BMS Sem VI International Finance

Theory Topics

Table of Contents

1. Concept of International Trade and International Business

International Trade:

Foreign trade is exchange of capital, goods, and services across international borders or territories. In most countries, it represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history, its economic, social, and political importance has been on the rise in recent centuries.

All countries need goods and services to satisfy wants of their people. Production of goods and services requires resources. Every country has only limited resources. No country can produce all the goods and services that it requires. It has to buy from other countries what it cannot produce or can produce less than its requirements. Similarly, it sells to other countries the goods which it has in surplus quantities. India too, buys from and sells to other countries various types of goods and services.

Generally, no country is self-sufficient. It has to depend upon other countries for importing the goods which are either non-available with it or are available in insufficient quantities. Similarly, it can export goods, which are in excess quantity with it and are in high demand outside.

International trade means trade between the two or more countries. International trade involves different currencies of different countries and is regulated by laws, rules and regulations of the concerned countries. Thus, International trade is more complex.

International Business

A business activity done across national borders is International Business. The International business is the purchasing and selling of the goods, commodities and services outside its national borders. Such trade modes might be owned by the state or privately owned organization. In which, the organization explores trade opportunities outside its domestic national borders to extend their own particular business activities, for example, manufacturing, mining, construction, agriculture, banking, insurance, health, education, transportation, communication and so on.

Nations that were away from each other, because of their geological separations and financial and social contrasts are now connecting with each other. World Trade Organization established by the administration of various nations is one of the major contributory factors to the expanded connections and the business relationship among the countries. The national economies are dynamically getting borderless and fused into the world economy as it is clear that the world has today come to be known as a ‘global village’. Numerous more organizations are making passage into a worldwide business which presents them with opportunities for development and tremendous benefits.

2. International Banking

Simply said, international banking is a type of banking that has a presence across international borders. It is a financial entity that offers financial services like lending opportunities and payment accounts to foreign clients. Basically, the clients of these banks can be both individuals and companies. However, every international bank has its own policy of choosing who they can do business with. Read below about the various types of banks, including correspondent, subsidiary, edge act and offshore.

Type of International Banking

International banks can be categorized by the products and services they offer. Basically, retail banks offer savings accounts deposits and withdrawals, as well as foreign exchange banking services to its customers. When they start offering an opportunity to invest in global markets then they become internationalized. This is done by incorporating investment banking features. International banking can be classified into the following types:

I. Correspondent Banks

It involves the relationship between a minimum number of two banks which includes those that are in different countries. Multinational Corporations (MNCs) often greatly use international banks for helping them with their international banking. These banks are usually small in size, and they generally have representatives that serve their customers out of their home country.

II. Subsidiaries and Affiliates

The subsidiary bank is incorporated in one country but it is owned by a parent bank in a foreign country either completely or partially. An affiliate bank is similar to the former — the only difference is that it can operate independently and is not completely owned by a parent company.

III. Edge Act Banks

Certain US banks operate as edge act banks based on the constitutional amendment of 1919. They conduct business internationally under a federal charter while being physically located in the United States.

IV. Offshore Banking Centre

Offshore banking centres are a type of banking system in a country that allows foreign accounts. They are independent of the banking regulations of the country. They offer special products and services. The Swiss Bank is the best example of an offshore bank.

3. Adam Smith's Absolute Cost Advantage Theory of International Trade

Adam Smith, the Scottish economist observed some drawbacks of existing Mercantilism theory of International trade and proposed his own theory to remove drawbacks and to increase trade between countries. The drawbacks of the Mercantilism theory were that it weakens a country and that restrictions on free trade decreases country's wealth.

Adam Smith's theory:

1. It is based on the principle of division of work and that free trade among countries can increase a country's wealth.
2. Free trade enables a country to provide a variety of goods and services to its people by specializing in production of some goods and services at low cost and importing others that cannot be produced at that cost and are available at cheaper rates from others. This way both can exchange required quantity and enjoy the benefit of absolute cost advantage.

Advantages of skilled labour and specialisation:

1. Absolute cost advantage: It is a resultant of specialization, suitability and economies of scale. Specialization of labor leads to higher productivity and less labor cost per unit of output. Suitability of the skill of the labor in producing certain goods also leads to cot advantage. Economies of scale also help to reduce labor cost per unit of output.
2. Natural advantage: The climatic conditions and the natural resources of the country provide natural advantage. E.g.- Indian climate is suitable for production of rice, wheat, sweet mangoes, grapes, tea, coconuts, cashew nuts, cotton etc. Sri Lanka's climate is suitable for production of tea and rubber.
3. Acquired advantage: Technology acquired and skill development done be a country's advantage. E.g.- Japan advantages in steel production through imports of both iron and coal (labor saving and material saving technology), England in textiles and France in wine.

Assumptions of theory:

1. Trade is between two countries.
2. Only two commodities are traded.
3. Free trade exists between the countries.
4. The only element of cost of production is labor.

