International finance

**International finance** (also referred to as **international monetary economics** or **international macroeconomics**) is the branch of [financial economics](https://en.wikipedia.org/wiki/Financial_economics) broadly concerned with [monetary](https://en.wikipedia.org/wiki/Monetary_economics) and [macroeconomic](https://en.wikipedia.org/wiki/Macroeconomics) interrelations between two or more countries.International finance is a section of [financial economics](http://www.investopedia.com/terms/i/investment.asp) that deals with the monetary interactions that occur between two or more countries.  
  
 International finance examines the dynamics of the [global financial system](https://en.wikipedia.org/wiki/Global_financial_system), [international monetary systems](https://en.wikipedia.org/wiki/International_monetary_systems),[balance of payments](https://en.wikipedia.org/wiki/Balance_of_payments), [exchange rates](https://en.wikipedia.org/wiki/Exchange_rates), [foreign direct investment](https://en.wikipedia.org/wiki/Foreign_direct_investment), and how these topics relate to [international trade](https://en.wikipedia.org/wiki/International_trade).

SCOPE OF international finance

International finance is concerned with the following areas

1.**International institutions**:International institutions is an organization with an international membership. There are two types

**a.** international nongovernmental Organisation. These include non profitorganization such as international committee of red cross, world organization of scout movement etc

**b**.intergovernmentalorganisations: These organisations are made primarily of sovereign states, for eg: SAARC, ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT.

**2**. **International markets**: International markets involves recognizing that people all over the world have different needs. The entire globe is one market where any country has the access to any goods of other countries.

**3**.**International finance services**. It invoves the study of international monetary economics, it includes the study of national income, money and prices.

**4.International financial institutions:** These institutions are involved in resolving conflict situations in a country where violations of law are widespread

5. **International Risk management:**it helps in identification of risk, its analysis and consequences for international business. It evaluates risk magnitudes and exposure levels.

**6. Foreign exchange market**: The foreign exchange marketis the network of private citizens, corporations and govt officials that trade oversees curriencies.Foreign exchange markets function as leading economic indicators

7. **Balance of payments**: It is an important component of international finance. The balance of payments account is the accounting system for all international commercial and financial transactions of an individual country.

**Importance or need for international finance**

**Diminishing national boundaries**

* Efficiently produce products in [foreign](https://en.wikipedia.org/wiki/Foreign_corporation) [markets](https://en.wikipedia.org/wiki/Market_(economics))
* Broaden [markets](https://en.wikipedia.org/wiki/Market_(economics)) and diversify
* Earn higher returns

**Rise in global companies**

* Single market
* Competitive advantage, eg Honda has moved a considerable part of its operations to china in order to get competitive advantage of lower labour costs.
* New technologies

International finance has gained importance or the need for international finance is felt due to following reasons

1. Sometimes countries can produce efficiently in foreign markets than that domestically.
2. It is necessary to obtain the essential raw materials needed for production.
3. To broaden markets and diversify.
4. To earn higher returns.
5. Effective financial planning and control.
6. For efficient allocation of funds among various assets.
7. Core factor for success in business operations.

**Issues involved in international finance**

***De-regulation of financial markets***

* Financial deregulation can be referred to a variety of changes in the law which allow financial institution more freedom in how they compete.

*So deregulation is very important as:*

* It helps in creation and expansion of world wide banking structure.

by increasing competition it increases ,it increases efficiency of business also.

But there were *criticisms* also for this excessive deregulation

As according to the UN report a sustained process of deregulation within countries and between countries can lead to global crisis.

*Suggestions*:

Those financial instrument which do not contribute to long term economic growth should be removed, and speculative and risky activities should be encouraged.

***Cross border M and A activity***

* *Mergers*

It refers to legal consolidation of two companies into one entity .

* *Acquisition*

It occurs when one company takes over another and completely established itself as the new owner.

* In 2007 when the economic conditions were good there was an increase of about 27% .
* But in 2008 it slowed down because of financial crisis.
* But till 2014 it has increased to *double..*

***Rising popularity of Euro markets***

*Euro market*

* It is a kind of market which is virtually free from regulations ,which provides excellent opportunities for investment ,funding and speculation.
* Also provide risk management products.

***Emergence of MNCs from emerging economies***

* The last two decades have seen the emergence of a large number of multinational companies from emerging economies .
* About 22 MNCs from top 100 infrastructure MNCs are headquartered in developing economies .
* *Example* :TATA

***Integration of markets globally***

* Through integration ,domestic investors can buy foreign asset and foreign investors can buy domestic asset .
* So this gives the investors the freedom and opportunity to raise funds and to invest anywhere in the world, through any type of instrument.
* Integration has lead to redistribution of financial resource from the surplus to deficit countries.

**1**The **global financial system**

**2.The international monetary system**

**3.Balance of payments**

**4. Exchange rate**

**5. Foreign direct investment**

**1**The **global financial system** is the worldwide framework of legal agreements, institutions, and both formal and informal [economic actors](https://en.wikipedia.org/wiki/Agent_(economics)) that together facilitate international flows of [financial capital](https://en.wikipedia.org/wiki/Financial_capital) for purposes of [investment](https://en.wikipedia.org/wiki/Investment) and [trade financing](https://en.wikipedia.org/wiki/Trade_finance). Since emerging in the late 19th century during the first modern wave of [economic globalization](https://en.wikipedia.org/wiki/Economic_globalization), its evolution is marked by the establishment of [central banks](https://en.wikipedia.org/wiki/Central_bank), multilateral treaties, and [intergovernmental organizations](https://en.wikipedia.org/wiki/Intergovernmental_organization) aimed at improving the transparency, regulation, and effectiveness of international markets

**2.The international monetary system**

The international monetary system are sets of internationally agreed rules , conventions and supporting institutions that facilitate international trade , cross border investment and generally there allocation between nation states

The international monetary system can be defined as the institutional frame work within which international payments are made , movements of capital are accomadated and exchange rates among currencies are determined. Developments in international monetary system are given below

1. GOLD STANDARD(1876-1913)
2. INTERWARPERIOD(**1915-1944)**
3. THE BRETTON WOODS SYSTEM(1945\_1971)
4. THE SMITHSONIAN ARGREEMENT(1971-1975)

The IMF was established to support the monetary system by facilitating cooperation on international monetary issues, providing advisory and technical assistance to members, and offering emergency lending to nations experiencing repeated difficulties restoring the balance of payments equilibrium

**The gold standard:**

This was an exchange rate in which gold coins were freely minted by the central bank of the country. Its features were

1.Gold Jewellery could be converted into gold coins and used as legal tender

2.If there was a paper currency also circulating as legal tender, it was convertible into gold coins at a pre determined ratio called mint parity. paper currency was backed by gold held by the central bank

3. If the central bank specified that a pound note was equal to one ounce of gold , then pound note carried an implicit promise to convert the paper currency into gold at the ratio specified.

Consider two countries Britain and france on the gold standard, each has its own paper currency. Lets assume

1 pound= 1 oz of gold

1 franc= 0.5 oz of gold

Pound/ franc rate will be

1 pound= 2 franc

Thus the value of one country’s currency against the other was determined by currency/ gold ratios of each country.

If british imports from franc were greater than british exports to franc, then gold moved from british to franc. Paper currency was backed by gold , therefore the amount of paper currency in circulation was determined by the amount of gold with the central bank. If British had a trade deficit with franc, gold moved from Britain to france, leading to a contraction of money supply in Britain and in increase in money supply in franc.

* **Interwar period: 1915-1944**
  + World War I ended the classical gold standard in 1914
  + Trade in gold broke down
  + After the war, many countries suffered hyper inflation
  + Countries started to “cheat” (sterilization of gold)
  + Predatory devaluations (recovery through exports!)
  + The US, Great Britain, Switzerland, France and the Scandinavian countries restored the gold standard in the 1920s.
  + After the great depression, and ensuing banking crises, most countries abandoned the gold standard.

**THE BRETTON WOODS AGREEMENT**

Its main features were

**1**.Paper currency was the legal tender of 44 countries

**2**.The US dollar would be expressed in terms of gold. It was decided that $35= one ounce of fine gold.Only US would hold gold as reserves.The US central bank could issue only as many dollars as the gold reserves available with it.

**3**.The remaining 43 countries would link each of their currencies to the US dollar.The value of each currency against US dollar was to be determined by each country.This value was called the par value.. For Eg, franc could have a par value of 5FFr=1USD.

**4**.The market value of the currency was permitted to fluctuate within +-1% of the par value. The upper limit and the lower limit of the fluctuation were called support points. In the above example ,the support points for the franc would be 5.05FFr and 4.95FFr.

**5.**Each member – country’s central bank had to ensure that the market value of the currency fluctuated only within the support points. If the support points were likely to be breached , the central bank would have to buy (or sell) US dollars. If the market value of the franc dropped to 5.03 FFr/USD, then the French central bank would start selling US dollars(this would increase the supply of dollars) and buy francs (increase the demand for francs). The actions would increase the value of the franc against the dollar.

**6**.Each member –country could devalue its currency up to 10% of the exchange rate. Any devaluation above this required IMF permission.

International payments could be made either in gold or in US dollars. Thus , officially the dollar became an international reserve currency, and a denomination currency for cross-border payments. The central banks of each of the 43 member –country were permitted to hold US dollars as reserves. They did not have to hold gold, unless they wanted to.

Though the Bretton Woods system no longer exists, the trend of holding US dollars reserves continues. The advantages of the Bretton Woods system were that the dollar became an international reserve currency overcoming the limited supplies of gold,member-countries could earn interest on their dollar reserves (unlike in the case of gold reserves),and the security requirements needed for gold reserves were no longer necessary.

**THE SMITHSONIAN ARGREEMENT**

From August to December 1971, most of the major currencies were allowed to fluctuate. The US dollars fell in value against a number of major currencies. Several countries imposed trade and exchange controls causing major concerns. It was feared that such protective measures may become widespread and limit the international trade. In other to solve these problems, the world’s leading trading countries called the ‘Group of ten’ signed an agreement on 18 December 1971.

Although the US dollars was not convertible into gold,it was still defined in terms of gold. The other nine currencies were defined in terms of either gold or the dollar. The united states agreed to devalue the dollar from $35 per ounce of gold to $38 in return for promises from other members to up value their currencies relative to the dollar by the specified amounts.

**International Monetary Fund**

* “It is an organization of 186 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth and reduce poverty”.
* The IMF is the most detailed attempt to organize the conduct of international monetary affairs.

Established in Washington D.C in 1944 & its purpose is to lend foreign exchange to any member country whose supply of foreign exchange has become scarce.

1. Increasing international monetary cooperation
2. Promoting the growth of trade
3. Promoting exchange rate stability
4. Establishing a system of multilateral payments, eliminating exchange restrictions which hamper the growth of world trade and encouraging progress towards convertibility of member currencies.
5. Building a reserve base.

**3.BALANCE OF PAYMENTS**

The balance of payments is a summary of transactions between domestic and foreign residents for a specific country over a specified period of time. It represents an accounting of a country’s international transactions for a period , usually a quarter or a year. It accounts for transactions by business, individuals, and the government.

FEATURES OF BOP

The BOP is a statistical record of a country’s past inflows and outflows of foreign currency.

**1.**Trends in a country’s BOP affect international expectations. Trends have a ‘signalling’ effect, and indicate that the country’s future prospects are bright or bleak.

**2**.If India consistently runs a BOP surplus over the next five years, international investors will conclude that the government’s policies of liberalization and privatization have paid off, and that the country is a safe investment destination.

**3**.The BOP is an account and has a debit side and a credit side. All inflows of foreign currency are shown as credits and all outflows of foreign currency are shown as debits. Foreign exchange inflows create a demand for domestic currency ( since the foreign currency is sold and the domestic currency is purchased). Foreign exchange outflows create a supply of domestic currency (since the foreign currency is purchased and the domestic currency is sold). The net inflows(foreign exchange inflows minus foreign exchange outflows) or the ‘balance’ over a period , can be positive , zero or negative.

**4**.When the sum of credits exceeds the sum of debits, net inflows of foreign exchange are positive and the country accumulates foreign exchange reserves.

**5**.The BOP is an ex-port analysis of the flow of foreign exchange. It merely records past information of activities between a country and the rest of the world. As such it has limited relevance as a corrective tool.

COMPONENTS OF THE BOP:

Balance of payments can be broken into various components. The most important ones are

**Current Account**

**CapitalAccount**

Current Account: This records the short term foreign exchange inflows ans outflows. When the net inflows are positive , there is current account surplus.

The main components of current account are payments for

Goods &services

Factor income

Tranfers.

**Payments for merchandise and services**

Merchandise exports and imports represent tangible products, such as computers and clothing, that are transported between countries. Service exports and imports represent tourism and other services, such as legal , insurance, and consulting services, provided for customers based in other countries.

Factor income payments

A second component of the current account is factor in-come, which represents income (interest and dividend payments) received by investors on foreign investments in financial assets (securities). Thus , factor income received by U.S. investors reflects an inflow of funds into the united states. factor income paid by the united states reflects an outflow of funds from the united states.

Transfer payments

A third component of the current account is transfer payments, which represent aid, grants, and gifts from one country to another.

Actual current account balance

The US current account balance in the year 2007 is summarized in exhibit 2.2. notice that the exports of merchandise were valued at $1,148 billion, while imports of merchandise by the united states were valued at $1,967 billion. Total US exports of merchandise and services and income receipts amounted to $2,463 billion, while total US imports and income payments amounted to $3,082 billion. The bottom of the exhibit shows that net transfers( which include grants and gifts provided to other countries) were -$112 billion. The negative number for net transfers represents cash outflow from the united states. overall , the current account balance was-$731 billion, which is primarily attributed to the excess in US payments sent for imports beyond the payments received from exports.

