***

Risk-sharing is a contractual arrangement in which the buyer and seller agree to share or split currency movement impacts on payments

### ***Parallel Loan***

A *back-to-back loan*, also referred to as a *parallel loan* or *credit swap*, occurs when two firms in different countries arrange to borrow each other's currency for a specific period of time

- The operation is conducted outside the FOREX markets, although spot rates may be used to decide the equivalent amount
- This swap creates a covered hedge against exchange loss, since each company, on its own books, borrows the same currency it repays



## Currency Swaps

- *Currency swaps* resemble back-to-back loans except that it does not appear on a firm's balance sheet.
- In a currency swap, a dealer and a firm agree to exchange an equivalent amount of two different currencies for a specified period of time
  - Currency swaps can be negotiated for a wide range of maturities
- A typical currency swap requires two firms to borrow funds in the markets and currencies in which they are best known or get the best rates

## Leads and Lags: Re-Timing the Transfer of Funds

- Firms can reduce both operating and transaction exposure by accelerating or decelerating the timing of payments that must be made or received in foreign currencies
  - To *lead* is to pay early
  - To *lag* is to pay late
- Leading and lagging can be done between related firms (intracompany) or with independent firms (intercompany)
- Leading and lagging **between related firms** is more feasible because they presumably share a common set of goals for the consolidated group
- In the case of financing cash flows with foreign subsidiaries, there is an additional motivation for early or late payments to position funds for liquidity reasons
- For example, a subsidiary which is allowed to lag payments to the parent company is in reality "borrowing" from the parent company
- Leading or lagging **between independent firms** requires the time preference of one firm to be imposed to the detriment of the other firm
- For example, Trident Europe may wish to lead in collecting its Brazilian accounts receivable (A/R) that are denominated in real because it expects the real to drop in value compared with the euro
- However, the only way the Brazilians would be willing to pay their accounts payable early would be for the German creditor to **offer a discount** about equal to the forward discount on the real (or the difference between Brazilian and German interest rates for the period of prepayment)

### **Re-Invoicing Centers**

- ▶ A re-invoicing center is a separate corporate subsidiary that serves as a type of “middle-man” between the parent or related unit in one location and all foreign subsidiaries in a geographic region
- ▶ For example, the U.S. manufacturing unit of Trident Corporation invoices the firm’s re-invoicing center – located within the corporate HQ in Los Angeles – in U.S. dollars
- ▶ However, the physical goods are shipped directly to Trident Brazil
- ▶ The re-invoicing center in turn re-sells to Trident Brazil in Brazilian real
- ▶ Consequently, all operating units deal only in their own currency, and all transaction exposure lies with the re-invoicing center

There are three basic benefits arising from the creation of a re-invoicing center:

- ▶ Manage foreign exchange exposures (specialization; economies of scale)
- ▶ Guarantee the exchange rate for future orders (marketing focus)
- ▶ Manage intra-subsidiary cash flows (hedge residual cash flows)

The main disadvantage: an additional corporate unit must be created (setup cost) and a separate set of books must be kept.

### **Management of Currency Risk**

Managers of multinational firms employ a number of foreign exchange hedging strategies in order to protect against exchange rate risk. Transaction exposure is often managed either with the use of the money markets, foreign exchange derivatives such as forward contracts, futures contracts, options, and swaps, or with operational techniques such as currency invoicing, leading and lagging of receipts and payments, and exposure netting.

Firms may exercise alternative strategies to financial hedging for managing their economic or operating exposure, by carefully selecting production sites with a mind for lowering costs, using a policy of flexible sourcing in its supply chain management, diversifying its export market across a greater number of countries, or by implementing strong research and development activities and differentiating its products in pursuit of greater inelasticity and less foreign exchange risk exposure.

Translation exposure is largely dependent on the accounting standards of the home country and the translation methods required by those standards. For example, the United States Federal Accounting Standards Board specifies when and where to use certain methods such as the temporal method and current rate method. Firms can manage translation exposure by performing a balance sheet hedge. Since translation exposure arises from discrepancies between net assets and net liabilities on a balance sheet solely from exchange rate differences. Following this logic, a firm could acquire an appropriate amount of exposed assets or liabilities to balance any outstanding discrepancy. Foreign exchange derivatives may also be used to hedge against translation exposure.

### **Value at Risk**

Practitioners have advanced and regulators have accepted a financial risk management technique called value at risk (VAR), which examines the tail end of a distribution of returns for changes in exchange rates to highlight the outcomes with the worst returns. Banks in Europe have been authorized by the Bank for International Settlements to employ VAR models of their own design in establishing capital requirements for given levels of market risk. Using the VAR model helps risk managers determine the amount that could be lost on an investment portfolio over a certain period of time with a given probability of changes in exchange rates.

### **Self Assessment Questions**

1. What is operating exposure? How do you measure the operating exposure?
2. What are 'Leads' and 'Lags'?

### **CASE STUDY**

The 6 month interest rate (annualized) in Italy and France are 13 percent and 11 percent, respectively. The current exchange rate is Lira 296.10/FF and the 6 month forward rate is Lira 326.50/FF.

- (a) Where should a French investor invest?
- (b) Where should be borrow from?
- (c) Is there any arbitrage opportunity for the investor?

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## UNIT - V

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### Lesson 5.1 - Foreign Direct Investment

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#### Learning Objective

*After reading this chapter you will be able to:*

- Understand meaning and importance of FDI.
- Describe the forms of FDI.
- Analyze FDI in the World.
- Elucidate purpose of overseas investment.
- Discuss the benefits of FDI to the Host Countries.
- Recognize the effects and FDI.