Numerical Example:

Output per one day of labour		
	India	Japan
Pens	90	30
Mobiles	3	9

Production Possibilities: Ability of labour to produce different goods/services in a day

India	Japan
One labour per day can produce either 90 pens or 3 mobiles	One labour per day can produce either 30 pens or 9 mobiles
Absolute advantage is production of pens	Absolute advantage is production of mobiles

If India and Japan will exchange these products, both will get advantage. India will export 60 pens to Japan and Japan will export 6 Mobiles to India. So, 60 pens for 6 mobiles. 2 days of Japanese labour needed to produce 60 pens and only 0.67 days of labour is enough to produce 6 mobiles. Japan can save 1.33 days of labour and so can India. Thus, both countries can get benefit of trade and can save labour as well as cost per unit.

Implications of the theory:

1. More quantity of both products.
2. Increased standards of living in both countries.
3. Increased production Efficiency.
4. Increase in global efficiency and effectiveness.
5. Maximization of global productivity and other resources productivity.

Criticism:

1. No absolute advantage for many countries.
2. Country size variations.
3. Difference in specialization in countries.
4. Deals with only labor and neglects other factors.

4. Ricardo's Comparative/Relative Cost Advantage Theory of International Trade

David Ricardo believed that the international trade is governed by the comparative cost advantage rather than the absolute cost advantage. A country will specialise in that line of production in which it has a greater relative or comparative advantage in costs than other countries and will depend upon imports from abroad of all such commodities in which it has relative cost disadvantage.

Suppose India produces computers and rice at a high cost while Japan produces both the commodities at a low cost. It does not mean that Japan will specialise in both rice and computers and India will have nothing to export. If Japan can produce rice at a relatively lesser cost than computers, it will decide to specialise in the production and export of computers and India, which has less comparative cost disadvantage in the production of rice than computers will decide to specialise in the production of rice and export it to Japan in exchange of computers.

The Ricardian comparative costs analysis is based upon the following assumptions:

(i) There is no intervention by the government in economic system.

(ii) Perfect competition exists both in the commodity and factor markets.

(iii) There are static conditions in the economy. It implies that factors supplies, techniques of production and tastes and preferences are given and constant.

(iv) Production function is homogeneous of the first degree. It implies that output changes exactly in the same ratio in which the factor inputs are varied. In other words, production is governed by constant returns to scale.

(v) Labour is the only factor of production and the cost of producing a commodity is expressed in labour units.

(vi) Labour is perfectly mobile within the country but perfectly immobile among different countries.

(vii) Transport costs are absent so that production cost, measured in terms of labour input alone, determines the cost of producing a given commodity.

(viii) There are only two commodities to be exchanged between the two countries.

(ix) Money is non-existent and prices of different goods are measured by their real cost of production.

(x) There is full employment of resources in both the countries.

(xi) Trade between two countries takes place on the basis of barter.

This two-country, two-commodity model can be analysed through the following table:

Country	Labour cost per unit of commodity in man-hours	
	Commodity X	Commodity Y
A	12	10
B	16	12

The Table indicates that country A has an absolute advantage in producing both the commodities through smaller inputs of labour than in country B. In relative terms, however, country A has comparative advantage in specialising in the production and export of commodity X while country B will specialise in the production and export of commodity Y.

In country A, domestic exchange ratio between X and Y is 12: 10, i.e., 1 unit of X = 12/10 or 1.20 units of Y. Alternatively, 1 unit of Y= 10/12 or 0.83 units of X.

In country B, the domestic exchange ratio is 16: 12, i.e., 1 unit of X = 16/12 or 1.33 units of Y. Alternatively, 1 unit of Y = 16/12 or 0.75 unit of X.

From the above cost ratios, it follows that country A has comparative cost advantage in the production of X and B has comparatively lesser cost disadvantage in the production of Y.

Gain from Trade:

The comparative cost principle underlines the fact that two countries will stand to gain through trade so long as the cost ratios for two countries are not equal. On the basis of Table, country A specialises in the production of X commodity, while country B specialises in the production of Y commodity.

In the absence of international trade, the domestic exchange ratio between X and Y commodities in these two countries are:

Country A: 1 unit of X = 12/10 or 1-20 units of Y

Country B: 1 unit of Y = 12/16 or 0-75 unit of X

If trade takes place and two countries agree to exchange 1 unit of X for 1 unit of Y, the gain from trade for country A amounts to 0.20 units of Y for each unit of X. In case of country B, the gain from trade amounts to 0.25 unit of X for each unit of Y. Thus, the comparative costs principle confers gain upon both the countries.

5. Heckscher – Ohlin ‘s Modern Theory of International Trade

Heckscher-Ohlin theory is known as modern theory of international trade. It was first formulated by Swedish economist Heckscher in 1919 and later on fully developed by his student Ohlin in 1935. Heckscher-Ohlin theory, also called the factor endowments theory of international trade, attempts to explain that international trade is simply a special case of inter-local or inter-regional trade, and there is no need for a separate theory of international trade. It emphasises that differences in factor endowments, and not differences in factor efficiency as maintained in the classical theory, are the true basis of international trade.