Capital and financial accounts

The capital account category has been changed to separate it from the financial account, which is described next. The capital account includes the value of financial assets transferred across country borders by people who move to a different country. It also includes the value of nonfinancial assets that are transferred across country borders, such as patents and trademarks. The sale of patent rights by a US firm to a Canadian firm reflects a credit to the U.S balance-of-payments accounts, while a U.S purchase of patent rights from a Canadian firm reflects a debit to the U.S balance-of-payments account.

The key component of the financial account are payments for :

Direct foreign investment

Portfolio investment

Other capital investment.

**Direct foreign investment**: Direct foreign investment represents the investment in fixed assets in foreign countries that can be used to conduct business operations. Examples of direct foreign investment include a firm’s acquisition of a foreign company, its construction of a new manufacturing plant, or its expansion of an existing plant in a foreign country.

**Portfolio investment** : Portfolio investment represents transactions involving long term financial assets(such as stocks and bonds) between countries that do not affects the transfer of control. Thus, a purchase of Heineken (Netherlands) stock by a U.S investors is classified as portfolio investment because it represents a purchase of foreign financial assets without changing control of the company, if a U.S firm purchased all of Heineken’s stock in an acquisition, this transaction would result in a transfer of control and therefore would be classified as direct foreign investment instead of portfolio investment.

Other capital investment: A third component of the financial account consists of other capital investment, which represents transactions involving short term financial assets(such as money market securities) between countries.

**Methods of payment**

1. Cash in advance
2. Letter of credit
3. Documentary collection
4. Open account or credit
5. Counter trade or barter

**HOME CURRENCY AND FOREIGN CURRENCY:**  
Home currency is the unit of exchange that can be used to purchase goods and services in one or more countries.Home currency is also called base currency, domestic currency or primary currency. It is a unit of exchange that can be used to purchase goods and services in the home country

**Quoting a currency**

When a currency is quoted , it is usually done in relation to another currency, in other words the value of a currency is determined by its comparison to another currency

Currencies are quoted in pairs, the quote for a currency pair has a base currency and a quote currency. A quote is read as “ the base currency in terms of the quote currency”. In a quote Rs 44.20/$, the base currency is the rupee and the quote currency is US$ and the quote is read as Rs 44.20 in terms of a dollar.The currency quoted first is the base currency and the currency quoted second is the quote currency.

**DIRECT QUOTE**

In a direct quote , the domestic currency is expressed in terms of one unit of foreign currency, that is the number of units of home currency for one unit of foreign currency.It is expressed as H/F. The domestic currency is the quoted currency. The direct quote varies the domestic currency , wherein the base or foreign currency remains fixed at one unit.

**'Indirect Quote'**

. An indirect quote is also known as a “quantity quotation,” since it expresses the quantity of foreign currency required to buy one unit of the domestic currency.It is expressed as F/H. In indirect quote , the domestic currency is the base currency and the foreign currency is the quoted currency.

|  |  |
| --- | --- |
| Direct quote | Indirect quote |
| 1.A direct currency quote is a pair in which the domestic currency is the quoted currency | 1. An indirect quote is currency pair where the domestic currency is te base currency |
| 2.The direct quote varies the domestic currency and the base or foreign currency remains fixed at one unit | 2. Here the foreign currency is variable and domestic currency is fixed at one unit |

**BID AND ASK PRICE**

The bid and the ask price of forex trading is the most fundamental element. A bid price in the forex market is a rate at which the forex market is willing to buy a currency. Bid is the price in one currency at which a dealer will buy another currency. The bid price represents what will be obtained in the quote currency when selling one unit of home currency.

The forex ask price is defined as the price at which the forex market is willing to sell out a particular currency to buyers in the market.The ask price represents what has to be paid in the quote currency to obtain one unit of home currency.Dealers generally bid( buy) at one price and offer(sell) at a slightly higher price, making their profits from the spread , that is the difference between the buying and selling prices.

Ex: All foreign exchange dealers are interested in making a profit out of each transcation.Therefore when a dealer in india tries to sell foreign currency , he will try to get as high a price as is possible for every unit of foreign currency sold, but when the dealer is buying foreign currency , his aim will be to get the most reasonable price for every unit of foreign currency he buys.

A dealer in New Delhi may give the following quotation

US$1= Rs 43.30 – 43.70

This means that the dealer will buy dollars from the exporter at us$1=43.30 and sell dollars to an importer at US$ 1=43.70. The difference between bid and ask is spread.

**SPOT RATE:**

A spot contract refers to buying and selling of currency for settlement and payment on the spot date which is normally two business days after the trade has been made.**A spot rate** is a exchange rate agreed at which one currency is traded for another within two business days.The day the deal is struck is called the ‘trade date’ and the day that the exchange of currencies takes place is called ‘value date’ or settlement date’.

**FORWARD RATE**:

A forward contract is one where contract terms are agreed in the present but delivery and payment will occur at future date. A forward rate is the rate quoted by the bank or trader for the purchase or sale of foreign currency in future.

The forward rate is calculated with reference to the spot rate. The dealer gives the forward margins(know as swap points) that corresponds to spot bid rate and spot ask rate. This is used to determine forward rate.

Calculation of forward premium or discount

F= forward rate of exchange

S= the spot rate of exchange

n= no of months in the forward contract

forward exchange rate depends mainly on three instruments

The spot exchange rate

Domestic interest rate

Foreign interest rate

|  |  |
| --- | --- |
| SPOT RATE | FORWARD RATE |
| 1.A spot rate is a contract that involves the purchase or sale of a commodity , security or currency for immediate delivery and payment on the spot date which is normally two business days after the trade date. | 1. A forward contract is a contract that involves ansgreement of contract terms on the current date with the delivery and payment at a specified future date. |
| 2.A spot rate or price is the price quoted for immediate settlement of the spot contract | 2. A forward rate is used to quote a financial transaction that takes place on the future date and is the settlement price of the forward contract |
| 3.A spot rate cannot be calculated using the forward rate | 3. Depending on the security being traded , the forward rate can be calculated using the spot rate. |

**Currency appreciation and depreciation:**

When the value of the domestic currency against an intervention currency is determined by the forces of demand and supply , the domestic currency is said to be on floating exchange rate.Its market value against all other currencies is also determined by the forces of demand and supply

**Depreciation**

Depreciation is the decline in the market of the domestic currency with respect to a foreign currency.

**Appreciation**

Appreciation is the rise in the market value of the domestic currencywith respect to a foreign currency.

**What is Rupee appreciation and depreciation?**

Let us take an example. If we want to buy $100 today and the dollar-rupee exchange rate is Rs.63, which means we can get 1 dollar for Rs.63. We have to pay Rs.6300 to get $100. But say you decided to buy $100 tomorrow and the exchange rate became Rs.64. Now we have to pay Rs.6400 to get $100. Here we have to pay more to get the same amount of $100. This tells us that rupee has lost its value and in economic terms we say Rupee has been depreciated.

In the same example if we want to buy $100 and the dollar exchange rate became Rs.62. Then we have to pay Rs.6200. This means that we have to pay less than normal. This is also known as appreciation of rupee which means rupee became stronger than dollar in terms of its value.

**How does appreciation or depreciation of rupee impact our country’s imports and exports?**

|  |  |  |
| --- | --- | --- |
| Effect on | Appreciation of Rupee | Depreciation of Rupee |
| Imports | Imports become cheap as they have to pay less than compared to what they paid earlier. People tend to buy more imported goods, this leads to more outflow of money from country. | Imports become costlier as compared to earlier. Say previously 1 dollar was Rs.63 and not it became Rs.65. People have to pay Rs.2 more to get the goods. Due to this imports will reduce and domestic goods consumption will increase. |
| Exports | Exports get less revenue as previously 1 dollar was say Rs.63, now they will get Rs.60. There is a loss of Rs.3. Due to this number of exports will reduce because people find it less advantageous. | Exports get more revenue compared to previous scenario. Earlier 1 dollar was say Rs.63 now it became Rs.65, which will increase the revenue of exporters by Rs.2. Due to this exports in the country will increase. |

Appreciation of currency is the increase in the value of currency.

E.g

**$1 = ₹ 50**

**It changes and become ,**

**$1= ₹ 40**

Now, you can argue that the rupees becomes ₹40 from ₹50 , it has decreased.

But the VALUE of currency has increased, because earlier we purchase something worth of $1 by giving them ₹50. Now after changes, we just need to give ₹ 40 for $1 good. So we can buy more of goods. Which result in **increase in imports.**

Other way round is: value of currency has increased, so foreign has to pay more to buy same goods, our goods become expensive to purchase. So **exports will reduce due to the effect of appreciation.**

**Reasons for appreciation**

1.When the exports are high, the buyers of these exports need its currency to pay for those exports as the result there is a rise in the rate of the currency

2.When the country’s central bank increases interest rates**:** A country with high interest rates attracts foreign investors because interest rates in their country are less. Thus demand for the rupee increases, resulting in appreciation in the value

.

3 When the demand of the currency is high in foreign exchange market it leads to the appreciation of the currency.

4 The cuurency rate appreciates due to Govt borrowing or relaxing the fiscal policy.

5.Those countries with restrictive (hard) monetary policies will be decreasing the supply of their currency and the currency should appreciate

**Effects of Appreciation**

1.It helps in improving the standard of living of the consumers

2.It results in improved competitiveness

3.An appreciation generally tends to reduce inflation. This in turn leads to stronger exports in the long term and therefore helps in improving the current account.

4.The exports are expensive and the imports are cheaper. Therefore with cheaper imports one would expect to see an increase in the quantity of imports. With lower export demand and greater amount of spending on imports , one would expect fall in domestic aggregate demand . this causes lower economic growth

**Reasons for Depreciation**

1. A currency depreciates if there is a fall in the world price of a country’s major export. This fall leads to a decline in export revenues and a fall in overseas demand.
2. There is a value of imported goods and services coming into a country which leads to a trade deficit. A deficit on the current account of the balance of payments generally leads to a net outflow of currency. This causes exchange rate weakness.
3. A country’s central bank reduces monetary policy interest rates. When it does so, it leads to a net outflow of money. It offers a risk-adjusted rate of return.
4. Depreciation might be caused by interference of the central bank.
5. Countries running large current account deficits on their balance of payments tend to cause the currency to fall.A trade deficit occurs when the value of goods a country imports is more than the value of goods it exports. When the trade deficit of a country increases, the value of the domestic currency depreciates against the value of the currency of its trading partners
6. ·**Monetary Policy** - Countries with expansionary (easy) monetary policies will be increasing the supply of their currencies, which will cause the currency to depreciate.
7. **Inflation:** High inflation impacts the country’s exports as goods become expensive for other countries resulting in decreased demand for the rupee leading to depreciated rupee value
8. •**Income Changes:** When employment and per capita income in a country increases then increased domestic income is associated with an increased consumption of imported goods. As consumers purchase more imported goods, the demand for dollars will exceed its supply and dollar will appreciate and rupee value decreases

UNIT-2

**FOREIGN –EXCHANGE AND BALANCE OF PAYMENTS**

[Foreign exchange](https://www.investopedia.com/terms/f/foreign-exchange.asp), or [Forex](https://www.investopedia.com/terms/f/forex.asp), is the conversion of one country's currency into that of another.**Foreign Exchange (FOREX)** refers to the foreign exchange [market](http://www.investinganswers.com/node/3609). It is the [over-the-counter market](http://www.investinganswers.com/node/5091) in which the foreign currencies of the world are traded. It is considered the largest and most [liquid market](http://www.investinganswers.com/node/594) in the world.

It is the exchange of one currency for another by governments, businesses and residents in two different countries

**Importance of foreign exchange**

1.The foreign exchange is the backbone of international trade and global investing. It is critical to support imports and exports, which are necessary to gain access to resources and to create additional demand for goods and services. Without the ability to trade in different currencies, companies’ prospects would be limited and global economic growth would suffer.

2.Investors also use the forex market. Those who seek international diversification benefits need to trade currencies to buy and sell foreign assets and securities.

3.Foreign exchange is necessary to avail the services such as education, tourism, health care , insurance banking etc

The **Foreign Exchange Regulation Act** (**FERA**) was legislation passed in[India](https://en.wikipedia.org/wiki/India) in 1973[[1]](https://en.wikipedia.org/wiki/Foreign_Exchange_Regulation_Act#cite_note-1) that imposed strict regulations on certain kinds of payments, the dealings in [foreign exchange](https://en.wikipedia.org/wiki/Foreign_exchange_market) (forex)and [securities](https://en.wikipedia.org/wiki/Securities) and the transactions which had an indirect impact on the foreign exchange and the import and export of [currency](https://en.wikipedia.org/wiki/Currency).[[2]](https://en.wikipedia.org/wiki/Foreign_Exchange_Regulation_Act#cite_note-rbi-2) The bill was formulated with the aim of regulating payments and foreign exchange.[[2]](https://en.wikipedia.org/wiki/Foreign_Exchange_Regulation_Act#cite_note-rbi-2)[[3]](https://en.wikipedia.org/wiki/Foreign_Exchange_Regulation_Act#cite_note-3)

FERA was introduced at a time when foreign exchange (Forex) reserves of the country were low, Forex being a scarce commodity. FERA therefore proceeded on the presumption that all foreign exchange earned by Indian residents rightfully belonged to the Government of India and had to be collected and surrendered to the [Reserve Bank of India](https://en.wikipedia.org/wiki/Reserve_Bank_of_India) (RBI). FERA primarily prohibited all transactions not permitted by RBI

**Objectives**

1.To regulate certain payment dealings in foreign exchange and securities

2.To regulate transactions that indirectly affects foreign exchange.

3.To regulate the import and export of currency

4.To conserve precious foreign exchange and to optimize the proper utilization of foreign exchange so as to promote the economic development of the country.