#### Introduction

The international movement of capital, in all variety in forms, aspirations and impacts, is the prominent feature of the economic landscape. Facing deep economic crisis and seeking after effective ways of recovery governments are supposed to be more attentive to economic and not political rationale in their decision-making. It gives for scientists a hope to be heard and motivation to move forward.

The political and economic reforms that swept across the erstwhile communist and socialist countries, economic liberalizations in other countries and the continuing liberalization under the auspices of the WTO have been accelerating the pace of progress towards the borderless world.

Two main types of international capital movement can be distinguished. First is international borrowing and lending which can be seen as inter-temporal trade. Country abundant with capital, exports future consumption at a price of interest rate. Borrowing country imports current consumption at the same price (Krugman, Obstfeld, 1994). The other part of international capital movement takes a different form, that of foreign direct

investment. In most common sense, foreign investment is international capital flows in which a firm in one country creates or expands a subsidiary in another. To put it in other words, it is a measure of foreign ownership of productive assets, such as factories, mines and land. The politicians in our home country seem to have no doubt about the growth effects of foreign capital.

The attraction of foreign direct investments (FDI) is often underlined as a precondition for a successful economic venue by most governments of less developed countries. Strategists in high developed countries seem to be more cautious. Loudly arguing for a free movement of capital, western governments do a lot in restricting the entrance of foreign investors to their own market. Moreover, maybe they have a good reason of doing so.

### **Types of Foreign Investment**

Broadly there are two types of foreign investment, namely, foreign direct investment (FDI) and portfolio investment.

FDI refers to investment in a foreign country where the investor retains control over investment. It typically takes the form of starting a subsidiary, acquiring a stake in an existing firm or starting a joint venture in the foreign country. Direct investment and management of the firms concerned normally go together.

If the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad, it is referred to as portfolio investment. That is, in the case of portfolio investments, the investor uses capital in order to get a return on it, but has not much control over the use of the capital.

FDIs are governed by long-term considerations because these investments cannot be easily liquidated. Hence, factors like long-term political stability, government policy, industrial and economic prospects etc., influence the FDI decision. However, portfolio investments, which can be liquidated fairly easily, are influenced by short term gains. Portfolio investments are generally much more sensitive than FDIs. Direct investors have direct responsibility in the promotion and management of the enterprise. Portfolio investors do not have such direct involvement with promotion and management.

Since the economic liberalization of 1991, there has been a surge in the FDI and portfolio investment in India.

There are mainly two routes for portfolio investments in India, viz. by Foreign Institutional Investors (FIIs) like mutual funds, and through Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs).

GDRs/ADRs and FCCBs are instruments issued by Indian companies in the foreign markets for mobilizing foreign capital by facilitating portfolio investment by foreigners in Indian securities. Since 1992, Indian companies satisfying certain conditions are allowed to access foreign capital markets via Euro Issues. With reference to India, foreign investment may be classified as follows:



**Foreign Direct Investment (FDI)** is a direct investment into production or business in a country by an individual or company in another country, either by buying a company in the target country or by expanding operations of an existing business in that country. Foreign direct investment is in contrast to portfolio investment which is a passive investment in the securities of another country such as stocks and bonds.

Broadly, foreign direct investment includes “mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations and intra company loans”.<sup>[1]</sup> In a narrow sense, foreign direct investment refers just to building new facilities. The numerical FDI figures based on varied definitions are not easily comparable.

As a part of the national accounts of a country, and in regard to the GDP equation  $Y=C+I+G+(X-M)$ , I is investment plus foreign investment, FDI is defined as the net inflows of investment (inflow minus outflow) to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor.<sup>[2]</sup> FDI is the sum of equity capital, other long-term capital, and short-term capital as shown the balance of payments. FDI usually involves participation in management, joint-venture, transfer of technology and expertise. There are two types of FDI: inward and outward, resulting in a *net FDI inflow* (positive or negative) and “stock of foreign direct investment”, which is the cumulative number for a given period. Direct investment excludes investment through purchase of shares.<sup>[3]</sup> FDI is one example of international factor movements

## Forms of FDI

Foreign direct investment incentives may take the following forms:

- Low corporate tax and individual income tax rates
- Tax holidays
- Other types of tax concessions
- Preferential tariffs
- Special economic zones
- EPZ – Export Processing Zones
- Bonded Warehouses
- Maquiladoras
- Investment financial subsidies
- Soft loan or loan guarantees
- Free land or land subsidies
- Relocation & expatriation
- Infrastructure subsidies
- R&D support
- Derogation from regulations (usually for very large projects)

## FDI in World

A 2010 meta-analysis of the effects of foreign direct investment on local firms in developing and transition countries suggests that foreign investment robustly increases local productivity growth. The Commitment to Development Index ranks the “development-friendliness” of rich country investment policies.

### China

FDI in China, also known as RFDI (Renminbi Foreign Direct Investment), has increased considerably in the last decade, reaching \$59.1 billion in the first six months of 2012, making China the largest recipient of foreign direct investment and topping the United States which had \$57.4 billion of FDI. During the global financial crisis FDI fell by over one-third in 2009 but rebounded in 2010.

## India

Foreign investment was introduced in 1991 under Foreign Exchange Management Act (FEMA), driven by then finance minister Manmohan Singh. As Singh subsequently became the prime minister, this has been one of his top political problems, even in the current times.<sup>[9][10]</sup> India disallowed overseas corporate bodies (OCB) to invest in India.<sup>[11]</sup> India imposes cap on equity holding by foreign investors in various sectors, current FDI limit in aviation sector is maximum 49%.

Starting from a baseline of less than \$1 billion in 1990, a 2012 UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010–2012. As per the data, the sectors that attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, US and UK were among the leading sources of FDI. Based on UNCTAD data FDI flows were \$10.4 billion, a drop of 43% from the first half of the last year.