Heckscher-Ohlin theory is the factor endowment theory which explains the pattern of comparative advantage and hence the pattern of trade in terms of factor endowments. The theory states that a country has a comparative advantage in the production and export of the good that is relatively intensive in the country's relatively abundant factor. In other words, the theory predicts that goods requiring greater amounts of labour should be produced in countries where labour is abundant relative to other factors of production, and where the labour costs are therefore low relative to cost of other factors. These countries then export labour-intensive goods to other countries where labour is relatively scarce and labour costs are relatively high.

In the words of Ohlin- "Generally, abundant factors are relatively cheap, scanty factors are relatively dear, in each region. Commodities requiring for their production much of the former and little of the latter are exported in exchange for goods that call for factors in the opposite proportions. Thus, indirectly, factors in abundant supply are exported and the factors in scanty supply are imported."

Heckscher-Ohlin theory involves the following arguments:

(i) Two countries A and B involve in trade if relative prices of goods X and Y are different. According to Ohlin, "the immediate cause of inter-regional trade is always that goods can be bought cheaper from outside in terms of money than they can be produced at home."

(ii) Under competitive market conditions, prices are equal to average costs. Thus, relative price differences are due to cost differences.

(iii) Cost differences exist because of the factor-price differences in the two countries.

(iv) Factor prices are determined by factors' supply and demand. Assuming a given demand, it follows that a capital-rich country has cheaper capital or lower capital price and a labour-abundant country has a relatively lower labour price.

(v) Each country has an advantage in the production and export of goods into which enter considerable amounts of factors, abundant and cheaper in that country.

An example of the Heckscher-Ohlin theory of two countries India and England is as follows: - Suppose in India labour is in plenty and cheap, while capital is scarce and costly. On the other hand, England is capital-rich, but labour-poor. Further suppose wheat and cloth are two goods, former being labour-intensive and latter being capital-intensive. Thus, India will specialise in labour- intensive good wheat which can be relatively cheaply produced here.

On the other hand, the production of capital-intensive cloth will be relatively cheaper in England. Hence the trade will occur between India and England. Indian will import cloth from England and export wheat; England will import wheat from India and export cloth.

Putting the same thing in another way, India's import is indirectly an import of scarce factor capital and its export is indirectly an export of abundant factor labour; England indirectly imports her scarce factor labour and exports here abundant factor capital.

Thus, Heckscher-Ohlin theory concludes that:

(a) The basis of international trade is the difference in commodity prices in the two countries.

(b) Differences in commodity prices are due to cost differences which are a result of differences in factor endowments in the two countries.

(c) Labour-rich country specialises in labour-intensive goods and exports them. Capital-abundant country specialises in capital- intensive goods and exports them.

6. International Trade Financing

International trade financing is required specially to get funds to carry out international trade operations. Depending on the types and attributes of financing, there are five major methods of transactions in international trade.

International Trade Payment Methods

The five major processes of transaction in international trade are the following −

A. Prepayment

Prepayment occurs when the payment of a debt or instalment payment is done before the due date. A prepayment can include the entire balance or any upcoming part of the entire payment paid in advance of the due date. In prepayment, the borrower is obligated by a contract to pay for the due amount. Examples of prepayment include rent or loan repayments.

B. Letter of Credit

A Letter of Credit is a letter from a bank that guarantees that the payment due by the buyer to a seller will be made timely and for the given amount. In case the buyer cannot make payment, the bank will cover the entire or remaining portion of the payment.

C. Drafts

Sight Draft − It is a kind of bill of exchange, where the exporter owns the title to the transported goods until the importer acknowledges and pays for them. Sight drafts are usually found in case of air shipments and ocean shipments for financing the transactions of goods in case of international trade.

Time Draft − It is a type of foreign check guaranteed by the bank. However, it is not payable in full until the duration of time after it is obtained and accepted. In fact, time drafts are a short-term credit vehicle used for financing goods' transactions in international trade.

D. Consignment

It is an arrangement to leave the goods in the possession of another party to sell. Typically, the party that sells receives a good percentage of the sale. Consignments are used to sell a variety of products including artwork, clothing, books, etc. Recently, consignment dealers have become quite trendy, such as those offering specialty items, infant clothing, and luxurious fashion items.

E. Open Account

Open account is a method of making payments for various trade transactions. In this arrangement, the supplier ships the goods to the buyer. After receiving and checking the concerned shipping documents, the buyer credits the supplier's account in their own books with the required invoice amount.

The account is then usually settled periodically; say monthly, by sending bank drafts by the buyer, or arranging through wire transfers and air mails in favour of the exporter.

Trade Finance Methods

The most popular trade financing methods are the following −

A. Accounts Receivable Financing

It is a special type of asset-financing arrangement. In such an arrangement, a company utilizes the receivables – the money owed by the customers – as a collateral in getting a finance.

In this type of financing, the company gets an amount that is a reduced value of the total receivables owed by customers. The time-frame of the receivables exert a large influence on the amount of financing. For older receivables, the company will get less financing. It is also, sometimes, referred to as **"factoring"**.