**What is the 'Foreign Exchange Market'**

The foreign exchange market is the market in which participants are able to buy, sell, exchange and speculate on currencies. [Foreign exchange](https://www.investopedia.com/terms/f/foreign-exchange.asp) markets are made up of banks, commercial companies, [central banks](https://www.investopedia.com/terms/c/centralbank.asp), [investment management](https://www.investopedia.com/terms/i/investment-management.asp) firms, [hedge funds](https://www.investopedia.com/terms/h/hedgefund.asp), and retail [forex](https://www.investopedia.com/terms/f/forex.asp) brokers and investors. The [forex market](https://www.investopedia.com/terms/forex/f/forex-market.asp) is considered the largest [financial market](https://www.investopedia.com/terms/f/financial-market.asp) in the world

**Characteristics of the Forex Market**

Being the world's largest financial market, the foreign exchange (or forex) market offers unmatched benefits and advantages to the prospective investor. With superior liquidity and leverage compared to stocks and futures markets, the forex market is arguably the best financial investment you can find.

What makes the forex market an excellent financial market? The characteristics that make the forex market a good one are lower trading costs, excellent transparency, superior liquidity and very strong market trends.

**LOWER TRADING COSTS**

Ask anyone dealing in stocks and they will tell you that they have to shell thousands of dollars to get started. Not so with the forex market. With just a few hundred dollars (often $250 or less), you can open a mini forex account and start trading!

The lower trading costs in the forex market has made it possible for even small, individual investors to make decent profits from [forex trading](http://www.tjfengcai.com/). With lower costs, the possible losses are also much lower. You will discover that forex trading usually has no commission fees unlike in other investments. The costs of forex trading are limited to the spread or the difference between the selling and buying prices for a particular currency pair.

**EXCELLENT TRANSPARENCY**

Transparency means the free access to trading information. Forex trading is a transparent process because the trader has full access to market data and information that are necessary to perform successful transactions. The excellent transparency of the forex market means that forex traders have more control over their investments and can decide what to do based on the information available.

**SUPERIOR LIQUIDITY**

In a forex market, traders are free to buy and sell currencies of their own choosing. The superior liquidity of the forex market enables traders to easily exchange currencies without affecting the prices of the currencies being traded.

So whether you trade a few thousand dollars or several millions, you can be assured of the same currency prices during the time an order was placed and then executed. The forex market's superior liquidity allows you to get the profits you expect at the time you made the trade.

**STRONG MARKET TRENDS**

Forex traders make money by getting accurate market data and then analyzing the direction the market takes. To do this, forex traders rely heavily on trends and trending in an attempt to predict the direction of the forex market. Most traders use technical analysis to analyze past and present forex market data and then search for trends.

Other financial markets use trends and trending but this characteristic is much stronger in the forex market. Due to strong trending, forex markets are much easier to analyze and identify possible entry and exit positions during trading.

Now you already know the characteristics that make the forex market a sound, financially-stable and profitable investment area, maybe it's time to put your money into the forex market and earn handsome profits. You can just take advantage of the forex market's positive assets and make your money work for you.

**Functions of the Foreign Exchange Market:**

The foreign exchange market performs the following important functions:

(i) to effect transfer of purchasing power between countries- transfer function;

(ii) to provide credit for foreign trade - credit function; and

(iii) to furnish facilities for hedging foreign exchange risks - hedging function.

**Transfer Function**:This is one of the most basic and primary functions performed by the foreign exchange market

The basic function of the foreign exchange market is to facilitate the conversion of one currency into another, . Eg an exporter can convert his dollar export earnings into Indian rupees through the foreign exchange market, similarly an Indian importer can make euro payments to a German firm by converting the Indian rupees to Euros through foreign exchange market. This function is normally performed through a variety of credit instruments, such as telegraphic transfers, bank drafts and foreign bills.

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**Credit Function**:

Another function of the foreign exchange market is to provide credit, both national and international, to promote foreign trade. Obviously, when foreign bills of exchange are used in international payments, a credit for about 3 months is given , till their maturity,

**Hedging Function:**

A third function of the foreign exchange market is that it allows for covering the risks on the foreign exchange transactions.. In a free exchange market when exchange rates, i.e., the price of one currency in terms of another currency, change, there may be a gain or loss to the party concerned. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilities which are to be met in foreign money.

Exchange risk as such should be avoided or reduced. For this the exchange market provides facilities for hedging anticipated or actual claims or liabilities through forward contracts in exchange. A forward contract which is normally for three months is a contract to buy or sell foreign exchange against another currency at some fixed date in the future at a price agreed upon now. No money passes at the time of the contract. But the contract makes it possible to ignore any likely changes in exchange rate.

The existence of a forward market thus makes it possible to hedge an exchange position.

**Parcticipants/Dealers in foreign exchange market**

foreign exchange market needs dealers to facilitate foreign exchange transactions. Bulk of foreign exchange transactions is dealt by commercial banks and financial institutions. RBI has allowed private authorized dealers to deal with foreign exchange transactions that is buying and selling of foreign currency. The main participants in foreign exchange markets are

1. **Retail clients**: They comprise people, international investors, multinational corporations and others who need foreign exchange . They deal through commercial banks and authorized dealers.
2. **Commercial Banks**: They deal with retail clients, other commercial banks and foreign exchange brokers. They are the biggest participants and earn profits by buying and selling currencies from and to each other. These transactions are conducted both on the customers behalf and on their own and they account for two-thirds of the total forex transactions.
3. **Foreign exchange brokers**.:Brokers act as intermediaries between buyers and sellers, mainly banks
4. **Central banks:** The Bank is entrusted with the important task of managing the economy of the country. Their involvement in the foreign exchange market is not for speculative purpose but to manage and control the money supply of the nation. These banks use the forex market to either acquire foreign exchange reserves or spend the same so that the home currency price can be stabilized. For e.g. RBI may enter the forex market to buy dollars and sell rupee if it feels that Indian rupee is overpriced against dollar
5. **Investment firms:** These are companies that represent hedge funds, mutual funds arbitrage funds etc. They invest in securities of other countries with the objective of earning profits through a highly diversified portfolio

**Types of foreign exchange market**

1. Wholesale market:It is generally the central bank, commercial banks , investment institutions which are included in this tier. Size of transactions arelarge. It is interbank market

2.Retail market: It is the client or retail market where very specific and smaller amount of transactions takes place. It comprises of travellers, tourists etc

FOREIGN EXCHANGE

MARKET

RETAIL MARKET

WHOLESALE MARKET

Moneychangers

Banks

Non Financialcos

Investment

firms

Banks

Central bank

**American depositary receipt (ADR**

An American depositary receipt (ADR) is a [negotiable](https://www.investopedia.com/terms/n/negotiable.asp) certificate issued by a U.S. bank representing a specified number of shares (or one share) in a foreign stock traded on a U.S. exchange. ADRs are denominated in U.S. dollars, with the [underlying security](https://www.investopedia.com/terms/u/underlying-security.asp) held by a U.S. financial institution overseas, and holders of ADRs realize any dividends and [capital gains](https://www.investopedia.com/terms/c/capitalgain.asp) in U.S. dollars

The company of any country can deposits a fixed number of shares with the Bank and the Bank acts as a depository for these shares. The Bank issues receipts against these shares and these receipts are traded on the stock exchanges in United States. Investors can buy these receipts if they are interested in buying shares of that company.   
  
ADRs were developed because of the complexities involved in buying shares in foreign countries and the difficulties associated with trading at different prices and currency values. ADRs allow U.S. banks to  purchase a bulk of shares from a foreign company, bundle the shares into groups and reissue them on U.S. stock markets – namely, the [New York Stock Exchange](http://www.investopedia.com/terms/n/nyse.asp) and [NASDAQ](http://www.investopedia.com/terms/n/nasdaq.asp).  
Thus ADRs enable American investors to buy shares in foreign company without cross border and cross currency transcations.

**Types of ADRs**

**ADRs can be**[**sponsored**](http://www.investopedia.com/terms/s/sponsoredadr.asp)**or**[**unsponsored**](http://www.investopedia.com/terms/u/unsponsoredadr.asp).

**1.**[**sponsored**](http://www.investopedia.com/terms/s/sponsoredadr.asp) **ADRs**

With sponsored ADRs, the foreign company enters into an agreement directly with the U.S. depositary bank to make plans for recordkeeping, distribution of shareholder communications, payment of dividends (some ADRs are dividend-paying stocks) and other services. Sponsored ADRs can be listed on major exchanges  
  
**2**.An unsponsored ADR is an [American depositary receipt (ADR)](https://www.investopedia.com/terms/a/adr.asp) issued by a depositary bank without the involvement or participation - or even the consent - of the foreign [issuer](https://www.investopedia.com/terms/i/issuer.asp) whose stock underlies the ADR. The issuer therefore has no control over an unsponsored ADR, in contrast to a [sponsored ADR](https://www.investopedia.com/terms/s/sponsoredadr.asp) where it retains control. Unsponsored ADRs are usually established by depositary banks in response to investor demand. Shareholder benefits and [voting rights](https://www.investopedia.com/terms/v/votingright.asp) may not be extended to the holders of these particular securities. Unsponsored ADRs generally trade over-the-counter (OTC) rather than on United States exchanges.

The number of shares underlying the receipt is depicted using a ratio ORD (ordinary share value): ADRS.   
  
For example, HDFC Bank's ratio is 3:1 implies that 3 shares of HDFC equal to a single ADR. This ratio is important to understand if the receipt has been priced at fair market value. For example, if Robert decides to purchase ADRs of HDFC Bank Ltd. whose current price is $151.73, he should verify if the ADRs are priced fairly. Assuming the current exchange rate is Rs.46.30: $1.00, the price of 3 shares of HDFC Bank on the Indian stock exchange should be around Rs 7,025 ($151.73 \* 46.30).   
  
So, a single share should be trading around Rs 2,342. However, the demand for the ADR also puts a premium / discount on the prices

**Benefits of ADRs:** They are benefits to the issuers and investors

**BENEFITS FOR INVESTORS**

With continued globalization, increasingly American investors aim to diversify their portfolios globally. There are many obstacles that preclude many institutional and individual investors from purchasing foreign equities. These include undependable settlements, unreliable custody services for foreign securities, costly currency conversions, poor information flow, confusion tax issues, and unfamiliar market practices. The core benefit for investors - individuals and institutions alike - is that ADRs make it easy to purchase and hold a non-U.S. issuer's securities.

**:**

1. **Easy accessibility**: Setting up trading accounts to buy in the local market in many foreign markets is difficult and complex. Many brokers may not allow direct access to overseas markets that will allow investors to buy and sell stocks in that country’s local market. So ADRs eliminates this issues and allows investors to access companies in far away countries easily.As US securities, ADRs are quoted in US dollars and registered in US securities and exchange commission and trade like any other US security.They enjoy rights which are comparable to those of holding underlying securities, plus they have the benefits ,convenience and efficiency of trading in US securities
2. **Diversification**: The second most important advantage of owing ADRs is diversification. ADRs provide an opportunity to diversify across countries.. Owing ADRs from counries could help to boost the portfolio returns
3. **Dividends**: All dividends paid out by foreign firms are paid out in US dollars to their ADR holders. Hence an investors is not burdened with the converting dividends from local currency to US dollars. All currency-related work are taken care of by the ADR issuer.
4. **Benefit from currency fluctuations:** When a foreign company pays out dividends they are paid to investors in local currency. If the local currency appreciates then the US holder of the ADR will benefit since the dividends have to be converted to US dollars. Because the foreign currency has gained in value, the dividends paid out in US dollars will be more. So in addition to any gains from price appreciation of the ADR, an investor can also benefit from currency volatility. But it is also possible to receive in dividends when the same foreign currency depreciates against the dollar.
5. **Liquidity**: Many ADRs offer ample liquidity when an investors wants to buy or sell. Sometimes an ADR may have more daily trading volume than the ordinary trading in the home market since stock market participation rate may be low in that country
6. **Information flow:**Firms that have ADRs distribute all information to investors widely in English. This allows ADRs to keep themselves fully informed of all the news regarding that company.
7. **BENEFITS FOR COMPANIES IN ISSUING ADRS**

Companies issuing ADRs have found that the ADRs provide numerous advantages, in two main categories, financial advantages and commercial advantages, including:

• Broadening and diversifying a company’s US investor base

• Enhancing a company’s visibility, status and profile in the US and internationally, among investors, consumers and customers

• Increasing US liquidity, and potentially total global issuer liquidity by attracting new investors

• Offering a new avenue for raising equity capital, often at highly competitive rates

• Enhancing communications with shareholders in the United States

• By enabling a company to tap U.S. equity markets, the ADR offers a new avenue for raising capital, often at highly competitive costs. For companies with a desire to build a stronger presence in the United States, an ADR program can help finance U.S. initiatives or facilitate U.S. acquisitions.

**Types of foreign exchange rates**

**Fixed exchange rate**

There are two ways the price of a currency can be determined against another. A [fixed](https://www.investopedia.com/terms/f/fixedexchangerate.asp), or pegged, rate is a rate the government ([central bank](https://www.investopedia.com/terms/c/centralbank.asp)) sets and maintains as the official exchange rate. A fixed [exchange rate](https://www.thebalance.com/what-are-exchange-rates-3306083) is when a country ties the value of its currency to some other widely-used commodity or currency. Today, most fixed exchange rates are pegged to the [U.S. dollar](https://www.thebalance.com/the-u-s-dollar-3305729). That's because the dollar is used for most transactions in [international trade](https://www.thebalance.com/international-trade-pros-cons-effect-on-economy-3305579). In order to maintain the local exchange rate, the central bank buys and sells its own currency on the foreign exchange market in return for the currency to which it is pegged.

If, for example, it is determined that the value of a single unit of local currency is equal to US$3, A fixed exchange rate tells you that you can always exchange your money for the same amount of the other currency.  It allows you to determine how much of one currency you can trade for another. The central bank will have to ensure that it can supply the market with those dollars. In order to maintain the rate, the central bank must keep a high level of[foreign reserves](https://www.investopedia.com/terms/r/reservecurrency.asp). This is a reserved amount of foreign currency held by the central bank that it can use to release (or absorb) extra funds into (or out of) the market. This ensures an appropriate [money supply](https://www.investopedia.com/terms/m/moneysupply.asp), appropriate fluctuations in the market ([inflation](https://www.investopedia.com/terms/i/inflation.asp)/[deflation](https://www.investopedia.com/terms/d/deflation.asp)) and ultimately, the exchange rate. The central bank can also adjust the official exchange rate when necessary.