## United States

Broadly speaking, the U.S. has a fundamentally 'open economy' and low barriers to foreign direct investment.

U.S. FDI totaled \$194 billion in 2010. 84% of FDI in the U.S. in 2010 came from or through eight countries: Switzerland, the United Kingdom, Japan, France, Germany, Luxembourg, the Netherlands, and Canada.<sup>[14]</sup> A 2008 study by the Federal Reserve Bank of San Francisco indicated that foreigners hold greater shares of their investment portfolios in the United States if their own countries have less developed financial markets, an effect whose magnitude decreases with income per capita. Countries with fewer capital controls and greater trade with the United States also invest more in U.S. equity and bond markets.

White House data reported in July 1991 found that a total of 5.7 million workers were employed at facilities highly dependent on foreign direct investors. Thus, about 13% of the American manufacturing workforce depended on such investments. The average pay of said jobs was found as around \$70,000 per worker, over 30% higher than the average pay across the entire U.S. workforce.

President Barack Obama said in 2012, "In a global economy, the United States faces increasing competition for the jobs and industries of the future. Taking steps to ensure that we remain the destination of choice for investors around the world will help us win that competition and bring prosperity to our people."



## Benefits of Foreign Direct Investment (Host Country)

Foreign Direct Investment (FDI) has become a very popular means of transfer for capital flows from one country to another. In short, FDI refers to an investment in which an entity for another country invests capital in some income generating assets in another country and maintains full or partial control over such assets acquired.

There are several benefits of foreign direct investment which accrue to both the home country as well as the host country. However, it must be noted that such benefits accrue only when appropriate regulation and an ethical sense of doing business exists with the home country, the host country as well as the foreign investor.

Some benefits of foreign direct investment are mentioned below.

- 1. Technological Gap:** Generally, it is seen that underdeveloped economies or developing economies have a very low level of technology. Although there may be opportunities and resources which can be used to have economically viable production, however, technology may be a huge constraint to utilize such resources. Here, foreign investors from developed countries can provide the needed technical assistance to such countries. The gains can be shared in the form of royalties or a share of profits from such investments.
- 2. Exploitation of Natural Resources:** Many-a-times it is seen that underdeveloped and developing countries have abundant natural resources, but they do not possess the needed technical and managerial expertise to exploit these resources. FDI helps such countries get access to the needed technical expertise resulting in higher income for the governments and local communities.
- 3. Employment Generation:** FDI in a host country results in the generation of jobs for both skilled and unskilled labor. The foreign investors open offices and factories which require people to work. Employment ultimately leads to better living conditions and higher standards of living among the workers.
- 4. Development of Managerial Pool:** Often it is seen that such MNCs develop managerial talent. Firstly, these companies provide their own seasoned and developed managers to setup and run the entity in the host country, while doing so, these managers also seek to develop the next set of managers who will take over the reins and these managers are appointed from the host country mostly due to them having better knowledge of the local market.

## Critical Views on FDI

Positive effects of FDI are more featured in case of green field investment. When FDI takes a form of simple merger and acquisition (M&A) actions positive externalities are much lower if not negative.

In the early stage of market economy, foreign direct investments may produce some externalities in the form of higher employment rates and technology transfers, often filling the “idea gaps” between old and emerging market economies. Nevertheless, they often cause a lot of harm too as not a charity but the aspiration to earn more via cheaper resources-land and labor is the primary aim of investors. Foreign investors can reduce employment by dismissing local workers, by crowding out local businesses that cannot compete with multinationals; technology transfers may not occur if the degree of market integration is insufficient; positive capital flows often turn to negative if investors use cheap local raw materials and resources and sell expensive final goods.

In the years of booming economy, domestic producers in advanced economies are strong enough not to be forced out of business by foreign competitors. The effects of FDI became more positive. Enhanced competition, knowledge and technology spillovers, financial stability of incoming investors can bring externalities that are more positive.

In a high turbulence, economic environment governments need to be strategic and more calculative inviting multinational competitors to operate side by side with home industry. According to numerous literatures effort to attract investment by subsidies and tax breaks can lead to substantial reduction of government revenues, which could otherwise be used to invest in education and infrastructure what ultimately fastens economic growth and increases total welfare.

Manning & Shea (1989) argue that strong economic rationale must lay behind the incentives to attract the FDI, as the economic impact of foreign direct investment is dependent of what form it takes. This includes the type of FDI, sector, scale, duration, location of business, density of local firms in the sector and many other secondary effects. One more aspect that is important is that FDI might serve not only a way of doing money, but also a way of acquiring a certain control, both economical and political, in the host country (Krugman). On an empirical level, there is a body of evidence that suggests possible positive correlation between FDI and economic growth in developing countries. Yet, while much evidence indicates a one-way causality between FDI and growth, there are many indications that the causality may run both ways.

The evidence also appears to suggest that FDI is favorable to economic welfare only if appropriate conditions exist in the host economy. This includes such factors as adequate absorptive capacity and human capital, a capacity of domestic businesses to face and hold out foreign competition, abundance of projects and market gaps that cannot to be filled up by home producers.

Therefore, the article analyses different approaches towards this particular form of international capital movement, namely foreign direct investment. The economic effects of foreign direct investment FDI was an important source of developing country external finance for about 25 years after World War II. Lithuania skipped that period under the veil of command economy. Over the 1970 global role of foreign direct investment declined in importance. During the early 1980s direct investment declined in volume further. FDI in developing countries (this includes Latin America, Asia and Central and Eastern Europe) made a comeback in about 1994.

The reason of eased restrictions on FDI was diminishing lending of commercial banks to developing economies. The composition of external capital underwent a dramatic transformation during this period. Because of the Asian and Russian financial and economic crises, official capital flows in these countries either stagnated or declined. In their place, private capital flows became the major source of external finance for a good number of emerging market economies. Foreign direct investment accounted for only about 30 per cent in early 1980s but over 60 per cent of private capital flows in 2000 and next few years then.