B. Letters of Credit

As mentioned earlier, Letters of Credit are one of the oldest methods of trade financing.

C. Banker's Acceptance

A banker's acceptance (BA) is a short-term debt instrument that is issued by a firm that guarantees payment by a commercial bank. BAs are used by firms as a part of the commercial transaction. These instruments are like **T-Bills** and are often used in case of money market funds.

BAs are also traded at a discount from the actual face value on the secondary market. This is an advantage because the BA is not required to be held until maturity. BAs are regular instruments that are used in international trade.

D. Working Capital Finance

Working capital finance is a process termed as the capital of a business and is used in its daily trading operations. It is calculated as the current assets minus the current liabilities. For many firms, this is fully made up of trade debtors (bills outstanding) and the trade creditors (the bills the firm needs to pay).

E. Forfaiting

Forfaiting is the purchase of the amount importers owe the exporter at a discounted value by paying cash. The forfeiter that is the buyer of the receivables then becomes the party the importer is obligated to pay the debt.

F. Countertrade

It is a form of international trade where goods are exchanged for other goods, in place of hard currency. Countertrade is classified into three major categories – barter, counter-purchase, and offset.

Barter is the oldest countertrade process. It involves the direct receipt and offer of goods and services having an equivalent value.

In a **counter-purchase,** the foreign seller contractually accepts to buy the goods or services obtained from the buyer's nation for a defined amount.

In an **offset** arrangement, the seller assists in marketing the products manufactured in the buying country. It may also allow a portion of the assembly of the exported products for the manufacturers to carry out in the buying country. This is often practiced in the aerospace and defence industries.

7. Current Account Deficit (CAD)

A current account deficit is when a country imports more goods, services, and capital than it exports. The current account measures trade plus transfers of capital. The Bureau of Economic Analysis specifies three types. First is international income. Second are direct transfers of capital. The third is investment income made on assets. A current account deficit is created when a country relies on foreigners for the capital to invest and spend. Depending on why the country is running the deficit, it could be a positive sign of growth. It could also be a negative sign that the country is a credit risk.

Components

The largest component of a current account deficit is the trade deficit. That's when the country imports more goods and services than it exports. The current U.S. trade deficit shows just how competitive the United States economy is in the global market.

The second largest component is a deficit in net income. That's when foreign investment income exceeds the savings of the country's residents. This foreign investment can help a country's economy grow. But if foreign investors worry, they won't get a return in a reasonable amount of time, they will cut off funding. That causes widespread panic.

Net income is measured by the following four things.

1. Payments made to foreigners in the form of dividends of domestic stocks.
2. Interest payments on bonds.
3. Wages paid to foreigners working in the country.
4. Direct transfers, mostly money foreign residents send back to their home countries. It also includes government grants to foreigners. This component is the smallest, but the most hotly contested.

Causes

Countries with current account deficits are big spenders that foreign investors consider credit worthy. These countries' businesses can't borrow from their own residents. They simply haven't saved enough in local banks. Businesses in a country like this can't expand unless they borrow from foreigners. That's where the credit-worthiness comes into the picture. If a country has a lot of spendthrifts, it won't find any other country to lend to it unless it is very wealthy and looks like it will pay back the loans. Why would another country lend to such a spender, even if it is credit-worthy? The lender country also exports a lot of goods and even some services to the borrower. The lender country benefits. It can manufacture more goods, thus giving more jobs its people.

Consequences

In the short-run, a current account deficit is helpful to the debtor nation. Foreigners are willing to pump capital into it. That drives economic growth beyond what then country could manage on its own. But in the long run, a current account deficit saps economic vitality. Foreign investors question whether economic growth will provide enough return on their investment. Demand weakens for the country's assets, including the country's government bonds. As foreign investors withdraw funds, bond yields rise. The national currency loses value relative to other currencies. That lowers the value of the assets in the foreign investors' strengthening currency. It further depresses investor demand for the country's assets. This can lead to a tipping point where investors will dump the assets at any price.

8. India's Balance of Payment's position – Contemporary and Changes since Liberalisation

Balance of Payments (BoP), being a record of the monetary transactions over a period with the rest of the world, reflects all payments and liabilities to foreigners and all payments and obligations received from foreigners. In this sense, the balance of payments is one of the major indicators of a country's status in international trade. BoP accounting serves to highlight a country's competitive strengths and weaknesses and helps in achieving balanced economic growth.

It can significantly affect the economic policies of a government and the economy itself. India's balance of payment position was quite unfavourable during the time of country's entry into liberalized trade regime. Two decades of economic reforms and free trade opened several opportunities that, of course, reflected in the balance of payments performance of the country. This paper, therefore, attempts to evaluate the trends and emerging challenges of India's Balance of Payments.

India's Balance of Payments picture since 1991

Independent India's external trade and performance had faced severe threats many a times. The most challenging one was that of 1991.The economic crisis of 1991 was primarily due to the large and growing fiscal imbalances over the 1980s. India's balance of payments in 1990-91 also suffered from capital account problems due to a loss of investor confidence. The widening current account imbalances and reserve losses contributed to low investor confidence putting the external sector in deep dilemma. During 1990-91, the current account deficit steeply hiked to $9680 million while the capital account surplus was far below at $ 7188 million. This led to an ever time high deficit in BoP position of India.