**Advantages of Fixed Exchange Rates**

The main arguments advanced in favor of the system of fixed or stable exchange rates are as follows:

1. **Promotes International Trade and** **Reduces risk in international trade**

By maintaining a fixedrate, buyers and sellers of goods internationally can agree a price and not be subject to the risk of later changes in the exchangerate before contracts are settled. The greater certainty shouldhelp encourage investment.Fixed or stable exchange rates ensure certainty about the foreign payments and inspire confidence among the importers and exporters. This helps to promote international trade.

**2. Necessary for Small Nations:**

Fixed exchange rates are even more essential for the smaller nations like the U.K., Denmark, Belgium, in whose economies foreign trade plays a dominant role. Fluctuating exchange rates will seriously affect the process of economic growth in these economies.

**3. Promotes International Investment:**

Fixed exchange rates promote international investments. If the exchange rates are fluctuating, the lenders and investors will not be prepared to lend for long-term invest­ments.

**4. Removes Speculation:**

Fixed exchange rates eliminate the speculative activities in the international transactions. There is no possibility of panic flight of capital from one country to another in the system of fixed exchange rates.

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**5. Necessary for Developing Countries:**

Fixed exchanges rates are necessary and desirable for the developing countries for carrying out planned development efforts. Fluctuating rates disturb the smooth process of economic development and restrict the inflow of foreign capital.

**6. Suitable for Currency Area:**

A fixed or stable exchange rate system is most suitable to a world of currency areas, such as the sterling area. If the exchange rates of the countries in the common currency area are flexible, the fluctuations in the leading country, like England (whose currency dominates), will also disturb the exchange rates of the whole area.

**7. Economic Stabilization:**

Fixed foreign exchange rate ensures internal economic stabilization and checks unwarranted changes in the prices within the economy. In a system of flexible exchange rates, the liquidity preference is high because the businessmen will like to enjoy wind fall gains from the fluctuating exchange rates. This tends to Increase price and hoarding activities in country.

**8. Not Permanently Fixed:**

Under the fixed exchange rate system, the exchange rate does not remain fixed or is permanently frozen. Rather the rate is changed at the appropriate time to correct the fundamental disequilibrium in the balance of payments.

9. **Other Arguments:**

Besides, the fixed exchange rate system is also beneficial on account of the following reasons.

(i) It ensures orderly growth of world's money and capital markets and regularises the international capital movements.

(ii) It ensures smooth functioning of the international monetary system. That is why, IMF has adopted pegged or fixed exchange rate system.

(iii) It encourages multilateral trade through regional cooperation of different countries.

(iv) In modern times when economic transactions and relations among nations have become too vast and complex, it is more useful to follow a fixed exchange rate system.

**Disadvantages of Fixed Exchange Rates**

The system of fixed exchange rates has been criticized on the following grounds:

**1. Outmoded System:**

Fixed exchange rate system worked successfully under the favorable conditions of gold standard during 19th century when

(a) the countries permitted the balance of payments to influence the domestic economic policy;

(b) there was coordination of monetary policies of the trading countries;

(c) the central banks primarily aimed at maintaining the external value of the currency in their respective countries; and

(d) the prices were more flexible. Since all these conditions are absent today, the smooth functioning of the fixed exchange rate system is not possible.

**2. Discourage Foreign Investment:**

Fixed exchange rates are not permanently fixed or rigid. Therefore, such a system discourages long-term foreign investment which is considered available under the really fixed exchange rate system.

**3. Monetary Dependence:**

Under the fixed exchange rate system, a country is deprived of its monetary independence. It requires a country to pursue a policy of monetary expansion or contraction in order to maintain stability in its rate of exchange.

**4. Cost-Price Relationship not Reflected:**

The fixed exchange rate system does not reflect the true cost-price relationship between the currencies of the countries. No two countries follow the same economic policies. Therefore the cost-price relationship between them go on changing. If the exchange rate is to reflect the changing cost-price relationship between the countries, it must be flexible.

**5Large holdings of foreign exchange reserves required**

-Fixed exchange rates require a government to hold large scalereserves of foreign currency to maintain the fixed rate - suchreserves have an opportunity cost.

**6. Difficulties of IMF System:**

The system of fixed or pegged exchange rates, as followed by the International Monetary Fund (IMF), is in reality a system of managed flexibility.

It involves certain difficulties, such as deciding as to

(a) when to change the external value of the currency,

(b) what should be acceptable criteria for devaluation; and

(c) how much devaluation is needed to reestablish equilibrium in the balance of payments of the devaluing country

**Floating Exchange Rates**  
Unlike the fixed rate, a [floating exchange rate](https://www.investopedia.com/terms/f/floatingexchangerate.asp) is determined by the private market through [supply and demand](https://www.investopedia.com/articles/economics/11/intro-supply-demand.asp). A floating rate is often termed "self-correcting," as any differences in supply and demand will automatically be corrected in the market. Look at this simplified model: if demand for a currency is low, its value will decrease, thus making imported goods more expensive and stimulating demand for local goods and services. This in turn will generate more jobs, causing an auto-correction in the market. A floating exchange rate is constantly changing.

**Advantage of Flexible Exchange Rates**

Flexible exchange rate system is claimed to have the following advantages:

**1. Independent Monetary Policy:**

Under flexible exchange rate system, a country is free to adopt an independent policy to conduct properly the domestic economic affairs. The monetary policy of a country is not limited or affected by the economic conditions of other countries.

**2. Shock Absorber:**

A fluctuating exchange rate system protects the domestic economy from the shocks produced by the disturbances generated in other countries. Thus, it acts as a shock absorber and saves the internal economy from the disturbing effects from abroad.

**3. Promotes Economic Development:**

The flexible exchange rate system promotes economic development and helps to achieve full employment in the country. The exchange rates can be changed in accordance with the requirements of the monetary policy of the country to achieve the planned national objectives.

**4. Solutions to Balance of Payment Probem**

Any disequilibrium in the balance of pay­ments would be automatically corrected by a change in the exchange rate. For example, if a country suffers from a deficit in the balance of payments then, other things being equal, the country’s currency should depreciate.This would make the country’s exports cheaper, thus increasing demand, while at the same time making imports expensive and decreasing demand. The balance of payments equilibrium would therefore be restored. On the contrary, a balance of payments surplus would be automatically eliminated through a change in the exchange rate.

**5. Promotes International Trade:**

The system of flexible exchange rates does not permit exchange control and promotes free trade. Restrictions on international trade are removed and there is free movement of capital and money between countries.

**6. Increase in International Liquidity:**

The system of flexible exchange rates eliminates the need for official foreign exchange reserves, if the individual governments do not employ stabilization funds to influence the rate. Thus, the problem of international liquidity is automatically solved. In fact, the present shortage of international liquidity is due to pegging the exchange rates and the intervention of the IMF authorities to prevent fluctuations in the rates beyond a narrow limit.

**7. Market Forces at Work:**

Under the flexible exchange rate system, the foreign exchange rates are determined by the market forces of demand and supply. Market is cleared off automatically through changes in exchange rates and the possibility of scarcity or surplus of any currency does not exist.

1. No need to maintain large reserves of foreign exchange

**Disadvantage of Flexible Exchange Rates**

The following are the main drawbacks of the system of flexible exchange rates :

1. **Uncertainty –** The fact that a currency changes in value from day to day introduces instability or uncertainty into trade. Sellers may be unsure of how much money they will receive when they sell abroad or what their price actually is abroad. Of course the rate changing will affect price and thus sales. In a similar way importers never know how much it is going to cost them to import a given amount of foreign goods. This uncertainty can be reduced by hedging the foreign exchange risk on the forward market.

**2. Adverse Effect on Economic Structure:**

The system of flexible exchange rates has serious repercussion on the economic structure of the economy. Fluctuating exchange rates cause changes in the price of imported and exported goods which, in turn, destabilise the economy of the country.

**3. Unnecessary Capital Movements:**

The system of fluctuating exchange rates leads to unnecessary international capital movements. By encouraging speculative activities, such a system causes large-scale capital outflows and inflows, thus, seriously disturbing the economy of the country.

**4. Depression Effects of Capital Movements:**

Speculative capital movements caused by fluctuating ex­change rates may lead to the problem of extremely high liquidity preference. In a situation of high liquidity preference, people tend to hoard currency, interest rates rise, investment falls and there is large-scale unemployment in the economy

**5 Lack of investment –** The uncertainty can lead to a lack of investment internally as well as from abroad.

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**6.Speculation –** Speculation will tend to be an inherent part of a floating system and it can be damaging and destabilising for the economy, as the speculative flows may often differ from the underlying pattern of trade flows

**7 Inflation –** The floating exchange rate can be inflationary., the float can cause inflation by allowing import prices to rise as the exchange rate falls.

**Factors affecting foreign exchange rate**

Foreign Exchange rate (ForEx rate) is one of the most important means through which a country’s relative level of economic health is determined. A country's foreign exchange rate provides a window to its economic stability, which is why it is constantly watched and analyzed. The exchange rate is defined as "the rate at which one country's currency may be converted into another." It may fluctuate daily with the changing market forces of supply and demand of currencies from one country to another. It is necessary to examinesome of the leading factors that influence the variations and fluctuations in exchange rates and explains the reasons behind their volatility,

**Factors affecting foreign exchange rate**

**Country’s Current Account / Balance of Payments**

A Balance of PaymentsIt consists of total number of transactions including its exports, imports, debt, etc. The [current account](https://www.investopedia.com/terms/c/currentaccount.asp) is the [balance of trade](https://www.investopedia.com/articles/03/061803.asp) between a country and its trading partners, reflecting all payments between countries for goods, services, interest and dividends. A [deficit](https://www.investopedia.com/terms/d/deficit.asp) in the current account shows the country is spending more on foreign trade than it is earning, and that it is borrowing capital from foreign sources to make up the deficit. In other words, the country requires more foreign currency than it receives through sales of exports, and it supplies more of its own currency than foreigners demand for its products. The excess demand for foreign currency lowers the country's exchange rate .

**Political Stability & Performance**

A country's political state and economic performance can affect its currency strength. A country with less risk for political turmoil is more attractive to foreign investors, as a result, drawing investment away from other countries with more political and economic stability. Increase in foreign capital, in turn, leads to an appreciation in the value of its domestic currency. A country with sound financial and trade policy does not give any room for uncertainty in value of its currency. But, a country prone to political confusions may see a depreciation in exchange rates.

**Interest rates,**

Interest rates, inflation and exchange rates are all highly correlated. By manipulating interest rates, [central banks](https://www.investopedia.com/terms/c/centralbank.asp) exert influence over both inflation and exchange rates, and changing interest rates impact inflation and currency values. Higher interest rates offer [lenders](https://www.investopedia.com/terms/l/lender.asp) in an economy a higher return andcause a country's currency to appreciate because higher interest rates attract more foreign capital, which causes a rise in exchange rates

**Inflation rate**

The rate of [inflation](https://www.investopedia.com/terms/i/inflation.asp) in a country can have a major impact on the value of the country's currency and the rates of foreign exchange it has with the currencies of other nations.. As a general rule, a country with a consistently lower inflation rate exhibits a rising currency value, as its [purchasing power](https://www.investopedia.com/terms/p/purchasingpower.asp) increases relative to other currencies. Those countries with higher inflation typically see [depreciation](https://www.investopedia.com/terms/d/depreciation.asp) in their currency in relation to the currencies of their trading partners.

**Speculation :**

If a country's currency value is expected to rise, investors will demand more of that currency in order to make a profit in the near future. As a result, the value of the currency will rise due to the increase in demand. With this increase in currency value comes a rise in the exchange rate as well.

**Monetary policy.**Central bank participate in the forex trading and influence the exchange rate when necessary. Central bank generally participates by buying or selling the domestic currency so as to stabilize it at a level it deems fit

## VOLATILITY AND RISK :The likely chnges in the exchange rate can effect the cost, profit and return on investments of international firms, thus resulting in the following levels of risk

## 1.Economic Exposure'

## 2.Transaction Exposure

## 3.Translation Exposure'

## What is 'Economic Exposure'

Economic exposure is a type of foreign exchange exposure caused by the effect of unexpected [currency](https://www.investopedia.com/terms/c/currency.asp) fluctuations on a company’s future cash flows, foreign investments and earnings.

# For example, assume that a large U.S. company that gets about 50% of its [revenues](https://www.investopedia.com/terms/r/revenue.asp) from overseas markets has factored in a gradual decline of the U.S. dollar against major global currencies – say 2% per annum – into its operating forecasts for the next few years. If the U.S. dollar appreciates instead of declining gradually in the years ahead, this would represent economic exposure for the company. The dollar’s strength means that the 50% of revenues and [cash flows](https://www.investopedia.com/terms/c/cashflow.asp) the company receives from overseas will be lower when converted back into dollars, which will have a negative effect on its profitability and [valuation](https://www.investopedia.com/terms/v/valuation.asp).

# Economic exposure to exchange rate fluctuations is often more difficult to manage. The Japanese automobile manufacturer Toyota provides a prominent example of this exposure and its management. This company developed a very sizable market in the United States by initially producing an inexpensive, fuel-efficient vehicle. As time passed, Toyota developed a broader line of products to expand its share of the U.S. automobile market. Beginning in the early 1980s, however, the yen began to appreciate relative to the dollar. Even with constant dollar sales in the U.S. market, Toyota's revenues began to drop significantly when converted back to yen. Since the majority of their production costs were already yen denominated, this hurt their profitability. Toyota was reluctant to raise the dollar price of their products because they feared that they would lose market share. The firm had significant economic exposure because a large proportion of its revenues were denominated in dollars while most of its costs were denominated in yen. Toyota responded to this problem by building manufacturing facilities in the United States. This generated dollar-denominated production costs that could be used to offset dollar revenues. The result was a reduced need for foreign exchange and more stable corporate earnings in Toyota's home country of Japan.

