## UNIT – I

## INTRODUCTION TO INTERNATIONAL FINANCE

**International financial management is a well-known term in today’s word and it is also known as international finance. It means financial management in an international business environment.**

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

**International finance also follows techniques for allocation of funds and resource in international trade.**

International Financial Markets: Concerned With International Financial/ Investments Instruments, Foreign Exchange Markets, International Banking, International Securities Markets Financial Derivatives Etc.

### FEATURES OF INTERNATIONAL FINANCE:

* 1. ***Expanded Opportunity To Business:-*** *due to globalization in business there is an expanded opportunity to the business. Business can raise more funds through less cost of capital.*
  2. ***Foreign Exchange Risk:*** *- It Is Financial Risk That Exists When A Financial Transaction Is Denominates In A Currency Other Than That Of The Base Currency Of The Company.*
  3. ***Imperfect Market:****- Due to difference in law and customs among the countries, tax system, cultural difference, business practices, there is distinction between international business practices, there is distinction between international business practice, there is distinction between international business practices, there is distinction between international finance and domestic finance. so, it is said that there is always an imperfect market. due to imperfection in market.*
  4. ***Political Risk:****- International Financial System Affected By Government Policies And Political Issues. So There Is A Risk Of Political Policies, International Finance Can Be Affected. Similarly A Favorable Political Decision Can Increase International Financial Stability.*

### SCOPE OF INTERNATIONAL FINANCE

Currently, International Finance Has Become More Comprehensive of the businesses. In Scope And Is Dealing With Matters Related To Globalization, Fair Trade Multinational Banking, And Multinational Corporation. International Finance Consist Of Foreign Exchange Market, Currency Convertibility, BOP, International Finance And International Monetary System. So There Is A Big Scope International Finance. It Is Discusses Below:

***International Monetary System:-*** *For Better Economic Growth And To Do Trade And Investments Efficiently, A Country Need To Have Its Own Monetary System And An Authority Who Can Control The System. For Example, RBI in India Controls Over The Monetary System Of India Through Controlling Over Inflation, Supply Of Money And Maintaining Interest Rate.*

* + 1. ***International Financial System:****- The Growth In Word Trade, Liberalization And Globalization In Business Brought Tremendous Change In International Financial System. It Organization And Customs Which Enable The International Payments And Receipts Between The Countries. Comparing To Past, The Volume Of Transaction Has Increased In International Finance.*
    2. ***Foreign Exchange Market:****- This Is A Market Where One Country’s Currency Denominated In That Currency Can Be Purchase Through Sales Of Another Country’s Currency. International Financial System Provides This Facility.*
    3. ***Currency Convertibility:****- The Currency Of A Country Is Freely Convertible When The Resident Or Nor Resident Of The Country Are Allowed To Convert The Local Currency In Foreign Currency. But The Governments Of The Country Restricts The Residents And Non-Residents To Do This. Various Countries Do Not Allow Converting The Currency Freely. It Makes The International Business Difficult.*
    4. ***Balance of Payment:*** *Balance Of Payment (BOP) Of A Country Is Defined As, “Systematic Record Of All Economic Transaction With The Residents Of A Reporting Country And Residents Of Foreign Countries During A Given Period Of Time”-Kindle Berger. Thus Balance Of Payments Includes All Visible And Non-Visible Transactions Of A Country During A Given Period, Usually A Year. It Represents A Summation Of Country’s Current Demand And Supply Of The Claims On Foreign Currencies And Of Foreign Claims On Its.*

### IMPORTANCE OF INTERNATIONAL FINANCE

International Finance Plays A Critical Role In International Trade And Inter-Economy Exchange Of Goods And Services. It Is Important For A Number Of Reasons; The Most Notable Ones Are Listed Here:

1. *International finance is an important tool to find the exchange rates, compare inflation rates, get an idea about investing in international debt securities, ascertain the economic status of other countries and judge the foreign markets.*
2. *International finance helps in calculating exchange rates which are very important in international finance, as they let us determine the relative values of currencies.*
3. *Various economic factors help in making international investments decisions.*
4. *Utilizing IFRS is an import factor for any stages of international finance. financial factor for many stages of international finance . financial statements made by the countries that have adopted ifrs are similar. it helps many countries to follow similar reporting systems.*
5. *IRFS system’ which is a part of international finance’ also helps in saving money by following the rules of reporting on a single accounting standard.*
6. *International Finance Has Grown In Nature Due To Globalization. It Helps Understand The Basic Of All International Organization And Keeps The Balance Intact Among Them.*
7. *An International Finance System Maintains Peace Among The Nations. Without A Solid Finance Measures, All Nations Would Work For Their Self-Interest. International Finance Helps In Keeping That Issue At Bay.*