India initiated economic reforms to find the way out of the growing crisis. Structural measures emphasized accelerating the process of industrial and import delicensing and then shifted to further trade liberalization, financial sector reform and tax reform. Prior to 1991, capital flows to India predominately consisted of aid flows, commercial borrowings, and non-resident Indian deposits. Direct investment was restricted, foreign portfolio investment was channelled almost exclusively into a small number of public sector bond issues, and foreign equity holdings in Indian companies were not permitted (Chopra and others, 1995). However, this development strategy of both inward-looking and highly interventionist, consisting of import protection, complex industrial licensing requirements etc underwent radical changes with liberalization policies of 1991.

The post reform period really eased India's struggles with regard to external sector. This is evident from the RBI data summarizing the BOP in current account and capital account. The current account which measures all transactions including exports and imports of goods and services, income receivable and payable abroad, and current transfers from and to abroad remained almost negative throughout the post reform period except for the three financial years. Until 2000-01, the current account deficit that comprises both trade balance and the invisible balance, remained stagnant and stood around $ 5000 million. However, for the first time since 1991, the current account recorded surplus in its account during three consecutive financial years 2 from 2001-02. The deficit in current account continued to occur from 2004-05 onwards and the growth rate was comparatively faster. Surprisingly, the current account deficit grew like anything since 2007-08, the period witnessed financial crisis. The current account balance of India during 2011-12 is recorded to be $ - 78155 million, signifying a deficit eight times that of the figures of 2007-08. Huge negative debits and comparatively low positive credits caused for this negative value in current account. Another notable feature of current account balance is that the deficit was mounting during the previous years. Two major items of current account are merchandise and the invisibles. These two items generate the value of current account balance of the country. The net merchandise has been always found to be huge negative figure. During 2011-12 it was recorded to be $ - 189759 million. During the same period, our total merchandise credit was $ 309774 million

while our merchandise debit was $ 499533 million. This is a common feature of India’s merchandise figures during all the years.

The recent crisis of 2008 affected the trade performance of India in a large way. Indian economy had been growing robustly at an annual average rate of 8.8 per cent for the period 2003-04 to 2007-08. Concerned by the inflationary pressures, Reserve Bank of India (RBI) increased the interest rates, which resulted in a slowdown of India’s trade flows prior to the Lehman crisis (Kumar and Alex, 2009). The trade flows, which are one of the important channels through which India was affected during the recent global crisis of 2008, started to collapse from late 2008. Merchandise trade, software exports and remittances declined in absolute terms in response to the exogenous external shock.

India’s current/contemporary Balance of Payment Situation

India's current account deficit (CAD) worsened to USD 16.9 billion (2.5% of GDP) during October-December (Q4 2018) from a level of USD 13.7 billion (2.1% of GDP) in the corresponding quarter a year ago. The widening of CAD was on account of higher imports which resulted in a widening trade deficit. The merchandise trade deficit rose to USD 49.5 billion in Q4 2018. With the given decline in crude oil prices in the global market, we can expect trade deficit to slightly reduce in the last quarter of the current year. On account of net sales in the equity market, the portfolio investment recorded a net outflow of USD 2.1 billion in Q4 2018, as compared with an inflow of USD 5.3 billion in Q4 2017.

Despite the widening CAD on year-on-year (y-o-y) basis, the Q4 2018 witnessed an accretion of USD 9.4 billion to the foreign exchange reserves (on a BoP basis) as capital account have eased appreciably lately. The capital and financial account surplus rose to USD 18 billion in Q4 2018 from USD 12.6 billion in Q4 2017, supported by stronger FDI and portfolio investment inflows worth USD 10.4 billion.

On a cumulative basis, during April-December 2018, the CAD increased to 2.6% of GDP from 1.8% of GDP during April-December 2017, led by higher trade deficit. India's trade deficit increased to USD 145.3 billion in April-December 2018 from USD 118.4 billion in the same period last year.

With the softening of oil prices as expected in the global market, the oil import bill of India is likely to witness a fall in the January-March quarter. If a stable government emerges post elections, then the foreign direct investment inflows and portfolio inflows can remain intact and strong, thus help boost rupee exchange rate.

9. Bill of Lading

For the shipping documents, the bill of lading (B/L) is the most important. It serves three main and separate functions:

1. It is a contract between the carrier and shipper (exporter) in which the carrier agrees to carry the goods from port of shipment to port of destination.

2. It is the shipper's receipt for the goods.

3. The negotiable B/L, its most common form, is a document that establishes control over the goods.

A bill of lading can be either a straight or an order B/L. A straight B/L consigns the goods to a specific party, normally the importer, and is not negotiable. Title cannot be transferred to a third party merely by endorsement and delivery; therefore, a straight B/L is not good collateral and is used only when no financing is involved.