Latest picture is different again. Amid a sharpening financial and economic crisis, global FDI inflows have made one more significant slide down. This slide was from historic high of \$1,979 billion in 2007 to \$ 1,697 billion in 2008, a decline of 14%. The slide continued into 2009. Preliminary data suggest that FDI fell a further 44% compared with their level 2008 (World Investment Report, 2009). Nevertheless, there is a good chance that foreign direct investments will increase rapidly at the first signs of economic stability. Moreover, there is a good chance that the effects of such actions will be very different (depending from countries and firms involved) and not always positive for both investors (core) and host economies.

FDI has an advantage over other investments such as portfolio or loans as it proved to be much more resilient in times of economic crisis. During financial crisis of 1997-98 it was stable compared with other types of investment especially short-term, which were subject to large reversals. The same was apparent during Mexico crisis and Latin American debt crisis of 1980 (Loungani, Razin, 2001). On the other hand, latest events show that during recent crisis some large transnational companies, in example American car producers who

were broadly settled in European Union (Spain, Poland, England), are closing European factories paying little attention on huge negative economic and social distortions.

While claiming that FDI benefits receiving country, encourages growth and development, Neo-liberals would say that countries should open up and let the market to work freely; that all the efforts should be concentrated on attracting FDI because it means development of the country; that every country should welcome FDI because it will improve economic conditions and increase potential of the receiving country's development (Sabonienė2009).

Implementation of this purely Neo- liberal pro- foreign direct investment policy seems to be the only approach recognized by Lithuanian authorities. At least theoretically, While admitting that benefits mentioned above can be provided by FDI many economists have reasonable doubts whether it happens every time in every country. Many scientists strongly disagree that one size fits all. That particular, more cautious approach is characteristic to representatives of so- called Keynesian school. Keynesians argue that if FDI brought benefits in one country it does not necessary mean that the same will happen in another. Many things depend on prevailing conditions in receiving country. This means that the effects should differ not only across countries but also within countries at different time as conditions change.

When attracting FDI governments can use tax cuts, subsidies and many other means. When deciding to slow down the volume of incoming foreign capital governments most commonly use institutional barriers of FDI: ownership restrictions, rate of return restrictions, project approval requirements, trade and financial restrictions etc. China's government proved as very rational decision maker in attracting FDI when economic rationale suggested they should and hampering the flow foreign capital when positive effects approached the apex.

However, often it is difficult for developing country Governments to manage foreign investment to their advantage as there is a large asymmetry in bargaining power between core countries investors on the one hand and host governments - especially those from countries that are poor, lack scarce natural resources and/or small - on the other.

Countries not clearly understanding all the effects that FDI can bring to their economies sometimes engage in such kind of actions which ultimately can actually hamper growth. Epstein (1999) claims that countries trying to attract investment by subsidies and tax breaks can lead to substantial reduction of government revenues which could otherwise be used to invest in education and infrastructure what ultimately creates attractive environment

to FDI it self, fastens economic growth and increases total welfare. Such environment may be even more important than tax breaks. Finally, the country finds itself in a situation when it is not attractive to FDI though their actions should have attracted it.

Finally, not all types of FDI equally contribute to the development of local economy. As it is stated in World Investment Report 1999, “green field investment are likely to encourage development most while mergers and acquisitions (M&A), that entail a simple change of ownership can be of dubious value”.

Unfortunately, time when green field investment was a major form of foreign direct investment is in the past. In the last two decades more and more FDI has taken a form of mergers and acquisitions of domestically owned firms by foreign- owned firms. Most FDI that come to Lithuania have a form of M&A too.

FDI benefits the core industrial economies at the expense of the peripheral underdeveloped countries. As a result FDI can be contributing to increasing world inequality instead of giving positive externalities of FDI.

According to the dependency school, in the long- run, FDI tends to impede economic growth and development of recipient economies. Although underdeveloped countries lack capital and industrial technology, they often are rich in natural resources and/or inexpensive labour.

While income or wealth is created in the host country, it does not lead to an accumulation of wealth that would benefit the host economy. On the contrary, this wealth is transferred to the core countries. Consequently, the core stands to benefit from this structural dichotomy of the host economy because the foreign sector (i.e., the sector associated with FDI) does not benefit the rest of the host country because of lack of integration.

Therefore, there are cases when it is in the interest of the core countries to keep the periphery underdeveloped and dependent on the core.

A distinctive feature of foreign direct investment is that it involves not only a transfer of resources but also the acquisition of control. In some cases the extension of control is the essential purpose of incoming foreign capital. This implicates a necessity to screen foreign investments on economic as well as military grounds.

## Summary

1. The economic rationale for offering special incentives to attract FDI derives from the belief that it will facilitate faster economic growth; produce externalities in form of larger employment, technology transfers, skills to local industry, boosted productivity or filled 'idea gaps' between rich and poor countries.
2. Strong economic rationale must lay behind the incentives to attract the FDI, as the economic impact of foreign direct investment is not always positive. The impact of FDI is dependent of what form it takes. This includes the type of FDI, sector, scale, duration, location of business, density of local firms in the sector and many other secondary effects. Greenfield FDI has more positive externalities; M&A proved to have little positive and often negative effects to host economies.
3. One more aspect that is important is that FDI might serve not only a way of doing money, but also a way of acquiring a certain control, both economical and political, in the host country.
4. There are market failures, imperfect information and different conditions in receiving countries, different needs and level of development which all has to be taken into the consideration while setting an appropriate strategy towards foreign investments. One size cannot fit all.
5. Large country is able to affect its trading partners' accumulation of capital, and so it can alter future market conditions. A danger in attracting FDI is that capital movements can be regulated by perfectly discriminatory policy to maximize the welfare of the large country.
6. Individual strategy needs to be created and properly implemented what would ensure that FDI will provide those benefits and local economy will be able to absorb them. But governments may be imperfect as well as market. The question is then whether market or government failures are more costly for the economy's growth and development.
7. There are cases when incoming capital together with foreign know-how may have positive impact on other domestic firms, not only those receiving a capital from abroad. On the other hand, there is no clear evidence that FDI always has an advantage over other kind's of investment, like loans for developing local businesses.
8. The use of investment incentives focusing on foreign firms is not a recommendable strategy. The main argument in support of this is that the strongest theoretical motive for financial subsidies to inward FDI tends to be based on external effects such as

spillover of technology and human capital, which do not follow automatically from foreign direct investment.