### ADVANTAGES OF INTERNATIONAL FINANCE:

1. ***Promotion:-*** *International Finance Helps To Promote Domestic Investments And Growth Through Capital Market.*
2. ***Better Banking System:-*** *International Finance Helps To Healthy Competition Due To Which It Provides Better Banking System.*
3. ***More Equality:-*** *It Helps To Integrate The Economy Of Two Countries And Asy Flow Of Capital. Due To Free Flow Of Capital Results Into More Equality Between The Countries.*
4. ***Effective Capital Allocation:****- It Helps To Allocate The Country’s Capital Effectively By Providing Information Related To Different Areas.*
5. ***Capital In need :****- It Helps To Access The Capital Market Around The Word Which Enables The Country To Lend Money In Good Times And Borrow Capital Ijn Need.*
6. ***Corrective Measures:****- Due To Worldwide Cash Flows International Finance Helps To Take Corrective Measures to Bad Government Policies.*

**EVOLUTION OF INTERNATIONAL MONETARY SYSTEM**

The international monetary system is the framework within which countries borrow, lend, buy, sell and make payments acress political frontiers. Numerous frameworks are possible and most have been tried in one forms or another. The international monetary system can be broadly classified as below:

### PRE BWS PERIOD: GOLD STANDARD SYSTEM:

***Gold Standard System (1870-1914):***

**The gold standard was the first universally implemented system for valuing currencies. It was promoted by banks of England. It was an exchange rate in which gold coins were freely maintained by the central bank of a country.** The gold standard was adopted by UK in 1821, germany in 1875, france in 1878, us in 1879, and Russia in 1897.

The gold standard is a system in which international currencies are tied to a specific amount of gold. Almost from the dawn of the history gold was considered as the medium of exchange because gold was durable, storable, portable and easily divisible. the gold standard, gold jwellery could be converted into gold coins and used as legal tender.

**Under relative gold standard, gold was considered as the currency standard and each currency was convertible into gold as a specified rate.**

The official central exchange rate between two currencies remained constant since the official prices of gold was constant

### GOLD EXCHANGE STANDATD ( 1925-1933)

Another version of gold standard system was the **gold exchange standard**, where one country’s currency was expressed in terms of another country’s currency, which was on gold bullion standard. The advantage was that only the country on gold bullion standard had to maintain gold reserve and the other country needed to simply hold reserves of the currency to which its currency was linked.

**Under this system, the currency in use was made of gold or was convertible into gold at a fixed rate. The value of the currency unit was defined in terms of certain weight of gold, that is, so many grains of gold to the rupee, the dollar, the pound, etc. the central bank of the country was always ready to buy and sell gold at the specified price. The rate at which the standards money of the country was convertible into gold was called the mint price of gold.**

### BRETTON WOODS SYSTEM (BWS):

**Because of the breakdown of gold standard system, the world monetary system was in a very chaotic position. Hence the policymaker of US,UK and other allies initiated with the process of reviving and restructuring the world monetary system** as it was urgently required to revamp the economies after the destruction caused by world war II. **Hence in july 1944, representatives of 44 major economies met at brettenwoods, a town in Hampshire in US to finalize a new system for currency value** and new international financial architecture to be implemented during this conference, two multilateral institution were established:

#### FEATURES OF BWS:

1. ***Usd As Universal Reserve Asset:-*** *The USD Was Given The Status Of Universal Reserve Asset In Addition To Gold. This Means Countries Could Issue Currency Notes Against A Reserve Basket Containing Both Gold And Usd.*
2. ***Unconditional Guarantee By Us Federal Reserve Bank:*** *Us Federal Reserve Bank Provided An Unconditional Guarantee To Buy And Sell Unlimited Quantity Of Gold At The Fixed Prices. This Was Known As Gold Convertibility Clause.*
3. ***Par Value Mechanism:*** *Effectively A Three Way Relationship Was Created Between Gold, Usd And Individual Currency. This Was Called Par Value Mechanism.*
4. ***Central Bank Participation:*** *Exchange Rates Were Expected To Be Controlled Within The Variation Zone Through Intervention. This Concept Means The Central Bank Proactively Participates In Domestic Foreign Exchange Market By Buying And Selling Foreign Currency So As To Influence The Exchange Rate.*

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European Monetary System

The European Monetary System (EMS) refers to an arrangement established in 1979, whereby members of the European Economic Community (now the European Union) agreed to link their currencies to encourage monetary stability in Europe.