# Transaction Exposure

Transaction exposure, defined as a type of [foreign exchange](https://strategiccfo.com/shanghai-stock-exchange-sse/) risk faced by companies that engage in international trade, exists in any worldwide market. It is the risk that [exchange rate](https://strategiccfo.com/wikicfo/currency-exchange-rates/) fluctuations will change the value of a contract before it is settled. This can also called transaction risk. Once a cross-currency contract has been agreed upon, for a specific quantity of goods and a specific amount of money, subsequent fluctuations in exchange rates can change the value of that[contract](https://strategiccfo.com/completed-contract-method/).

For example, a domestic company signs a contract with a foreign company. The contract states that the domestic company will ship 1,000 units of product to the foreign company and the foreign company will pay for the goods in 3 months with 100 units of foreign currency. Assume the current exchange rate is: 1 unit of domestic currency equals 1 unit of foreign currency. The money the foreign company will pay the domestic company is equal to 100 units of domestic currency.

The domestic company, the one that is going to receive payment in a foreign currency, now has transaction exposure. The value of the[contract](https://strategiccfo.com/contract-price/) is exposed to the risk of exchange rate fluctuations.

The next day the exchange rate changes and then remains constant at the new exchange rate for 3 months. Now one unit of domestic currency is worth 2 units of foreign currency. The foreign currency has devalued against the domestic currency. Now the value of the 100 units of foreign currency that the foreign company will pay the domestic company has changed – the payment is now only worth 50 units of domestic currency.

The contract still stands at 100 units of foreign currency, because the contract specified payment in the foreign currency. However, the domestic firm suffered a 50% loss in [value](https://strategiccfo.com/how-does-a-cfo-add-value/).

What is 'Translation Exposure'

Translation exposure is the risk that a company's equities, assets, liabilities or income will change in value as a result of [exchange rate](https://www.investopedia.com/terms/e/exchangerate.asp) changes. This occurs when a firm denominates a portion of its equities, assets, liabilities or income in a foreign currency, and it's also known as "accounting exposure.”

Translation exposure is most evident in multinational organizations, since a portion of their operations, and assets, will be based in a foreign currency.

 In order to properly report the organization's financial situation, the assets and liabilities for the whole company need to be adjusted into the home currency. Since an exchange rate can vary dramatically in a short period of time, this unknown, or risk, creates accounting exposure.  
  
  
*The Purchasing Power Parity (PPP) model or else the “law of one price” estimates the adjustment needed on the exchange rate between countries in order for the exchange to be equivalent to each currency's purchasing power.*

Balance of Payment (BOP) is the accounting record of all monetary transactions between a given country and the rest of the world. The transactions comprises of payments for country's export and imports of goods and services.

The Balance of Payments is comprised of two main components:

* The Current Account (trade in goods, services + transfer payments and investment incomes)
* The Financial Account (used to be called capital account; this is capital flows such as foreign direct investment)

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BOP is said to be in equilibrium when the outward transactions (Cash & Fund outflow) of a country is equal to the inward transactions (Cash & Fund inflow  
Disequilibrium in the Balance of Payment may take place either in the form of deficit, that is, when the receipts from the foreigners fall below a country's payment If the UK imports more goods and services than we export – then we have a deficit on the current account. A significant deficit on the current account is generally referred to as disequilibrium.surplus disequilibrium which arises when the receipts of the country exceeds its payments, which is favorable.

Main types of disequilibrium in the balance of payments are:

1. Cyclical Disequilibrium
2. ii. Structural Disequilibrium
3. iii. Short-run Disequilibrium
4. iv. Long-run Disequilibrium!

**i. Cyclical Disequilibrium:**

It occurs on account of trade cycles. Depending upon the different phases of trade cycles like prosperity and depression, demand and other forces vary, causing changes in the terms of trade as well as growth of trade and accordingly a surplus or deficit will result in the balance of payments.

A**Cyclical disequilibrium in the balance of payments may occur because:**

i. Trade cycles follow different paths and patterns in different countries. There are no identical timings and periodicity of occurrence of cycles in different countries.

ii. No identical stabilisation programmes and measures are adopted by different countries.

iii. Income elasticities of demand for imports in different countries are not identical.

iv. Price elasticities of demand for imports differ in different countries.

In short, cyclical fluctuations cause disequilibrium in the balance of payments because of cyclical changes in income, employment, output and price variables. When prices rise during prosperity and fall during a depression, a country which has a highly elastic demand for imports experiences a decline in the value of imports and if it continues its exports further, it will show a surplus in the balance of payments.

Since deficit and surplus alternatively take place during the depression and prosperity phase of a cycle, the balance of payments equilibrium is automatically set forth over the complete cycle.

**ii. Structural Disequilibrium:**

It emerges on account of structural changes occurring in some sectors of the economy at home or abroad which may alter the demand or supply relations of exports or imports or both. Suppose the foreign demand for India’s jute products declines because of some substitutes, then the resources employed by India in the production of jute goods will have to be shifted to some other commodities of export.

If this is not easily possible, India’s exports may decline whereas with imports remaining the same, disequilibrium in the balance of payments will arise. Similarly, if the supply condition of export items is changed, i.e., supply is reduced due to crop failure in prime commodities or shortage of raw materials or labour strikes, etc. in the case of manufactured goods, then also exports may decline to that extent and structural disequilibrium in the balance of payments will arise.

Moreover, a shift in demand occurs with the changes in tastes, fashions, habits, income, economic progress, etc. Propensity to import may change as a result. Demand for some imported goods may increase, while that for certain goods may decline leading to a structural change.

Furthermore, structural changes are also produced by variations in the rate of international capital movements. A rise in the inflow of international capital tends to have a direct impact on a country’s balance of payments.

**iii. Short-run Disequilibrium:**

A short-run disequilibrium in a country’s balance of payments will be a temporary one, ‘lasting for a short period, which may occur once in a while. When a country borrows or lends internationally, it will have short-run disequilibrium in its balance of payments, as these loans are usually for a short period or even if they are for a long duration, they are repayable later on; hence the position will be automatically corrected and poses no serious problem.

As such, a disequilibrium arising from international lending and borrowing activities is perfectly justified. However, a short-run disequilibrium may also emerge if a country’s imports exceed its exports in a given year.

This will be a temporary one if it occurs once in a way, because later on, the country will be in a position to correct it easily by creating the required credit surplus by exporting more to offset the deficit. But even this type of disequilibrium in the balance of payments is not justified, because it may pave the way for a long-term disequilibrium.

When such disequilibrium (arising from imports exceeding exports or even vice versa) occurs year after year over a long period, it becomes chronic and may seriously affect the country’s economy and its international economic relations. A persistent deficit will tend to deplete its foreign exchange reserves and the country may not be able to raise any more loans from foreigners.

**iv. Long-run Disequilibrium:**

The long-term disequilibrium thus refers to a deep- rooted, persistent deficit or surplus in the balance of payments of a country. It is secular disequilibrium emerging on account of the chronologically accumulated short-­term disequilibria — deficits or surpluses.

It endangers the exchange stability of the country concerned. Especially, a long-term deficit in the balance of payments of a country tends to deplete its foreign exchange reserves and the country may also not be able to raise any more loans from foreigners during such a period of persistent deficits.

In short, true disequilibrium is a long-term phenomenon. It is caused by persistent deep-rooted dynamic changes which slowly take place in the economy over a long period of time. It is caused by changes in dynamic forces/factors such as capital formation, population growth, territorial expansion, technological advancement, innovations, etc.

A newly developing economy, for instance, in its initial stages of growth needs huge investment exceeding its savings. In view of its low capital formation, it has also to import a large amount of its capital requirements from foreign countries and its imports thus tend to exceed its exports. These become a chronic phenomenon. And in the absence of a sufficient inflow of foreign capital in such countries, a secular deficit balance of payments may result.

**Causes ofdisequilibrium   
Import related causes**1. **Population growth:** Most countries experience rapid population growth which lead to a high quantity of import that exceeds the quantity of export. This leads to a disequilibrium of deficit.  
  
2. **Development programmes**: Third world countries always have so many development programmes that require raw materials and highly skilled labor. Due to lack of these resources, imports have to be made and this continues for a long time leading a country to disequilibrium in balance of payment.  
  
3. **Inflation**: An increase in price levels and income leads to rapid economic development in developing countries. This increases imports and reduces exports leading to a deficit in balance of payment.  
  
4. **Natural calamities**:Natural calamities such as floods, earthquakes and diseases cause disequilibrium in balance of payment as they adversely affect agriculture and industrial production in the country.  
  
5**. Demonstration effect**: When people in less developed countries imitate the consumption pattern of developed countries they end up increasing imports as export remains constant or decline. This causes a disequilibrium on balance of payment.

**Export related causes**

1.**Appreciation of currency**: Appreciation of domestic currecy against foreign currency results in lower foreign exchange to exporters , and demotivates them.

2. Protectionist Trade policy: such a policy of the importing country would encourage domestic producers by giving them incentives, whereas the imports would be discouraged by imposing high duties  
**other causes**

1. **Flight of capital**: Due to speculative reasons countries may lose foreign exchange. Investors may withdraw their investments , which in turn put pressure on foreign exchange reserves

2.**Globlisation**:Globlisation and the rules of WTO have brought a liberal and open environment in the global trade. It has both positive and negative effects on imports, exports and investments. Poor countries are unable to cope up with this new environment ,ultimately they are the losers and are faced with adverse BOP.,

3.Cyclical transmission: Trade may be affected by business cycles, recession or depression. The negative effects of trade cycle are transmitted from one country to another.   
**Methods of Correcting Disequilibrium in Balance of Payments**:

In order to maintain a country’s sound economic condition, its disequilibrium in balance of payment position (if any) must be corrected. Naturally, the reasons for creating such a situation must be removed. Otherwise if the situation continues for a long, the country will exhaust its foreign exchange reserves.

If such a situation arises the country concerned will have to depreciate its currency below par. We describe hereunder, certain measures to correct or improve the adverse balance of payments position.

**These are explained below**

**MONETARY POLICY**

**1. Deflation:**

Deflation is the classical medicine for correcting the deficit in the balance of payments. Deflation refers to the policy of reducing the quantity of money in order to reduce the prices and the money income of the people.

The central bank, by raising the bank rate, by selling the securities in the open market and by other methods can reduce the volume of credit in the economy which will lead to a fall in prices and money income of the people.

Fall in prices will stimulate exports and reduction in income checks imports. Thus, deflationary policy restores equilibrium to the balance (a) by encouraging exports through reduction in their prices and (b) by discouraging imports through the reduction in incomes at home.

Moreover, a higher interest rate in the domestic market will attract foreign funds which can be used for correcting disequilibrium.

**Fiscal measures**

**Easy fiscal policy:** During inflation ,govt may adopt easy fiscal policy. The tax rates for the corporate may be reduced , which would encourage more production and distribution including exports.. Increased exports will bring in more foreign exchange therby making BOP position more favourable.

**Restrictive fiscal policy:** During deflation govt may adopt restrictive policy. It may impose additional taxes on consumers. This may reduce consumption which in turn enable more export surplus

**Exchange rate policy**

**. Depreciation:**

Another method of correcting disequilibrium in the balance of payments is depreciation. Deprecation means a fall in the rate of exchange of one currency (home currency) in terms of another (foreign currency).

A currency will depreciate when its supply in the foreign exchange market is large in relation to its demand. In other words, a currency is said to depreciate if its value falls in terms of foreign currencies, i.e., if more domestic currency is required to buy a unit of foreign currency.

The effect of depreciation of a currency is to make imports dearer and exports cheaper. Thus, depreciation helps a country to achieve a favourable balance of payments by checking imports and stimulating exports.

**3. Devaluation:**

Devaluation refers to the official reduction of the external values of a currency. The difference between devaluation and depreciation is that while devaluation means the lowering of external value of a currency by the government, depreciation means an automatic fall in the external value of the currency by the market forces; the former is arbitrary and the latter is the result of market mechanism.

Thus, devaluation serves only as an alternative method to depreciation. Both the methods imply the same thing, i.e., decrease in the value of a currency in terms of foreign currencies.

Both the methods can be used to produce the same effects; they discourage imports, encourage exports and thus lead to a reduction in the balance of payments deficit.

The success of the method of devaluation depends upon the following conditions :

(i) The elasticity of demand for the country's exports should be greater than unity.

(ii) The elasticity of demand for the country's imports should be greater than unity.

(iii) The exports of the country should be non-traditional and the increasingly demanded from other countries.

(iv) The domestic price should not rise and should remain stable after devaluation.

(v) Other countries should not retaliate by resorting to corresponding devaluation. Such a retaliatory measure will offset each other's gain.

NON monetary measures

* **) Export Promotion Measures :**The government encourage those industries which are producing exportable goods and services by giving them various facilities and incentives. These facilities are in form of cheap credit facility as well as marketing facilities. The government also provide tax rebates and subsidies to such industries. Declaration of SEZs and ECZs is the example of such export promotion measures adopted by countries to correct BOP disequilibrium.
* (ii)  **Import Substitution Measures**: This measure include the following aspects;
* (a)   **Tariffs:** Tariffs are the duties which are imposed on imports. The purpose of imposing tariffs is to curtail imports as prices of imports increase on account of tariffs. Increased prices of imports reduce their demand. On the other hand domestic producers get induced to produce import substitutes.
* (b)   **Quotas:** A quota means fixing themaximum limit to the quantity of imported items during a certain time period. The government may fix maximum quantity as well as value of a commodity to be imported. The quota system reduces imports and as a result deficit in BOP.
* (c)    **Various Concessions**: The government can provide some concessions to the industries producing import substituting goods. These concessions include tax concessions, technical assistance, subsidies etc.
* **(III) Others measures:**There are following others measures to correct disequilibrium of balance of payments. These measures are also known as non economic measures to correct balance of payments;
* **(a) Political Measures:**There are several political factors that they may correct of disequilibrium of balance of payments. These factors are**;**to take independent decision by a check on political alliances, to save foreign exchange by a check on political and administrative expenses and change in basic political ideology through socialistic pattern to globolised economy.
* **(b) Social Measures:**This measure includes change in consumption patterns, tastes and preferences, fashion and trends etc in the direction of social awareness. These factors may affect imports and exports of the country.  For a example in India, spread Swadeshi of movement went a long way in reduce import and correcting the BOP during British rule in India. Today, import of petroleum product is the major reason of adverse BOP. If the social awareness is spread among the people to economic use of petroleum product by using public convenience. That would be positive effect on balance of payments of the nation.