9. Incentives of motivating economic activities should, following the same logic, focus on those activities that create the strongest potential for spillovers, including linkages between foreign-owned and domestic firms, education, training and R&D. Rather than proposing narrowly defined FDI policies, attractive terms to investors should be seen as part of a country's overall industrial policy and be available on equal terms to all investors, foreign as well as domestic.

## **FDI in India**

India provides one of the safest and best investment opportunities in the world and particularly amongst the developing economies due to pro-active government policy for foreign investment and liberalization of the economy. Foreign direct investment (FDI) as a strategic component of investment is indispensable for India to achieve the economic reforms and maintains the pace of growth and development of the economy. India, the largest democracy and 10th largest economy in the world, with its consistent growth performance and abundant high skilled manpower provides enormous opportunities for investment, both domestic and foreign. India is the fourth largest economy in terms of purchase power parity and the tenth most industrialized country in the world. The policy of reforms followed by Government of India in the post-1991 period recognizes the important role of foreign capital in the industrial & economic development of the country. Foreign capital inflow is encouraged not only as source of financial capital but also as a tool of knowledge and technology transfer.

Government of India has taken several initiatives and measures during this period to encourage foreign investment inflows, particularly the flow of Foreign Direct Investment (FDI) into India. Major thrust areas include infrastructure development, particularly energy, power, telecom and township development. FDI in most of the sectors/activities including manufacturing sectors are under the automatic route and require only notifying the Reserve Bank of India. Initiatives have also been taken to make procedures related to transfer of shares and repatriation more simple. The policy & procedures for induction of foreign technology have also been progressively simplified. To create a more conducive investment climate, the procedures governing approvals/clearances are continuously reviewed.

The Government of India has released a comprehensive FDI policy document effective from April 1, 2010. And the government has allowed the Foreign Investment Promotion Board (FIPB), under the Ministry of Commerce and Industry to clear FDI

proposals of up to US\$ 258.3 million. Earlier all project proposals that involved investment of above US\$ 129.2 million were put up before the Cabinet Committee of Economic Affairs (CCEA) for approval. The relaxation would expedite FDI inflow.

In order to have a flow of FDI, India maintained Double Tax Avoidance Agreements (DTAA) with nearly 70 countries of the world. India has signed 57 (up to 2006) numbers of Bilateral Investments Treaties (BITS). The numbers of BITS are signed with developing countries of Asia 16, the Middle East 9, Africa 4, and Latin America 1 apart from the developed nations 27. India as the founding member of General Agreement on Tariffs and Trade (GATT), World Trade Organization (WTO), a signatory member of South Asian Free Trade Area (SAFTA) and a member of Multilateral Investment Guaranty Agency (MIGA) is making its presence felt in the economic landscape of globalised economies which will help a conducive and healthy atmosphere for foreign investors and thus resulting in substantial amount of FDI inflows in the country.

India's infrastructure sector has been in the doldrums for quite some time now because of huge delays in infrastructure projects. The top five sectors attracting FDI during April 2000 to December 2007 are Services Sector, Computer software & hardware, telecommunications, construction activities and automobile industry.

### **Foreign Direct Investments in India are Approved Through Two Routes**

#### ***Automatic Approval by RBI***

The Reserve Bank of India accords automatic approval within a period of two weeks (subject to compliance of norms) to all proposals and permits foreign equity up to 24%; 50%; 51%; 74% and 100% is allowed depending on the category of industries and the sectoral caps applicable. The lists are comprehensive and cover most industries of interest to foreign companies.

Investments in high-priority industries or for trading companies primarily engaged in exporting are given almost automatic approval by the RBI. The extant policy for most of the infrastructure sectors permits FDI up to 100% on the automatic route.

#### ***The FIPB Route – Processing of Non-Automatic Approval Cases***

FIPB stands for Foreign Investment Promotion Board which approves all other cases where the parameters of automatic approval are not met. Normal processing time is 4 to 6 weeks. Its approach is liberal for all sectors and all types of proposals, and rejections are



few. It is not necessary for foreign investors to have a local partner, even when the foreign investor wishes to hold less than the entire equity of the company. The portion of the equity not proposed to be held by the foreign investor can be offered to the public.

Power is an essential input for economic development and improving the quality of life of people. Development of conventional forms of energy for meeting the growing needs of people is the responsibility of the government. In the pre- independence period, the power supply was mainly in the private sector and that too restricted to the urban areas. With the formation of State Electricity Boards during the Five-Year Plans, a significant step was taken in bringing about a systematic growth of power supply for industries all over the country. A number of multi-purpose projects came into being with the setting up of hydro, thermal and nuclear power stations.

India at present is at the threshold of becoming a developed country. Its economy has been growing at a high GDP growth of over 8 per cent per annum. With the increase in population the demand for goods and services is increasing every year. The number of dwelling units in big and small cities is increasing. There is more demand for power to run home appliances in these as well as existing units. To meet this ever increasing demand we need to build a huge power infrastructure.