Most trade transactions do involve financing, which requires transfer of title, so the vast majority of bills of lading are order B/Ls. With an order B/L, the goods are consigned to the order of a named party, usually the exporter. In this way, the exporter retains title to the merchandise until it endorses the B/L on the reverse side. The exporter's representative may endorse to a specific party or endorse it in blank by simply signing his or her name. The shipper delivers the cargo in the port of destination to the bearer of the endorsed order B/L, who must surrender it.

An order B/L represents goods in transit that are probably readily marketable and fully insured, so this document is generally considered to be good collateral by banks. It is required under L/C financing and for discounting of drafts.

Bills of lading also can be classified in several other ways. An on-board B/L certifies that the goods have actually been placed on board the vessel. By contrast, a received-for-shipment B/L merely acknowledges that the carrier has received the goods for shipment. It does not state that the ship is in port or that space is available. The cargo can, therefore, sit on the dock for weeks, or even months, before it is shipped. When goods are seasonal or perishable, therefore, the received-for-shipment B/L is never satisfactory to either the shipper or the importer. A received-for-shipment B/L can easily be converted into an on-board B/L by stamping it ''on-board'' and supplying the name of the vessel, the date, and the signature of the captain or the captain's representative.

A clean B/L indicates that the goods were received in apparently good condition. However, the carrier is not obligated to check beyond the external visual appearance of the boxes. If boxes are damaged or in poor condition, this observation is noted on the B/L, which then becomes a foul B/L. It is important that the exporter get a clean B/L—that is, one with no such notation—because foul B/Ls generally are not acceptable under a letter of credit.

10. Letter of Credit

When credit is extended, the letter of credit (L/C) offers the exporter the greatest degree of safety. If the importer is not well known to the exporter or if exchange restrictions exist or are possible in the importer's country, the exporter selling on credit may wish to have the importer's promise of payment backed by a foreign or domestic bank. On the other hand, the importer may not wish to pay the exporter until it is reasonably certain that the merchandise has been shipped in good condition. A letter of credit satisfies both of these conditions. In essence, the letter of credit is a letter addressed to the seller, written and signed by a bank acting on behalf of the buyer. In the letter, the bank promises it will honor drafts drawn on itself if the seller conforms to the specific conditions set forth in the L/C. (The draft, which is a written order to pay, is discussed in the next part of this section.) Through an L/C, the bank substitutes its own commitment to pay for that of its customer (the importer). The letter of credit, therefore, becomes a financial contract between the issuing bank and a designated beneficiary that is separate from the commercial transaction.

Advantages of Letter of Credit:

To the seller:

1. An L/C eliminates credit risk if the bank that opens it is of undoubted standing. Therefore, the firm need check only on the credit reputation of the issuing bank.
2. An L/C also reduces the danger that payment will be delayed or withheld because of exchange controls or other political acts. Countries generally permit local banks to honor their letters of credit. Failure to honor them could severely damage the country's credit standing and credibility.
3. An L/C reduces uncertainty. The exporter knows all the requirements for payment because they are clearly stipulated on the L/C.
4. The L/C can also guard against pre-shipment risks. The exporter who manufactures under contract a specialized piece of equipment runs the risk of contract cancellation before shipment. Opening a letter of credit will provide protection during the manufacturing phase.
5. The L/C facilitates financing because it ensures the exporter a ready buyer for its product. It also becomes especially easy to create a banker's acceptance—a draft accepted by a bank.

To the buyer:

1. The importer is able to ascertain that the merchandise is actually shipped on, or before, a certain date by requiring an on-board bill of lading. The importer also can require an inspection certificate.
2. Any documents required are carefully inspected by clerks with years of experience. Moreover, the bank bears responsibility for any oversight.
3. Some exporters will sell only on a letter of credit. Willingness to provide one expands a firm's sources of supply.
4. If prepayment is required, the importer is better off depositing its money with a bank than with the seller because it is then easier to recover the deposit if the seller is unable or unwilling to make a proper shipment

11. Gold Standard and Gold Exchange Standard

Classical Gold Standard

1. The Gold Standard was a system under which nearly all countries fixed the value of their currencies in terms of a specified amount of gold, or linked their currency to that of a country which did so. As each currency was fixed in terms of gold, exchange rates between participating currencies were also fixed.

2. Under the Gold Standard, a country's money supply was linked to gold. The necessity of being able to convert fiat money into gold on demand strictly limited the amount of fiat money in circulation to a multiple of the reserves. Countries with a balance of payments surplus would receive gold inflows, while countries in deficit would experience an outflow of gold.

3. In theory, international settlement in gold meant that the international monetary system based on the Gold Standard was self-correcting. Namely, a country running a balance of payments deficit would experience an outflow of gold, a reduction in money supply, a decline in the domestic price level, a rise in competitiveness and, therefore, a correction in the balance of payments deficit.

4. The reverse would be true for countries with a balance of payments surplus. This was the so called 'price-specie flow mechanism' set out by 18th century philosopher and economist David Hume.