**Major Theories of Exchange Rates:**

Many factors affect the exchange rate,BOP position , inflation, monetary policies, interest rate and growth rate in GDP.Lingages between each of these determinents and exchange rate are explained through the following theories

**1. The Mint Parity Theory:**

The earliest theory of foreign exchange has been the mint parity theory. This theory was applicable for those countries which had the same metallic standard (gold or silver). Under the gold standard, countries had their standard currency unit either of gold or it was freely convertible into gold of a given purity.

The value of currency unit under gold standard was defined in terms of weight of gold of a specified purity contained in it. The central bank of the country was always willing to buy and sell gold upto an unlimited extent at the given price. The price at which the standard currency unit of the country was convertible into gold was called as the mint price.

Suppose the official price of gold in Britain was £ 20 per ounce and in the United States it was $ 80 per ounce, these were the mint prices of gold in the two countries. The rate of exchange between these two currencies would be determined as £ 20 = $ 80 or £ 1 = $ 4.

This rate of exchange determined on weight-to-weight basis of the metallic contents of currencies of the two countries was called mint par of exchange or the mint parity. So the mint par values of the two currencies determined the basic rate of exchange between them.

Under the gold standard, the balance of payments adjustments were made through the free international flows of gold. The export and import of gold involved costs of packing, freight, insurance, interest etc. Consequently, the actual rate of exchange between two currencies could vary above and below the mint parity by the extent of cost of gold export.

In order to illustrate it, the supposition is taken that the U.S. has a BOP deficit with Britain. It is adjusted through the export of gold to Britain. The mint parity between pound and dollar is £ 1 = $ 4. The cost of exporting gold including freight, insurance, packing, interest etc. of gold worth $ 4 is 0.04 dollar. So the U.S. importers have to pay 4.04 dollars (4+.04) for each pound.

No U.S. importer will pay more than 4.04 dollars for one British pound because he can buy 4 dollar worth of gold from the U.S. treasury and transport it to Britain and obtain 1 pound in exchange of that.

Therefore, the exchange rate between dollar and pound at the maximum can be £ 1 = $ 4.04. This exchange rate signifies U.S. gold export point or upper specie point. Similarly, the exchange rate of pound could not fall below $ 3.96 dollars, in case the United States had a BOP surplus resulting in flow of gold from Britain to that country.

If the rate of exchange were lower than £ 1 = $ 3.96, the exporter would have preferred to import gold from Britain. This rate of exchange (£ 1 = $ 3.96) is the U.S. gold import point or lower specie point. The upper and lower specie points prescribe the limits within which the fluctuation can take place in the market rate of exchange.

**2Purchasing Power Parity**  
[Purchasing Power Parity](https://www.investopedia.com/terms/p/ppp.asp) (PPP) is the economic theory that price levels between two countries should be equivalent to one another after exchange-rate adjustment. The basis of this theory is the law of one price, where the cost of an identical good should be the same around the world. In simple terms the rate of exchange will equate the ratio of currency required to buy a set of goods at home against the foreign currency units required to buy the same set of goods in a foreign country.Based on the theory, if there is a large difference in price between two countries for the same product after exchange rate adjustment, an arbitrage opportunity is created, because the product can be obtained from the country that sells it for the lowest price.

Eg: A pen is sold in india and USA, the exchange rate is 1$= 43 rupees. The price of the pen in india is 86 rupees, what would be the price of the pen in USA according to the PPPtheory

**3Balance of Payments Theory :**Thistheory states that the foreign exchange rate is determined by autonomous factors which are unrelated to the internal prices and money supply. According to this theory a deficit in the balance of payments of a country implies that the demand for foreign exchange would exceed the supply for foreign exchange.This will result in the fall or depreciation of the rate of the foreign exchange resulting in the appreciation of the exchange value of the foreign currency and at the same time the exchange value of the domestic currency depreciates..

If a country is running a large current account [surplus](https://www.investopedia.com/terms/s/surplus.asp) or [deficit](https://www.investopedia.com/terms/d/deficit.asp), it is a sign that a country's exchange rate is out of equilibrium. To bring the current account back into equilibrium, the exchange rate will need to adjust over time. Thus according to this theory , it is the international balance of payments position that determines the exchange rate.

**4. The Monetary Approach to Rate of Exchange:**

In contrast with the BOP theory of foreign exchange, in which the rate of exchange is determined by the flow of funds in the foreign exchange market, the monetary approach postulates that the rates of exchange are determined through the balancing of the total demand and supply of the national currency in each country.

According to this approach, the demand for money depends upon the level of real income, the general price level and the rate of interest. The demand for money is the direct function of the real income and the level of prices. On the other hand, it is an inverse function of the rate of interest. As regards, the supply of money, it is determined autonomously by the monetary authorities of different countries.

It is assumed that initially the foreign exchange market is in equilibrium or at interest parity. It is further supposed that the monetary authority in the home country increases the supply of money. This will lead to a proportionate increase in price level in the home country in the long run. It will also cause depreciation in the home currency as explained by the PPP theory.

For instance, if the Reserve Bank of India increases the supply of money by 20 percent, it may cause a 20 percent rise in price level and 20 percent depreciation of rupee relative to, say dollar, over the long period. The rate of interest, given the demand for money, is however likely to fall.

The expansion in money supply and consequent fall in the rate of interest will affect the financial markets and exchange rates immediately in the home country India. The decline in the rate of interest in India can result in increased Indian financial investments in the U.S.A. This is likely to cause an immediate depreciation of rupee by, say 15 percent, which exceeds or overshoots the 10 percent depreciation of rupee expected in the long run according to PPP theory.

Subsequently, as prices in the United States rise relative to India over time, there will be an appreciation of rupee by an extent (say 8 percent) such that overshooting or excessive depreciation that occurred soon after the increase in money supply and consequent fall in rate of interest in India gets neutralized.

**5.The Portfolio Balance Approach:**

In view of the deficiencies in the monetary approach, some writers have attempted to explain the determination of exchange rate through the portfolio balance approach which is more realistic than the monetary approach.

The portfolio balance approach brings trade explicitly into the analysis for determining the rate of exchange. It considers the domestic and foreign financial assets such as bonds to be imperfect substitutes. The essence of this approach is that the exchange rate is determined in the process of equilibrating or balancing the demand for and supply of financial assets out of which money is only one form of asset.

To start with, this approach postulates that an increase in the supply of money by the home country causes an immediate fall in the rate of interest. It leads to a shift in the asset portfolio from domestic bonds to home currency and foreign bonds. The substitution of foreign bonds for domestic bonds results in an immediate depreciation of home currency. This depreciation, over time, causes an expansion in exports and reduction in imports.

It leads to the appearance of a trade surplus and consequent appreciation of home currency, which offsets part of the original depreciation. Thus the portfolio balance approach explains also exchange over-shooting. This explanation, in contrast to the monetary approach, brings in trade explicitly into the adjustment process in the long run.

**UNIT-3**

**Instruments in International financial markets**

. A financial market is a broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Financial markets are typically defined by having transparent pricing, basic regulations on trading, costs and fees, and market forces determining the prices of securities that trade.  
  
Financial markets can be found in nearly every nation in the world. Some are very small, with only a few participants, while others - like the New York Stock Exchange (NYSE) and the forex markets - trade trillions of dollars daily.

Borrowers are benefited as the funds are made available in surplus and at low cost.Investors have access to a large number of financial markets and exchanges representing a vast array of financial products It benefits the investors by providing a wide range of investment oppurtunities and allowing the investors to build portfolio of international investments that diversify their risks.

International financial markets consist of international market for foreign exchange , euro bond and global equity market. IFM are categorized into five markets

* Foreign exchange market
* Lending by financial institutions
* Issue and trading of negotiable instruments of sebt
* Issue and trading of equity securities
* Lastly internationally arranged swaps

Nature and functions

Nature

1. IFM undertake intermediation by transferring purchasing power from lenders and investors to parties who desire to acquire assets that they expect to yield future benefits
2. IFM involve exchange of assets between residents of different financial centres across national borders
3. They are reservoirs of savings and transfer them to their most efficient use

**Functions**

1.The interaction of buyers and sellers in the market determine the prices of the assets traded

2 The financial market ensure liquidity by providing a mechanism for an investor to sell a financial asset

3.IFM reduce the cost of transaction and information

**Benefits**1. Helps in expansion of international trade

1. Helps in cross country financial flows which contribute to a more efficient allocation of resources

**Capital Markets**A capital market is one in which individuals and institutions trade financial securities. Organizations and institutions in the public and private sectors also often sell securities on the capital markets in order to raise funds. Thus, this type of market is composed of both the primary and secondary markets. 

FINANCIAL DEREGULATION The detrimental aspects of free flow of financial capital following the experience of the Great Depression was recognized by many countries across the World. Accordingly, not only developed but also newly-formed countries undertook various measures in order to prevent financial instability. It was recognized that to prevent the latter, there was a need to control financial flows that were purely speculative in nature, and to ensure that possible expansion of aggregate expenditure in the productive aspect of the economy was not constrained by inadequate financial flows. Consequently, regulations within national boundaries took the form of preventing financial flows that were mainly geared for speculative activity. In addition to those regulations almost every country made further provisions to ensure that the productive sectors were neither constrained by the price of finance nor by inadequate financial flows. These often arose either as a result of lenders’ incomplete knowledge about a particular sector, or as a result of borrowers’ inability to meet lenders’ credit standards.

As a result, the ceiling on interest rates was introduced in order to ensure that borrowers were not constrained by the price, and specialized banks were developed to ensure that the lenders’ lack of knowledge did not prevent the financial flows to specific sectors. Furthermore, in certain countries the government stood as guarantor, and in other countries banks were instructed to reduce the credit standard requirements. That was aimed at ensuring that certain groups of borrowers were not constrained by interruptions to the financial flows that arose from their inability to meet banks’ credit standard requirements.

On the international side, a variety of controls were established in order to ensure that foreign financial flows were mainly concentrated on the productive side of the economy. In order to prevent free financial flow and exit, those controls also embraced the purchase of foreign currency. In some instances, governments stood as a direct guarantor between the foreign lenders and the domestic borrowers. The reason was to ensure that the growth of local industries was not constrained by inadequate foreign financial flows arising from their inability to meet the foreign lenders’ credit standard requirements. The main objective of those regulations was to bring financial stability and to promote governments’ economic and social objectives. This was the case for developed as well as for developing countries. An important implication of those regulations was to undermine the independence of the financial sector as a profit-seeking economic unit.

A further implication was that, since banks were prohibited by regulation from advancing loans to certain areas of economic activity, there was the opportunity for new institutions to emerge in order to capture that end of the loan market. Banks’ share of the loan market fell as a result, thereby affecting the effectiveness of the traditional tools of monetary control This was mainly because these new institutions were not subject to the same regulations as the banks. Serious doubts were also raised about the merits of administrative controls over interest rates It was argued that in the absence of intervention, market forces would determine the interest rate, which in turn would govern the allocation of loans. The presumption was that interest rate plays a crucial linking and causal role amongst savings, investment and growth rates .

CONDITIONS FOR FINANCIAL GLOBALIZATION The crucial message of the financial liberalization thesis is that it is the lack of competition, which brings inefficiency to this sector. Interest rate liberalization is a first step, but it is recognized that this alone is not likely to generate competition in this market, in view of its oligopolistic nature. Consequently, not only is there a need to increase the number of players in this market, but also to tap a larger pool of savings for which a country may be required to go beyond their own domestic boundary. To increase the number of players there is a need to remove entry restrictions so that Non-Bank Financial Intermediaries (NBFI), as well as overseas banks can enter into this market. In order to tap a larger pool of savings, there is a need to not only remove controls over the purchase and sale of foreign currency, but also to relax laws relating to takeover and merger activities. This implies that there is a need to liberalize the external sector of the financial system.

A view emerged similar to that of the school of financial liberalization. Government intervention in the determination of the price of the currency causes a distortion in the allocation of exports and imports, thereby bringing an imbalance between them.This problem might be further aggravated by the undue restriction on foreign direct investment, which may cause debt to rise to an unnecessarily high level which otherwise could be addressed via foreign direct investment. It was argued that if the currency was allowed to float then the mechanism of its appreciation and depreciation would ultimately bring a balance between exports and imports.

**Globalization of capital markets**Financial globalization, by definition, means the integration of financial markets of all countries of the world into one.Hence, the word globalization was introduced which technically means the integration of the whole world into one; that different parts of the globe should be merged into one.

The term financial globalization refers to the process by which financial markets of various countries of the globe are integrated as one. Financial globalization may also be defined as a free movement of finance across national boundaries without facing any restrictions Financial globalization is understood as the integration of a country’s local financial system with international financial markets and institutions

Benefits and risks associated with the globalization of financial markets

**Economic benefits**

1.In order to attract the capital necessary for their development , national economies must remain open to foreign investment and must adopt responsible fiscal and monetary policies

2. A fully developed financial market also makes it possible to steer investmensts towards most useful projects . This development will be achieved more rapidly if foreign investors have access to domestic market

4. The majority of governments have made economic stability on of their highest priorities.This is possible if foreign capital is allowed to flow within the country

5.Lastly it is believed that , if governements reduce taxes on capital movement , create off shore markets and establish a stable and convertible currecy, private capital will flow in.