That is why India has entered into a nuclear deal with America whereby the sole superpower in the world shall provide us with nuclear technology. Many nuclear reactors will be set up in India. The nuclear fuel will be supplied by some of the countries in the Nuclear Suppliers Group (NSG). Nuclear energy will be harnessed to be used for peaceful purposes.

The transportation infrastructure includes roads, vehicles, railways, tracks, trains, ports, airports, ships and vessels. Road transportation is perhaps the most important because the railway tracks cannot be laid everywhere. The roads are the means by which the movement of people and goods from one place to another is ensured. Millions of people move out of their houses everyday to reach their places of work, trade or business daily. They not only generate income from working but also fulfill the needs of others. They use roads and vehicles available to them.

The national highways are mainly used to move from one city to another and for supply of essential goods-food grains and other articles of use from one city to another. Thus, roads are a key to the success of Public Distribution System. If there is no road transportation, the supply of these goods will not be possible to different cities and towns. The whole economy will collapse.

Railways are another important part of transportation infrastructure. India has a huge railway network with a route length of 63,221 km, a fleet of over 7,800 locomotives, 5,340 passenger service vehicles and nearly 5,000 other coaching vehicles. There are 7,031 stations across the length and breadth of the country. The total network is divided into 16 zones. Crores of passengers travel through railways for the job, work and personal needs every day. Thousands of tonnes of goods are taken from one place to another. The transportation of heavy goods like steel and raw material like coal cannot be transported by any other mode of transport than the railways. Apart from performing these vital functions for the economy and the country, the railways are a huge source of revenue for the government. It has also given employment to lakhs of employees directly or indirectly.

Airports and civil aviation are also part of the transportation network in the country. Air travel is fast and highly comfortable. It caters to the needs of rich sections of people and the high executives and political delegates whose time is highly precious. It is also used for speedy transportation of goods, particularly the perishable goods which, if sent through road or railway transport will rot in the way.

In India the civil aviation has three main functional divisions-regulatory, infrastructure and operational. On the operational side India Airlines, Alliance Air, private scheduled airlines and non-scheduled operators provide domestic air services while Air India provides international air services.

Pawan Hans Helicopters Limited provides helicopter services to 11 and Natural Gas Corporation (ONGC) in its offshore operations to inaccessible areas and difficult terrains. Sahara Airlines and Jet Airways have also been permitted to operate on international sector. In order to help the Indian exporters and make their exports more competitive, the government introduced an 'open sky policy' for cargo.

Under this policy, foreign airlines or associations of exporters can bring any freighters to the country for the up liftment of cargo. Charter flights for tourists are also allowed to and from India. Thus, air services infrastructure plays a key role in civil aviation, international flights and cargo transportation. It benefits the economy immensely and earns millions of rupees every year for the country.

India has a coastline of over 7500 km which is serviced by 12 major ports and 186 other ports. The major ports are under the purview of the central government while the minor ports come under the jurisdiction of the respective state governments. The major ports are: Mumbai, Nhava Sheva, Kandla, Marmugao, Mangalore, Cochin, on the west coast; Kolkata, Haldia, Paradip, Visakhapatnam, Chennai, Ennore, and Tuticorin on the east coast.

These ports have a capacity of over 450 million tonnes. The number of cargo vessels handled at these ports is about 16,500 per annum. The cargo handled is liquid cargo, dry cargo and container cargo. In order to improve the efficiency, productivity and quality of services and to bring competitiveness in port services, the government has encouraged private participation in it in the wake of liberalisation and Globalisation of the economy. The Eleventh Plan outlay for port sector is around ₹ 6,500 crore.

If one sector has developed more than any other sector during the last one decade or so, it is the communication sector. It encompasses the postal network, mail system, telecommunications, including telephones, mobile phone services, etc.

The postal service is catering to the mailing, telegraphic services which have now been supplemented by courier services. India has a huge infrastructure for postal and telecommunication services whereby letters, parcels and messages are sent to various parts of the country and abroad. Mobile phone services are the buzzword of our society now. Several companies like Bharti Airtel, Reliance Communication, Hutch and Vodafone are flourishing apart from the public sector MTNL.

Infrastructure is the base on which all economic activities of the country depend. The government is spending thousands of crores of rupees every year to create this infrastructure where it does not exist or is not fully functional. It has also established adequate systems for their maintenance and upkeep so that it remains efficient and durable.

FDI up to 100% is allowed under the automatic route in all activities/sectors except few sectors, which require Government Approvals. Recent changes have allowed Foreign Direct Investments even in retail sector, which had been a long pending demand of Foreign Investors.

Infini Juridique, being one of the leading Corporate Law Firms in India, is well equipped to advise and assist its clients on matters related to investment in India. The Firm not only advises how to structure the investment, but also provides necessary assistance in incorporating the Company in India; provide secretarial assistance and temporary address for registered office. The Firm also handles liaison activity with various government offices for necessary clarification/approval.

**In the renewable energy sector**, wind energy has emerged as the fastest growing category. The wind energy sector has attracted foreign direct investment of ₹ 1,510 crore over the past three years.

An investment of about ₹ 1,510 crore has been received as FDI in the wind energy sector during the last three years and the current year (up to June 2011),” he said. The Minister was responding to a query on whether the FDI in wind energy is nominal.

The Government allows 100 per cent FDI in the renewable energy generation and distribution projects including wind energy, subject to provisions of the Electricity Act 2003.

A total wind power capacity of 14,723 MW has already been installed up to July 2011 in various States. Of this 42 per cent capacity has been installed in Tamil Nadu.

A target of 9,000 MW wind power capacity addition has been fixed for the 11<sup>th</sup> Five-Year Plan. Out of this, 7,629 MW capacity has already been set up and the balance is expected in the remaining period of the current financial year.