1. The EMS had three components:
   1. Exchange Rate Mechanism (ERM) between European countries
   2. European Currency Unit (ECU)
   3. European Monetary Cooperation Fund (EMCF)

### FIXED EXCHANGE RATES:

The fixed exchange rate is the system in which the monetary authority fixes the value of the domestic currency to a foreign currency or to a basket of currencies. It is also called as hard peg or rigid peg and when one currency is pegged to a foreign currency and its value is set at regular intervals according to some preset criteria of the average exchange rate over the previous few months in the foreign exchange market which makes the system more responsive to the market value of the domestic currency this system of determining the value of currency is called as crawling peg system.

### ADVANTAGE OF FIXED EXCHANGE RATE SYSTEM:

1. ***Contribute to the strength of the domestic currency:***
2. ***Contributing to international economic integration:***
3. ***Control of inflation:***
4. ***Encourage long-term capital flows****:*
5. ***Encourages international trade****:*

### Flexible Exchange Rates:

Fixed exchange rate regime is rarely practiced by any country at present. Almost all countries, at present, have adopted some forms of flexible exchange rate policy. In spite of making several attempts, when the various ways of stabilizing the exchange rates went futile, IMF proposed the flexible exchange rate system in 1978.

The second amendment in IMF articles and it provided the monetary authorities to introduce a new exchange rate system which should be indented i.e which is not based on gold valuation.

When the exchange rate of a country is determined by the market forces i.e the demand and supply of the currency, it is called as floating or flexible exchange rate. It is called as free float or clen float.

### ADVANTAGE OF FLEXIBLE EXCHANGE RATE:

1. ***Boost international liquidity****: the system of flexible exchange rates eradicated the need for official foreign exchange reserve, if the individual governments do not empty stabilization funds to influence the rate.*
2. ***Flexible monetary policy****: floating exchange rates gives the government/ monetary authorities’ flexibility in determining interest Rtes. This is because interest rates do not have to be set to keep the value of the exchange rate within pre determined bands.*
3. ***Market forces of demand and supply****: under the flexible exchange rate system the foreign exchange rates are determined by the market forces of demand and supply.*
4. ***Optimum utilizing of monetary resources;*** *flexible exchange rate enables quicker adjustments in the rates depending upon the changes in the economic factors in country.*

***DISTINCTION BETWEEN FIXED AND FLEXIBLE EXCHANGE RATES***

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| --- | --- |
| ***Fixed exchange rate*** | ***Flexible exchange rate*** |
| *Value of currency was decide by central bank of the country* | *Value of currency decided by market demand supply* |
| *Exchange rates were fixed* | *Exchange rates were flexible* |
| *Changes in exchange rate took place by official action called devaluation or revaluation* | *Change in exchange rate is by market action represented by depreciation* |
| *Due to stability, use of derivatives and risk management system did not exist* | *Due to variability in exchange rate, the use of derivation and risk management techniques is critical* |
| *By implication central bank were required to parity rates through intervention* | *There is no mandatory requirement for central bank to Participate in market.* |
| *Value of gold was fixed i.e it was considered a financial commodity* | *Value of gold is variable, now considered as investments commodity.* |

**Exchange rate policy and Monetary policy**

The exchange rate policy refers to the manner in which  a country manages its currency in respect to foreign currencies and the foreign exchange market. The exchange rate is the rate at which the domestic currency can be converted into a foreign currency.

## Measuring Exchange Rates

### Bilateral exchange rate

There are many ways to measure an exchange rate. The most common way is to measure a bilateral exchange rate. A bilateral exchange rate refers to the value of one currency relative to another. Bilateral exchange rates are typically quoted against the US dollar (USD), as it is the most traded currency globally.

Bilateral exchange rates are visible in our daily lives and widely reported in the media. Consumers are exposed to them when they travel overseas or when they order goods and services from other countries

### Cross rates

A cross rate is an exchange rate calculated by reference to a third currency. For instance, if the exchange rate for the euro (EUR) against the US dollar is known as well as for the Australian dollar against the US dollar, the exchange rate between the euro and the Australian dollar (EUR/AUD) can be calculated by using the AUD/USD and EUR/USD rates (that is, EUR/AUD = EUR/USD x USD/AUD).