5. The adjustment process could be accelerated by central bank operations, with the discount rate (the rate at which the central bank would lend money to commercial banks or financial institutions) which in turn influenced market interest rates. A rise in interest rates would speed up the adjustment process through two channels. A fall in interest rates would have the opposite effect. The central bank could also directly affect the amount of money in circulation by buying or selling domestic assets though this required deep financial markets.

Gold Exchange Standard

1. Gold exchange standard refers to a system in which there is neither a gold currency in circulation not gold reserves held for external purposes. Under this system, the domestic currency of a country (which is composed of token coins and paper notes) is not converted into gold for meeting internal needs, but is converted into the currency of some foreign payments.

2. The external value of the domestic currency unit is determined in terms of the foreign currency. Thus, under gold exchange standard, the domestic currency has no direct link with gold; it is linked at a fixed exchange rate with the currency of another country which is convertible into gold.

3. In addition to gold reserves, the monetary authority of the country maintains sufficient amount of foreign exchange reserves for making international payments. Gold exchange standard is a cheaper form of gold standard particularly suitable for the underdeveloped or gold-scarce countries.

12. Bretton Woods System

The Bretton Woods agreement was created in a 1944 conference of all of the World War II Allied nations. It took place in Bretton Woods, New Hampshire, which established a new global monetary system. It replaced the gold standard with the U.S. dollar as the global currency. Under the agreement, countries promised that their central banks would maintain fixed exchange rates between their currencies and the dollar. It worked like this, if a country's currency value became too weak relative to the dollar, the bank would buy up its currency in foreign exchange markets. That would lower the currency's supply and raise its price. If its currency became too high, the bank would print more. That would increase the supply and lower its price.

Members of the Bretton Woods system agreed to avoid trade wars. For example, they wouldn't lower their currencies strictly to increase trade. But they could regulate their currencies under certain conditions. For example, they could take action if foreign direct investment began to destabilize their economies. They could also adjust their currency values to rebuild after a war. The reason behind using dollars was that the United States held three-fourths of the world's supply of gold. No other currency had enough gold to back it as a replacement. The dollar's value was 1/35 of an ounce of gold.

Bretton Woods allowed the world to slowly transition from a gold standard to a U.S. dollar standard. The Bretton Woods System was an attempt to avoid worldwide economic disasters, such as The Great Depression that began in 1929 and that continued for about ten years. In 1971, the United States was suffering from massive stagflation. In response, President Nixon started to deflate the dollar's value in gold. Nixon revalued the dollar to 1/38 of an ounce of gold, then 1/42 of an ounce. It created a run on the U.S. gold reserves at Fort Knox as people redeemed their quickly devaluing dollars for gold.

In 1973, Nixon unhooked the value of the dollar from gold altogether. Without price controls, gold quickly shot up to $120 per ounce in the free market. The Bretton Woods system was over.

13. Managed Float Exchange Rate System

Exchange rate (foreign exchange rate) is the rate at which domestic currency is traded for a foreign currency. Similarly, it is the rate that shows the value of domestic currency in terms of other currencies. India is having this type of exchange rate system. In this hybrid exchange rate system, the exchange rate is basically determined in the foreign exchange market through the operation of market forces. Market forces mean the selling and buying activities by various individuals and institutions.

But during extreme fluctuations, the central bank intervenes in the foreign exchange market to minimize the fluctuation in the exchange rate of rupee. Since, the exchange rate is basically determined by market forces, the upward and downward movement in the value of rupee are appreciation and depreciation. Depreciation and appreciation happen under a flexible exchange rate system or under a managed floating exchange rate system. In India, the exchange rate system is managed floating (from 1994 onwards) and hence the relevant currency movements are appreciation and depreciation.

Managed floats fall into three distinct categories of central bank intervention. The approaches, which vary in their reliance on market forces, are as follows:

A. Smoothing out daily fluctuations. Governments rather than resisting fundamental market forces, these governments occasionally enter the market on the buy or sell side to ease the transition from one rate to another; the smoother transition tends to bring about longer-term currency appreciation or depreciation.

B. ‘‘Leaning against the wind.’’. The rationale for this policy—which is primarily aimed at delaying, rather than resisting, fundamental exchange rate adjustments—is that government intervention can reduce for exporters and importers the uncertainty caused by disruptive exchange rate changes.

C. Unofficial pegging. It involves resisting, for reasons clearly unrelated to exchange market forces, any fundamental upward or downward exchange rate movements. With unofficial pegging, however, there is no publicly announced government commitment to a given exchange rate level.

14. Free Float Exchange Rate System

A floating exchange rate is a regime where the currency price of a nation is set by the forex market based on supply and demand relative to other currencies. This is in contrast to a fixed exchange rate in which the government entirely or predominantly determines the rate. Currency prices can be determined in two ways: a floating rate or a fixed rate. As mentioned above, the floating rate is usually determined by the open market through supply and demand. Therefore, if the demand for the currency is high, the value will increase. If demand is low, this will drive that currency price lower.