Besides existing policy enablers under the Electricity Act, the other key initiatives taken in the recent past to attract foreign investment in wind energy include introduction of a generation-based incentive scheme for wind power projects which do not avail themselves of accelerated growth of depreciation.

### **100% FDI Permitted in Power Sector**

The Minister of State (Independent Charge) for Power Shri Jyotiraditya Scindia informed Lok Sabha today that as per extant policy, Foreign Direct Investment (FDI) up to 100% is permitted in the power sector, under the automatic route, for:

- i) Generation and transmission of electric energy produced in hydro electric, coal/ lignite based thermal, oil based thermal and gas based thermal power plants;
- ii) Non-Conventional Energy Generation and Distribution;
- iii) Distribution of electric energy to households, industrial, commercial and other users; and
- iv) Power Trading.

Accordingly, any foreign power company can enter power sector through FDI route. Further, several global power plant equipment manufacturing companies from Japan, Europe and USA have formed Joint Ventures with Indian Companies for establishing manufacturing base in India for the manufacture of supercritical boilers/turbine generators and technology transfer. The companies are Mitsubishi Heavy Industries Ltd., Japan with

L&T at Gujarat; Hitachi, Japan with BGR at Tamil Nadu; Toshiba, Japan with JSW at Tamil Nadu; Alstom, France with Bharat Forge at Gujarat; Ansaldo Caldie, Italy with Gammon at Tamil Nadu; Babcock & Wilcox, USA with Thermax at Maharashtra; Hitachi Power Europe GmbH (Germany) with BGR at Tamil Nadu. Doosan, Korea (100% FDI) has come to establish its manufacturing facilities on their own strength in Tamil Nadu.

Besides, CLP India Pvt. Ltd., a wholly owned subsidiary of CLP Holdings has set up a 1320 MW thermal power project at Haryana. In addition, M/s. AES (Chhattisgarh Energy Pvt. Ltd.) proposes to setup 2x660 MW Thermal Power Project in Chhattisgarh and Odisha Power Generation Corporation Ltd. (A Joint Venture of Govt. of Odisha & AES Corp. USA) also proposes to setup a new Thermal Power Project (2x 660 MW) in Odisha.

### **Current Trend in FDI**

The FDI agenda has not been restricted to raising caps or allowing more sectors, but has been focused on removing red tapism and boosting the speed of FDI inflow. The government is now encouraged FDI entry via the automatic route rather than through the cumbersome Foreign Investment Protection Board (FIPB) of the past. To note, analysts blamed lingering clearance process of the FIPB as one of the reasons of the foreign investors' lack of interest in India.

Prime Minister Manmohan Singh wants to plain away the bureaucratic bump and allow the investors a smooth investment route. This becomes obvious given the experience of the last reform with hiking FDI cap, which was not encouraging.

Widening the door for FDI through reform is a welcome step. But it is not a long term solution. It is basically easy money and it can fly away at a much faster rate than it arrives.

“For FDI Investment, there are far too many procedural bureaucratic issues. Just raising the limit is not good enough to bring FDI into India. Bureaucratic problems, land acquisition issues and serious protests, railway creating bottlenecks if road have to pass over or under it have create problems. Many domestic investors in infrastructure like roads and metros are going out of business or becoming bankrupt like many power projects. For instance, GMR, GVK and some other are going out of some road projects. Relicense was involved in the Delhi and Mumbai Metro Projects. Now it has out of Delhi and I do not know how long it will be before the same happens with Mumbai.

### FDI: The Last Package

Sector	Existing	Proposed
Petroleum & Natural Gas	49% FIPB	49% automatic
Insurance & Pension	26% automatic	49% automatic
Single brand retail	100% FIPB	49% automatic. 49% <FIPB
Telecom	74% FDI cap, 49% through automatic. 49% <FIPB	100% FDI cap, 49% through automatic. 49% <FIPB
Stock Exchange	49% FIPB	49% automatic
Courier Service	-	100% automatic
Tea Garden	-	100% FDI cap, 49% through automatic. 49% <FIPB

In 2013, caps on FDI were increased and in some other cases, the automatic route was opened. Historically, FDI implementation has happened in two ways. One is a success story like in the case of mobile industry, the internet, the TV, automatic sectors, etc. In these sectors, production and employment had increased significantly. But in the case of retail and service sectors, the scenario is different, primarily because the Government has never been confident about what impact it would have on the vote banks, of which 60-70% are constituted by lower income group citizens.

Moreover, there's has been a lack of a detailed industrial policy and a roadmap, which was present in, say, the case of automatic industry. Profitability of the retail companies is the biggest concern because there are many conditions set by the government such as backend procurement and rural concentration.

FDI in retail or Insurance is not going to transform our dismal India economy of today. The real FDI India needs is an infrastructure: power plants, rail, airports, roads, telecom, etc. power is not a profitable business any more. Telecom is also not doing – well but recent policy changes especially on FDI might change the situation.

For instance, the mindset is the biggest challenge; we do not welcome FDI in many vital sectors such as railways and defense. Defense could benefit our speed of procurement and the economy. But Delhi is still carrying the mentality of Indira Gandhi's pseudo socialism and not serious about allowing fostering direct investment”.

So, is FDI the solution of our economic woes? Will foreign investments help boost our investment climate when domestic investors seem uninterested in the task. Ojha makes

an interesting point when it comes to reforms via FDI. Empirical results of some studies have shown that during 1990-91 and 2010-11. FDI has contributed much of the economic growth.

Causality test also confirmed a unidirectional causality from economic growth of FDI and not the other way round. In India, true potential of FDI could not be realized because of the absence of certain preconditions in the form of sound physical and social infrastructure, improved human resource, and stable macroeconomic framework.