### Trade-weighted index (TWI)

A trade-weighted index (TWI) provides a broader measure of general trends in a currency. This is because a TWI captures the price of a domestic currency in terms of a weighted average of a group or 'basket' of currencies (rather than a single foreign currency). The weights of each currency in the basket are generally based on the share of trade conducted with each of a country's trading partners (usually total trade shares, but import or export shares can also be used).

For example in calculating the trade weighted index of the Pound Sterling, the most important exchange rate would be with the Euro. If the UK exports 60% of total exports to the EU, the value of £ to Euro would account for 60% of the trade weighted index.

Monetary policy

Monetary policy is a set of tools used by a nation's [central bank](https://www.investopedia.com/terms/c/centralbank.asp) to control the overall money supply and promote economic growth and employ strategies such as revising interest rates and changing bank reserve requirements.

In the United States, the [Federal Reserve Bank](https://www.investopedia.com/terms/f/federalreservebank.asp) implements monetary policy through a dual mandate to achieve maximum employment while keeping inflation in check.

## Tools of Monetary Policy

### Open Market Operations

In [open market operations](https://www.investopedia.com/terms/o/openmarketoperations.asp) (OMO), the Federal Reserve Bank buys bonds from investors or sells additional bonds to investors to change the number of outstanding government securities and money available to the economy as a whole.

The objective of OMOs is to adjust the level of reserve balances to manipulate the short-term interest rates and that affect other interest rates.1

### Interest Rates

The central bank may change the interest rates or the required [collateral](https://www.investopedia.com/terms/c/collateral.asp) that it demands. In the U.S., this rate is known as the [discount rate](https://www.investopedia.com/terms/d/discountrate.asp). Banks will loan more or less freely depending on this interest rate.

*The Federal Reserve commonly uses three strategies for monetary policy including reserve requirements, the discount rate, and open market operations.*

### Reserve Requirements

Authorities can manipulate the [reserve requirements](https://www.investopedia.com/terms/r/requiredreserves.asp), the funds that banks must retain as a proportion of the deposits made by their customers to ensure that they can meet their [liabilities](https://www.investopedia.com/terms/l/liability.asp).

Lowering this reserve requirement releases more capital for the banks to offer loans or buy other assets. Increasing the requirement curtails bank lending and slows growth.

**International liquidity**

The term 'International Liquidity' means all the financial resources and facilities that are available to the monetary authorities of individual countries for financing the deficits in their international balance of payments when all other sources of supply of foreign funds prove insufficient to ensure a balance of payment.

#### Aspects of International Liquidity:

**There are three main aspects of international liquidity:**

**1. Nature:**

The outstanding external debts of a country may be settled through liquidity

**2. Size:**

The consideration of the size of stock of international liquidity is very important.

**3. Distribution:**

The world stock of international liquidity must be ideally distributed among the countries in relation to their needs, which can be determined by the degree of fluctuation to which a country’s balance of payments is subject, the volume of its trade and the requirements of its development. The present state of distribution of liquidity is by no means ideal.

Problems of International Liquidity

1. Bop deficits
2. High Tariff barriers
3. Attitude of developed countries
4. Unequal distribution of International reserves

**International Reserves or Forex Reserves**

Regarded as the health meter of a country, Foreign Exchange reserves or Forex reserves are assets such as foreign currencies, gold reserves, treasury bills, etc retained by a central bank or other monetary authority that checks the balance payments and influences the foreign exchange rate of its currency and maintains stability in financial markets.

RBI is the custodian of the Foreign exchange reserves in India. In 2020, India’s forex reserves crossed the $500-billion mark for the first time in history due to higher foreign direct investment, foreign institutional investment. Low oil prices also helped reduce outflows. This gave India an adequate cushion to combat external shocks.

# **Purpose of the Foreign Exchange Reserve:**

# 1. The most significant objective behind this is to ensure that RBI has backup funds if their national currency rapidly devalues or becomes altogether insolvent.

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# 2. If the value of the Rupee decreases due to an increase in demand of the foreign currency then RBI sells the dollar in the Indian money market so that depreciation of the Indian currency can be checked.

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# 3.  A country with a good stock of forex has a good image at the international level because the trading countries can be sure about their payments.

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# 4. A good forex reserve helps in attracting foreign trade and earns a good reputation in trading partners.

***INTRODUCTION:-***

## 2. BALANCE OF PAYMENT

**Meaning:** The Balance of Payment of a country is “a systematic record of all economic transactions between the residents of the reporting country and the residents of foreign countries during a given period of time”.