**More rapid spreading of technological advances**

In a global financial market, technological advances in payment, settlement and trading systems as well in financial information systems can be made available to all the market participants.

**Financial innovation**

Another benefit from the globalization of financial markets is the spreading of financial innovation. Financial market participants can make use of new financial products as soon as these instruments are being marketed in the global market

**Financial performance**.

Most importantly, in open financial markets the entry of foreign financial institutions into domestic financial market can bring sizeable benefits , as increased competition can help to enhance efficiency in the financial sector.

Thus the major benefits of Financial Globalization is that the risk of a "credit crunch" has been reduced to extremely low levels. When banks are under strain, they can now raise funds from international capital markets.

Another benefit is that, with more choices, borrowers and investors get a better pricing on their financing. Corporations can finance the investments more cheaply.

**Risks associated with globalization of financial markets**

1.In the last 3 decades , while more progress was made in the internationalization of financial markets, there have been numerous occurences of financial crises, these crises have had adverse affects on the economy of the country

2. Market inefficiencies causes financial instability . Market inefficiencies is because of information asymmetries as well as transaction costs. These inefficiencies can manifest themselves in various ways , including externality and co-ordination problems. Externalities would seem to occur in particular with setting up market infrastructures such as payment and settlement systems. co-ordination problems would seem to occur mainly in the form of principal-agent problems affecting the relationship between borrowers and lenders because of information asymmetries.

To conclude the markets are now extremely volatile, and this can be a threat to financial stability.

**Problems of financial globalization**

1.The degree of currency convertibility power is low for all the developing countries, all their foreign loans have to be paid in foreign currency

2. To attract foreign capital/ loan depends upon the country’s ability to offer international marketable assets as security. Given the poverty of the developing countries, it is reasonable to assume that their international marketable securities will mainly be comprised of those assets whose earning directly relates to the exporting sector.

3. Financial globalization has an impact on macroeconomic volatility

The problem is that the process of integration requires development of international institutions and introduction of single currency. The vital importance of both is overlooked so far.

There is a need to introduce a single international currency. This is necessary for the following two reasons

1. The first is related to the existence of different currencies across the globe itself signifies that the market is not integrated but segregated .this segregation arises from the fact that different currencies carry different degrees of convertibility in the international market. As aresult currencies which have a low degree of convertibility, would have to be converted to currencies with high degree of convertibility. Access to foreign loan market will be crucial determined by limited number of countries
2. The second reason for the need to introduce a single currency relates to the problem that arises from the fact that loan market operate in the presence of uncertainty. The existence of different currencies with different degrees of convertibility in the international market also causes a problem in introducing uniform credit standards across the globe

Innovation of foreign securities

Financial instruments

**A.Debt instruments**

1. commercial paper( unsecured short term upto 270 days) interest is discounted)

2. convertible bonds

3. carrot and stick bonds

4. convertible bonds with a premium put(issued at face value with a put entitling the bond holder to redeem the bonds for more than their face value)

5.Debt with equity warrants( bonds issued with warrants for purchase of shares)

6. Dual currency bonds: Bonds that are denominated and pay interest in one currency and redeemed in another currency

7.COPS( covered option securities): short term debt that gives the issuer an option to repay the principal and interest in U.S dollars or mutually acceptable foreign currency

**B.Assest backed securities**

**C.Equity instruments**

**D.Hedging instruments**

**Portfolio Management**

Meaning: PM guides the investor in selsecting the best available securities that will provide the expected rate of return for any given degree of risk and also to mitigate the risks

Interntional portfolio is defined as a grouping of investment assests that focus on securities in foreign markets.It is designed to give the investor a exposure to emerging international markets and provide diversification.

Interntional portfolio management

In 1992, indian opened up its economy and allowed FPI in its domestic stock markets. Since then , FPI has emerged as a major source of private capital inflow in this country.India is more dependend on FPI rather FDI

There is increase in competition among emerging markets to attract ,FPI, therefore it becomes necessary for developing countries to ensure attractive returns for investors.It needs to investigate whether the benefits brought by the foreign portfolio investors to the domestic economy are sufficient to justify the costs associated with the promotion of FPI in these countries

OBJECTIVES OF IPM

1.Security of principal amount

2.Capital growth

3.Consistency of returns

4.Marketability

5.Liquidity

6.diversification of portfolio

7. Favorable tax status

UNIT-4

**FOREIGN EXCHANGE RISK**

Foreign exchange risk is associated with unpredicted fluctuationsin the value of currencies.

Types of exchange exposure

1.Economic exposure

a)Transactionexposure

b)Operating exposure

2.Translation exposure

**Economic exposure** is a type of foreign exchange exposure caused by the effect of unexpected [currency](https://www.investopedia.com/terms/c/currency.asp) fluctuations on a company’s future cash flows, foreign investments and earnings

 Economic exposure is the extent to which the value of the company will change when the present value of expected cash flows fluctuates with exchange rate movements.

**Management of economic exposure**

1**.Selecting Low Cost Production Sites**

A firm may wish to diversify the location of their production sites to mitigate the effect of exchange rate movements.Insuch a case it can choose to set up its production facilities in a foreign country where the cost is low. Low cost may be due to lower price of factor of production,like land ,labour etc or depreciating currency of that country

.

2**Flexible Sourcing Policy**: Easy way of reducing economic exposure is to buy inputs from the place where the cost is low. Not only material it can also hire low cost manpower from abroad,Sourcing does not apply only to components, but also to “guest workers”.

*e.g.* Japan Air Lines hired foreign crews to remain competitive in international routes in the face of a strong yen, but later contemplated a reverse strategy in the face of a weak yen and rising domestic unemployment

*3.***Diversification of the Market**:Selling in multiple markets to take advantage of economies of scale and diversification of exchange rate risk.

4**R&D and Product Differentiation**: Successful R&D that allows for

cost cutting, enhanced productivity and product differentiation, it strengthens the competitive position of the firm.Successful product differentiation gives the firm less elastic demand—which may translate into less exchange rate risk.

* 5 **Financial Hedging:**The goal is to stabilize the firm’s cash flows in the near term.Financial Hedging involves use of derivative securities such as currency swaps, futures, forwards, currency options, among others

**Transaction exposure**, defined as a type of [foreign exchange](https://strategiccfo.com/shanghai-stock-exchange-sse/) risk faced by companies that engage in international trade,Once a cross-currency contract has been agreed upon, for a specific quantity of goods and a specific amount of money, subsequent fluctuations in exchange rates can change the value of that[contract](https://strategiccfo.com/completed-contract-method/)

**The internal techniques for management of transaction exposure are**

1. **Choice of a particular currency** for invoicing receivables and payables: Afirm can negotiate with its counter party to receive or make payments in its own currency or another currency which moves very closely with its own currency.

For eg : if anindian company is able to invoice all its revnues and purchases in rupees, then its revenues and costs will not be affected at all by currency fluctuations.This is the simplest technique to hedge exchange exposure. In some cases SDRs are used

1. **Leads & Lags**: A firm has a payable of USD 200 due in 3 months , fearing depreciation of rupee it may renegotiate to make payment in 2 months. Conversely, importing firms will delay the payment if an appreciation of the home currency is anticipated and exporting firms will advance the settlement in similar situation
2. **Netting**:Netting is a technique where the transaction entities try to match the maturity date and currencies of receivable and payable between themselves

Eg: A company A sells its products to B for rs.50,000 and buys from B for rs.25,000. The movement of funds will appear as shown below in the diagram

|  |
| --- |
| CompanyA |

|  |
| --- |
| COMPANY B |

Sells rs,50,000

The combined exposure of the companies A&B is obviously rs.75,000, but by netting the exposure is reduced to rs.25,000.

1. **Back to back credit swaps**: Under this method two companies located in two different countries agree to exchange loans in their respective currencies.

Eg: Mitsubishi (a MNC of Japan) has a subsidiary in USA, while Microsoft ( a MNC OF USA) has a subsidiary in japan. Thesubsidiary of Mitsubishi located in USA needs a dollar loan whereas thesubsidiary ofMicrosoft located in japan needs yen loan. Each parent company can advance loans to subsidiary of the other in the former’ s home currency

1. Sharing risk: The two companies from two different countries practice this technique. The basic principle underlying this technique is that neither the benefit of the favorable movement of the exchange rate should go one party nor the entire loss due to unfavorable movement should go one party, the risk has to be shared.

The most common external methods for hedging transaction exposures are –

a) use of currency forward market

b) use of money market

c) use of currency option market

d) use of currency futures market

* **Forward Contracts** − A forward contract is a financial contract to sell/buy a foreign currency at a certain period in the future at a predetermined price. A long forward contract is a contract to buy a foreign currency at a certain date at a prefixed price while a short forward contract is a contract to sell a foreign currency at a certain date at a prefixed price
* **Futures Contracts** − These are similar to forward contracts in function. Futures contracts are usually exchange traded and they have standardized and limited contract sizes, maturity dates, initial collateral, and several other features. In general, it is not possible to exactly offset the position to fully eliminate the exposure.

**Use of Money Market**

Transaction exposure can also be hedged by lending and borrowing in the domestic and foreign money markets—that is, money market hedge. Generally speaking, the firm may borrow (lend) in foreign currency to hedge its foreign currency receivables (payables), thereby matching its assets and liabilities in the same currency.

Money market hedge:

**A** If a US firm has pound payables from imports , the firm borrows dollars, converts the proceeds into pounds, buys British treasury bills and pays the import bill with the funds derived from the sale of the treasury bills. The firm’s dollarloan is not subject to exchange rate risk

B.IfIf a US firm has pound receivables, the firm borrows pounds converts the proceeds into dollars, and buys US treasury bills at maturity, the firm uses pound receivables to pay of its pound loan

* **Options** −Options are derivatives (derivatives are financial instruments whose value is derived from the value of another instrument, e.g foreign currency in our example) which give their holder the right but not the obligation to buy/sell foreign currency at preset prices (called the Exercise Price). A call option on a foreign currency is the right but not the obligation to buy a foreign currency at the Exercise price while a put option is the right but the not the obligation to sell the foreign currency at the Exercise Price.

Hedging

Hedging is covering the loss. It ultimately involves no gain no loss. It involves the making of two equal transactions by the hedger and if the price moves either way ,the hedger loses on one transaction and gains on the other.

Hedging is the practice using strategies to cover or mitigate risk of transaction exposure. This can be done in various means such as entering a forwards contract, Future contracts, money market hedges etc.  
  
Hence strategies helping to protect a transaction from such exposure to a fluctuating foreign currency is know as hedging transaction exposure.

**Techniques of hedging**

**Contractual hedges**

1. Forward market hedge
2. Hedging through currency futures
3. Hedging through currency options
4. Money market hedge

**Natural hedges**

1. Lead & lags
2. Cross hedging
3. Currency diversification:The smaller the number of currencies in which a firm transacts, the greater will be the magnitude of risk and vice versa. A firm is advised to diversify its operations in large number of currencies as a hedging tool.
4. Risk sharing
5. Currency swaps: Here two borrowers exchange the currency of borrowings with each other through a swap deal.
6. Parallel loans

**SWAPS**

**UNIT-5**

**International financial institutions and liquidity**

The purposes of the [IMF](http://www.nationsencyclopedia.com/knowledge/International_Monetary_Fund.html) are the following:

1. to promote international monetary cooperation;
2. to facilitate the expansion and balanced growth of international trade and contribute thereby to the promotion and maintenance of high levels of employment and real income;
3. to promote exchange stability, maintain orderly exchange arrangements among member states, and avoid competitive [currency](http://www.nationsencyclopedia.com/knowledge/Currency.html) depreciations;
4. to assist in establishing a multilateral system of payments of current transactions among members and in eliminating foreign-exchange restrictions that hamper world trade; and
5. to alleviate serious disequilibrium in the international balance of payments of members by making the resources of the Fund available under adequate safeguards, so as to prevent the members from resorting to measures that endanger national or international prosperity.

Activities of IMF

1.policy advice to govt and central banks based on the analysis of economic trends and cross country experiences

2.Research, forecasts and analysis

3.loans to countries to overcome economic diffculities

4. Concessional loans to help fight poverty in developing countries

5. Technical assistance and training

MEMBERSHIP

The International Monetary Fund (IMF) is an organization of 189 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. To become a member , a country must apply and then be accepted by the majority of the existing members. Each member country is assigned a quota based on its relative size in the world economy.

OPERATIONS OF IMF

1.The IMF hs shown great interest in the economic development of under developed countries

2. it has simplified the multiple exchange system. The IMF has promoted exchange rate stability and expansion of world trade

3. It has provided an excellent platform for the discussion and solution of economic , fiscal and financial problems

**Objectives of IMF:**

**The main objectives of IMF, as noted in the Articles of Agreement, are as follows:**

**(i) International Monetary Co-Operation:**

The most important objective of the Fund is to establish international monetary co-operation amongst the various member countries through a permanent institution that provides the machinery for consultation and collaborations in various international monetary problems and issues.

**(ii) Ensure Exchange Stability:**

Another important objective of the Fund is to ensure stability in the foreign exchange rates by maintaining orderly exchange arrangement among members and also to rule out unnecessary competitive exchange depreciations.

**(iii) Balanced Growth of Trade:**

IMF has also another important objective to promote international trade so as to achieve its required expansion and balanced growth. This would ensure development of production resources and thereby promote and maintain high levels of income and employment among all its member countries.

**(iv) Eliminate Exchange Control:**

Another important objective of the Fund is to eliminate or relax exchange controls imposed by almost each and every country before Second World War as a device to deliberately fix the exchange rate at a particular level. Such elimination of exchange controls was made so as to give encouragement to the flow of international trade.