The debates will on FDI, reforms and growth will go on. But the fact is that India needs foreign funds to supplement its own limited resources to expand its production processes, generate more jobs and to achieve higher GDP growth. And if the present reform fails to bring in funds, the country has to wait and design a more investor friendly reform agenda in the future.

## **The 2012 Edition**

### **FDI in Multi – Brand Retail**

The government cleared the proposal to allow up to 51% FDI in Multi-brand retail. The government has allowed the FDI on condition that seats will be allowed to decide whether they want to opt for it.

### **FDI in Single Brand Retail**

It is a 100% single brand FDI notification with the requirement of 30% local sourcing. The move would allow global firms such as Wal-Mart Stores to set up shop with a local partner and sell directly to consumers for the first time.

### **FDI in Insurance and Pension**

49% FDI was allowed in insurance and Pension here. Change in the companies' bill was also proposed.

### **FDI in Aviation**

Government decided to allow foreign airlines to buy up to 49% stake in local carriers. The foreign investment limit of 49% in local airlines includes both foreign institutional investments and foreign direct investment.

## FDI in Broadcast

Government decided to raise FDI cap to 74% in various services of the broadcast sector, except TV news channels and FM radio where the cap of 26% will apply. 74% FDI was allowed in mobile TV which is an area of future growth.

## Political Risk

**Political risk** is a type of risk faced by investors, corporations, and governments. It is a risk that can be understood and managed with reasoned foresight and investment.

Broadly, political risk refers to the complications businesses and governments may face as a result of what are commonly referred to as political decisions—or “any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives”<sup>[1]</sup> Political risk faced by firms can be defined as “the risk of a strategic, financial, or personnel loss for a firm because of such nonmarket factors as macroeconomic and social policies (fiscal, monetary, trade, investment, industrial, income, labour, and developmental), or events related to political instability (terrorism, riots, coups, civil war, and insurrection).” Portfolio investors may face similar financial losses.

Moreover, governments may face complications in their ability to execute diplomatic, military or other initiatives as a result of political risk.

A low level of political risk in a given country does not necessarily correspond to a high degree of political freedom. Indeed, some of the more stable states are also the most authoritarian. Long-term assessments of political risk must account for the danger that a politically oppressive environment is only stable as long as top-down control is maintained and citizens prevented from a free exchange of ideas and goods with the outside world.

Understanding risk partly as probability and partly as impact provides insight into political risk. For a business, the implication for political risk is that there is a measure of likelihood that political events may complicate its pursuit of earnings through direct impacts (such as taxes or fees) or indirect impacts (such as opportunity cost forgone).

As a result, political risk is similar to an expected value such that the likelihood of a political event occurring may reduce the desirability of that investment by reducing its anticipated returns.



There are both macro- and micro-level political risks. Macro-level political risks have similar impacts across all foreign actors in a given location. While these are included in country risk analysis, it would be incorrect to equate macro-level political risk analysis with country risk as country risk only looks at national-level risks and also includes financial and economic risks. Micro-level risks focus on sector, firm, or project specific risk.

### **Macro-Level Political Risk**

Macro-level political risk looks at non-project specific risks. Macro political risks affect all participants in a given country. A common misconception is that macro-level political risk only looks at country-level political risk; however, the coupling of local, national, and regional political events often means that events at the local level may have follow-on effects for stakeholders on a macro-level. Other types of risk include government currency actions, regulatory changes, sovereign credit defaults, endemic corruption, war declarations and government composition changes. These events pose both portfolio investment and foreign direct investment risks that can change the overall suitability of a destination for investment.

Moreover, these events pose risks that can alter the way a foreign government must conduct its affairs as well. Macro political risks also affect the organizations operating in the nations and the result of macro level political risks are like confiscation, causing the seizure of the businesses' property.

Research has shown that macro-level indicators can be quantified and modeled like other types of risk. For example, Eurasia Group produces a political risk index which incorporates four distinct categories of sub-risk into a calculation of macro-level political stability. This Global Political Risk Index can be found in publications like *The Economist*. Other companies which offer publications on macro-level political risk include Economist Intelligence Unit, DaMina Advisors and The PRS Group, Inc. DaMina Advisors is focused on frontier markets such as Africa.

### **Micro-Level Political Risk**

Micro-level political risks are project-specific risks. In addition to the macro political risks, companies have to pay attention to the industry and relative contribution of their firms to the local economy. An examination of these types of political risks might look at how the local political climate in a given region may affect a business endeavor. Micro political risks are more in the favour of local businesses rather than international organizations operating in the nation. This type of risk process includes the project-specific government review

Committee on Foreign Investment in the United States (CFIUS), the selection of dangerous local partners with political power, and expropriation/nationalization of projects and assets.

To extend the CFIUS example above, imagine a Chinese company wished to purchase a U.S. weapons component producer. A micro-level political risk report might include a full analysis of the CFIUS regulatory climate as it directly relates to project components and structuring, as well as analysis of congressional climate and public opinion in the United States toward such a deal.

This type of analysis can prove crucial in the decision-making process of a company assessing whether to pursue such a deal. For instance, Dubai Ports World suffered significant public relations damage from its attempt to purchase the U.S. port operations of P&O, which might have been avoided with more clear understanding of the US climate at the time.

Political risk is also relevant for government project decision-making, whereby government initiatives (be they diplomatic or military or other) may be complicated as a result of political risk. Whereas political risk for business may involve understanding the host government and how its actions and attitudes can affect a business initiative, government political risk analysis requires a keen understanding of politics and policy that includes both the client government as well as the host government of the activity.

### **Self Assessment Questions**

1. What is FDI?
2. What are the forms of FDI?
3. Explain the effects of FDI in India?
4. What are the benefits of FDI (Host country)?

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