Like all double entry book keeping accounts it always balances i.e. sum of credit entries & sum of debit entries.

For a country, the balance of payment specifies whether the country has an excess or shortage of funds. It gives an indication of whether the country’s export is more than its import or vice versa.

## **Importance of Balance of Payment**

A balance of payment is an essential document or transaction in the finance department as it gives the status of a country and its economy. The importance of the balance of payment can be calculated from the following points:

* It examines the transaction of all the exports and imports of goods and services for a given period.
* It helps the government to analyse the potential of a particular industry export growth and formulate policy to support that growth.
* It gives the government a broad perspective on a different range of import and export tariffs
* If the economy urges support in the mode of import, the government plans according to the BOP, and divert the cash flow and technology to the unfavourable sector of the economy, and seek future growth.
* The balance of payment also indicates the government to detect the state of the economy, and plan expansion. Monetary and fiscal policy are established on the basis of balance of payment status of the country.

### COMPONENTS OF THE BOP :

The analysis of Balance of Payment can be done in terms of its major sub-divisions:

1. Current A/c
2. Capital A/c
3. **Current A/c:** It can be broken down in to two parts viz., Balance of trade & Balance of Services. Balance of trade deals only with export & import, merchandise (or invisible items); It is not necessary that balance of trade always balances; more often, it will either show a surplus or a deficit. A surplus on trade balance may be matched with a surplus or a deficit on service balance. If the surplus on service balance equals the deficit on trade balance, the current A/c show a net balance.
4. **Capital A/c**: Similarly, the capital a/c represents transfer of money and other capital items & changes in the country’s foreign assets & liabilities resulting from the transactions recorded in the current a/c. It includes loans, investments, issue of bonds, etc.

**\*Reserve A/c:** The deficit on the current a/c or capital transactions can be financed by external assistance, drawings from IMF & allocations of the SDR’s.

Balance of Payment is a Double entry A/c. hence it always balances. There may be deficit or surplus in current account and capital a/c or any sub account. But final adjustment is made by increasing or decreasing forex reserves.

### BALANCE OF TRADE:-

**Balance of trade (BOT**) is described as the difference between the value of merchandise (goods) exports and the value of merchandise imports. It can also be described as the ‘goods balance’ or the “balance of merchandise trade”. This balance is reflects the country’s capacity to provide material requirements of the population. An active (positive) or ‘passive’ (negative) BOT represents the net trade in tangibles.

### FACTORS AFFECTING BALANCE OF TRADE:

* 1. *The cost of production )land. Labour, capital, taxes, incentives, etc.) in the exporting economy vis-à-vis those in the importing economy;*

### BALANCE OF VISIBLE TRADE:-

Balance of visible trade is also known as balance of merchandise trade, and it covers all transactions related to movable goods where the ownership of goods changes from residents to non-residents (exports) and from non-residents to residents (imports). The valuation should be on FOB basis so that international freight and insurance are treated as distinct services and not merged with the value of goods themselves.

Export valued on FOB basis are the credit entries. Data for these items are obtained from the various forms that the exporters have fill and submitted to the designated authorities. Imports value at CIF are the debit entries. Valuation CIF though inappriate between the total of debits and credits appears in the “NET” coloum. This is the ‘balance of visible trade.’ In visible trade if the receipts from exports of goods, we described the situation as one of zero’ goods balance.’ Balance.

Depending on whether we have receipts exceeding payments (positive) or payments exceeding receipts (negative).

### BALANCE OF INVISIBLE TRADE:-

Just as a country exports goods and imports goods a country also exports and imports what are called as services (invisibles). The services account records all the services exported and imported by a country in a year. Unlike goods which are tangible or visible services are intangible.

Accordingly services transactions are regarded as invisible items in the BOP. They are invisible in the sense that services receipts and payments are not recorded at the port of entry or exist as in the case with the merchandise imports and exports receipts.

#### UNILATERAL TRANSFERS:

It is an economic transactions between residents of two nations over a stipulated period of time, usually a calander year. Typically, these transaction consist of gift exchanges, pension payments and the like, but they can encompass other goods and services as well.

### ERRORS AND OMISSIONS:

Errors and omissions is a “statistical residue.” It is used to balance the statements beacauses in practice it is not possible to have complete and accurate data for reported items and beacause these cannot, therefore ordinarily have equal entries for debits and credits.