**(v) Multilateral Trade and Payments:**

To establish a multilateral trade and payment system in respect to current transactions between members in place of the old system of bilateral trade agreements was another important objective of IMF.

**(vi) Balanced Growth:**

Another objective of IMF is to help the member countries, especially the backward countries, to attain balanced economic growth by exchange the level of employment.

**(vii) Correction of BOP Maladjustments:**

IMF also helps the member countries in eliminating or reducing the disequilibrium or maladjustments in balance of payments. Accordingly, it gives confidence to members by selling or lending Fund’s foreign currency resources to the member nations.

**(viii) Promote Investment of Capital:**

Finally, the IMF also promotes the flow of capital from richer to poorer or backward countries so as to help the backward countries to develop their own economic resources for attaining higher standard of living for its people, in general

**FUNCTIONS OF IMF**

**1.EXCHANGE ARRANGEMENTS**

Each country can opt for any one of the following in connection with exchange rate

a.The par value of a currency can be represented in SDRs

b. No country is allowed to represent its currency in gold

2. surveillance:

It is the responsibility of the fund to see whether the members are serious regarding their functions

1. A member to get some undue benefit will not prefer any other member
2. Govt should not interfere in foreign exchange market
3. If govt interferes it should not affect the interest of other countries

**3Consultative Function:**It functions as a centre for international cooperation and a source of counsel and technical assistance to its members.

**4. Technical Assistance:**The IMF is also performing an useful function to provide technical assistance to the member countries. Such technical assistance in given in two ways, i.e., firstly by granting the members countries the services of its specialists and experts and secondly by sending the outside experts.

**5 Eliminating BOP Disequilibrium:**

The Fund is helping the member countries in eliminating or minimizing the short-period equilibrium of balance of payments either by selling or lending foreign currencies to the members. The Fund also helps its members towards removing the long period disequilibrium in their balance of payments. In case of fundamental changes in the economies of its members, the Fund can advise its members to change the par values of its currencies.

Criticisms  
1. Conditions of loan: IMF makes loan conditional on the implementation of certain economic policies. In real sense it becomes difficult to implement such policies as higher interest rates, privatization, deregulation etc in the country.

2. Exchange rate reforms: IIMF fails to understand the dynamics of a country they are dealing with and insist on some blanket reforms, eg remove controls over flow of capital

3.Devaluation: IMF sometimes allows for devaluation

4Free market criticism: IMF is also criticized for being too interventionist. Believers in free market argue that it is better to let capital markets operate without attempts at intervention

5.Lack of transparency and involvement: IMF has been criticized for imposing policies with little or no consultation with affected countries

**Failures:**

In spite of achieving some degree of success by the IMF in certain areas, the Fund suffers as a result of failures in many fronts.

**Following are some of these failures:**

(i) The IMF has failed in respect of achieving the basic objectives of international exchange stability. Neither the Fund put any loan exchange fluctuations nor it prevents competitive devaluation of currencies by its members.

(ii) The Fund has followed discriminatory treatment in favour of certain members in its day to day functioning. It favours some Western countries and neglects the genuine interests of underdeveloped and backward countries.

(iii) The IMF has also failed to establish a stable and sound international monetary system and thereby experiences serious monetary crisis arising out of rapidly fluctuating exchange rates. Thus the Fund has failed to bring complete stability in foreign exchange rates.

(iv)The Fund has also failed to persuade the member countries to eliminate exchange controls and other restrictions on foreign trade.

(v)In respect of promoting international liquidity the Fund has found it difficult to meet the foreign exchange requirements of the members.

(vi)The IMF has also failed to eliminate the multiple exchange rates with regard to different transactions.

(vii)The IMF has also failed to bring the free convertibility of currency of different countries.

(viii)In respect of problems of long term disequilibrium in the balance of payments faced by different countries, the IMF can provide only short term credit facilities.

(ix) The IMF has also failed to tackle the problem of petro dollars. The Fund should have played an effective role in recycling the surpluses of OPEC countries towards the developmental purposes of developing countries.

(x) The IMF has also failed to remove the various restrictions of trade imposed by different countries. Accordingly, the most of the countries are making extensive use of the trade and exchange controls.

(xi)In IMF affairs, the developing countries are having inadequate representation. Although developing countries of Asia, Africa and Latin America constitute about 90 per cent of the members of IMF but in reality these countries are having 38 per cent of the total voting power in various affairs of Fund.

(xii) As a result of non-revision of quota of IMF, the share of quotas as a percentage of world trade has been declining fast from 16 per cent in 1965 to a mere 4 per cent in 1981.

(xiii) As a result of following faulty and biased method of extending credit on the basis of quotas but not on the basis of need, the underdeveloped and developing countries are not getting adequate financial support from the IMF because of their small quotas.

(xiv) The rich member countries are maintaining larger quotas and thereby can influence the policies and decisions of the IMF easily. Therefore, the IMF has been branded as Rich Men’s Club because of their growing dominance.

(xv) Finally, it has also been argued that IMF has been interfering or influencing the economic policies of poor and developing countries by putting various restrictions on them.

International – liquidity

International liquidity consists essentially in the resources available to national monetary authorities to finance potential balance of payments deficit…it may consist in the possession of assets like gold, foreign exchange and in the ability to borrow internationally.

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Meaning of International liquidity holds all those assets which are internationally acceptable without the loss of value in discharge of debts. It comprises of all the reserves that are available to the monetary authorities of different countries for meeting their international payments.

Components of International liquidity

1. Gold reserves with the national monetary authorities- central banks

2.Dollar reserves of countries other than USA

3.Sterling reserves of countries other than UK

**Problems of international liquidity**

Broadly speaking, the problem of international liquidity has two aspects: quantitative and qualitative.

1.The quantitative aspect of the problem relates to the adequacy of international liquidity. 2.The qualitative aspect of the problem pertains to the nature and composition of international reserves for liquidity.

A major source of worry in maintaining international economic relations is the quantitative aspect of the problem of international reserves. It is generally feared that in future there is likely to arise a shortage of international liquidity.

It is regarded that there is no guarantee that the present international monetary system will automatically provide an increase in the supply of international liquidity over the years to finance the expanding volume of international trade and payments. As such, the total quantity of international reserves under the present international monetary system is going to be extremely inadequate for the world’s future demands.

Briefly, though there is no shortage of international liquidity at present it is feared that in future there will be a shortage of international means of payment, under the existing system of international monetary mechanism, which is bound to disrupt trade and international economic relations.

This fear is the logical outcome of the slow growth of gold reserves in relation to the rate of increase in international trade and transactions and expanding international payments. The present payments system is essentially a gold exchange standard, one with a rather high ratio of gold in official monetary reserves.

The gold base on which this payment system is based cannot increase by more than about two per cent per annum on an average. This rate of increase of gold reserves is considerably less than the rate of increase in the volume of international payment.

It has been estimated that the volume of international trade and resulting payments have been expanding at more than double the rate of gold reserve expansion, i.e., about 58 per cent per annum. Naturally, then, there is bound to emerge a liquidity gap, “inadequacy”, posing a serious problem of international liquidity.

In its qualitative aspect, the problem is related to the use of the dollar and sterling as reserve components. The U.S. dollar and the pound sterling are the principal reserve currencies or “key currencies” because of their role as the major trading currencies for carrying out a large number of international trade and investment transactions.

However, since World War II, the world’s international payments system has received its main support from the willingness of the world to hold dollar and use it as an international currency. Thus, today, dollar supply plays a pivotal role in determining the total reserves for international liquidity. In the composition of international liquidity, we now find that gold and dollar plus sterling — key currencies — are the major components.

But, since gold cannot be increased very much the requirements of growing international reserves may be sought to be met by increasing the supply of key currencies. Now, if currencies form an increasing part of international reserves, this implies an increase in the liquid liabilities of the countries whose currencies are held as reserves by other countries in relation to the gold stock

But, should these liquid liabilities grow beyond the gold reserves owned by the reserve currency countries, confidence may be seriously weakened in their continued ability to maintain the par values of their currencies and the stability of the international payments system may be undermined.

This is the precise situation which confronts the U.S. dollar today. As a matter of fact, the U.S. balance of payments deficits on capital account have added to the world’s reserves, but its recent deficits have created a sense of insecurity about the future. Since 1959, the U.S. balance of payments has turned adverse and she has been losing gold.

If this happens, the USA.might lose large quantities of gold and the dollar might have to go off the gold link as the £ (pound). Sterling was forced off the gold standard on September 21, 1931. In fact, confidence in dollar is weakening with a decline in American gold holdings.

Thus, there is the international liquidity dilemma. Under the present monetary set up, an increase in the supply of international liquidity commensurate with increased demand for liquidity due to the expanding world trade and transactions has been dependent on the USA’s willingness to incur continuing deficits in its balance of payments.

But persistent deficits in USA’s balance of payments of the sort that involve accumulating dollar reserves with the European countries may disincline the latter to keep their international reserves in the form of dollars. They may start converting their dollar reserves into gold. This may precipitate a crisis in the European dollar market.

This crisis may further reduce United States gold holdings which in turn may generate lack of confidence in the stability of the gold value of the dollar. It may further accelerate a rush for gold. To avoid this danger, the balance of payments deficit of the USA has to be reduced. And if she reduces this deficit, to those extent worlds liquidity reserves will also be depleted under the present international monetary system.

Another repercussion is that when the United States will reduce its grants of loans to newly-developing countries in order to improve her balance of payments, these countries will also have to make undesirable cuts in their development programmes. The problem of bridging the gap in the US balance of payments is, thus, interlinked with the problem of international liquidity.

**Special Drawing Rights – SDR**

Special drawing rights (SDR) refer to an international type of [monetary reserve](https://www.investopedia.com/terms/m/monetary-reserve.asp)currency created by the [International Monetary Fund (IMF)](https://www.investopedia.com/terms/i/imf.asp) in 1969 that operates as a supplement to the existing money reserves of member countries.

The international supply of the U.S. dollar and gold — the two main[reserve assets](https://www.investopedia.com/terms/r/reserve-assets.asp) — wasn’t sufficient to support growth in global trade and the related financial transactions that were taking place. This prompted member countries to form an international [reserve asset](http://www.federalist-debate.org/index.php/current/item/115-the-debate-about-the-sdr-as-a-global-reserve-currency-and-sdr-denominated-securities) under the guidance of the IMF

Thus SDRs were Created in response to concerns about the limitations of gold and dollars as the sole means of settling international accounts, SDRs augment international [liquidity](https://www.investopedia.com/terms/l/liquidity.asp)by supplementing the standard reserve currencies.

**A basket of currencies determines the value of the SDR**

An SDR is essentially an artificial currency instrument used by the IMF, and is built from a basket of important [national currencies](https://www.investopedia.com/terms/n/national-currency.asp)

The SDR was initially defined as equivalent to 0.888671 grams of fine gold—which, at the time, was also equivalent to one U.S. dollar. After the collapse of the Bretton Woods system, the SDR was redefined as a basket of currencies.

The SDR basket is reviewed every five years, or earlier if warranted, to ensure that the SDR reflects the relative importance of currencies in the world’s trading and financial systems.. The value of the SDR is determined daily based on market exchange rates.

. The IMF uses SDRs for internal accounting purposes. SDRs are allocated by the IMF to its member countries and are backed by the [full faith and credit](https://www.investopedia.com/terms/f/full-faith-credit.asp) of the member countries' governments. The makeup of the SDR is re-evaluated every five years. The current makeup on the SDR is represented by the following table:

|  |  |  |
| --- | --- | --- |
| **Currency** | **Weights determined in the 2015 Review** | **Fixed Number of Units of Currency for a 5-year period Starting Oct 1, 2016** |
| U.S. Dollar | 41.73 | 0.58252 |
| Euro | 30.93 | 0.38671 |
| Chinese Yuan | 8.33 | 1.0174 |
| Japanese Yen | 8.09 | 11.900 |
| Pound Sterling | 10.92 | 0.085946 |

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A few years after the SDR was created, the Bretton Woods system imploded, moving major currencies to the [floating exchange rate](https://www.imf.org/external/np/exr/facts/sdrcb.htm) system. With time, international [capital markets](https://www.investopedia.com/terms/c/capitalmarkets.asp) expanded considerably, enabling creditworthy governments to borrow funds. This saw many governments register exponential growth in their international reserves. These developments diminished the stature of the SDR as a global [reserve currency](https://www.investopedia.com/terms/r/reservecurrency.asp).

How the Concept of SDR Is Used to Settle Claims

The SDR isn’t regarded as a currency or a claim against the IMF assets. Instead, it is a prospective claim against the freely usable currencies that belong to the IMF member states. The Articles of Agreement of the IMF define a freely usable currency as one that is widely used in international transactions and is frequently traded in [foreign exchange markets](https://www.investopedia.com/terms/forex/f/foreign-exchange-markets.asp).

The IMF member states that holders of SDRs can exchange them for freely usable currencies by either agreeing among themselves for voluntary [swaps](https://www.investopedia.com/terms/s/swap.asp), or by the IMF instructing countries with stronger economies or larger foreign currency reserves to buy SDRs from the less-endowed members. IMF member countries can borrow SDRs from its reserves at favorable [interest rates](https://www.imf.org/external/np/fin/data/rms_sdrv.aspx), mostly to adjust their [balance of payments](https://www.investopedia.com/terms/b/bop.asp) to favorable positions.

Besides acting as an auxiliary reserve asset, the SDR is the unit of account of the IMF. Its value, which is summed up in U.S. dollars, is calculated from a [weighted](https://www.investopedia.com/terms/w/weighted.asp)basket of major currencies: the Japanese yen, the U.S. dollar, the pound sterling and the euro.

The SDR Interest Rate

The interest rate on SDRs, or the SDRi, provides the basis for calculating the interest rate charged to member countries when they borrow from the IMF, and paid to members for their remunerated creditor positions in the IMF. It is also the interest paid to member countries on their own SDR holdings and charged on their SDR allocation.