Advantages of a Floating Exchange Rate

A. Balance of payments stability: Theoretically, imbalances in the balance of payments lead to automatic changes in exchange rates. For instance, a deficit in the balance of payments would trigger currency depreciation. This would make a country’s exports cheaper in foreign markets, increasing their demand and ultimately restoring equilibrium in the balance of payments.

B. No restrictions on foreign exchange and capital flows: Unlike with a fixed exchange rate, there are no restrictions to trade with these currencies. Therefore, there is no need for a constant management process on the part of the government or central bank.

C. No need to keep large foreign currency reserves: Free-floating exchange rates do not require the monetary issuing authorities to keep large amounts of foreign currency reserves to defend the exchange rate. Those reserves, therefore, can be used to import capital goods to promote economic growth.

D. Protection against imported inflation One of the main problems facing countries with fixed exchange rates is that they may import inflation via higher import prices or via the balance of payments surpluses vis-à-vis deficit countries. Countries with free-floating exchange rates do not have that problem.

15. Current Monetary System

A Monetary System is defined as a set of policies, frameworks, and institutions by which the government creates money in an economy. Such institutions include the mint, the central bank treasury, and other financial Institutions There are three common types of monetary systems – commodity money, commodity-based money, and fiat money. Currently, fiat money is the most common type of monetary system in the world. For example, the US Dollar is fiat money.

Internal Features of India's Present Monetary System:
The following are the features of present monetary system of India:
A. Unit of Money: The unit of money in India is the rupee, it is not only a medium of exchange but also a unit of value which facilitates accounting. As a unit of account, the rupee helps in the estimation of costs and prices and revenues of firms and projects, and the gross national product.
B. Monetary Standard: The present monetary standard of India is the managed paper currency standard. According to this, the paper currency is in circulation which is non-convertible into gold. It is managed paper standard because the issue of notes and coins is managed by the Reserve Bank of India

C. Types of Coins and Notes (or Currency): The following types of coins and notes are included in India's present monetary system:
(i) Coins: The Rupee-coin in India is a standard token coin whose intrinsic value of the metal is less than its face value. If the Rupee-coin is melted, its metal will not be sold worth one rupee. The Rupee-coin is an unlimited legal tender in which payment of any amount can be made. There are also 2-Rupee coin and 5-Rupee coins in circulation since 1990.
(ii) Subsidiary Coins: There are also subsidiary coins in India to assist the token money. At present, coins of the denominations of 1 paisa and 3, 5, 10, 20, 25 and 50 paisa are in circulation. The 50-paise coin like the Indian rupee-coin is unlimited legal tender.
(iii) Notes or Paper Currency: Paper currency in India consists of notes of various denominations which are issued by the Reserve Bank of India and the Government of India. The one-rupee note is issued by the Ministry of Finance of the Government of India and bears the signature of the Secretary.
(iv) System of Note Issue: The present system of note issue in India is the Minimum Reserve System. Under this system, the RBI is authorised to issue notes up to any extent but it must keep a statutory minimum reserve of gold and foreign securities. Accordingly, the RBI is required to keep a minimum reserve of Rs.200 crores. Of this, Rs.115 crores must be in gold and Rs.85 crores in foreign securities.

D. Money Supply: In India, the money supply consists of both narrow money (M_1) and broad money (M_3). M_1 consists of currency notes and coins with the public, demand deposits with commercial and cooperative banks and other deposits with RBI. M_3 consists of M_1 plus time deposits with banks and is also known as aggregate monetary resources. As on 31 March, 2003, the total M_1 in India was Rs.4,72,827 crores and M_3 was Rs 17,25,222 crores.

External Features of India's Monetary System: The external features of India's present monetary system are the following: **A. Foreign Exchange Rate:**
Since January 1976 with the signing of Jamaica Agreement, India is following the policy of floating exchange rates. According to this, the external value of Indian rupee is linked to a 'basket' of currencies of those countries with which India has large trade. This is the Nominal Effective Exchange Rate (NEER) of the rupee which is a weighted average of exchange rates vis-a-vis the currencies of India's major trading partners.

16. European Monetary Union

The Economic and Monetary Union (EMU) represents a major step in the integration of EU economies. Launched in 1992, EMU involves the coordination of economic and fiscal policies, a common monetary policy, and a common currency, the euro. Whilst all 28 EU Member States take part in the economic union, some countries have taken integration further and adopted the euro. Together, these countries make up the euro area. The European Economic and Monetary Union (EMU) combined the European Union member states into a cohesive economic system. It is the successor to the European Monetary System (EMS). The European Economic and Monetary Union (EMU) is really a broad term, under which a group of policies aimed at the convergence of European Union member state economies. The EMU's succession over the EMS occurred through a three-phase process, with the third and final phase initiating the adoption of the euro currency in place of former national currencies. This has been completed by all initial EU members except for the United Kingdom and Denmark, who have opted out of adopting the euro. The decision to form an Economic and Monetary Union was taken by the European Council in the Dutch city of Maastricht in December 1991, and was later enshrined in the Treaty on European Union (the Maastricht Treaty). Economic and Monetary Union takes the EU one step further in its process of economic integration, which started in 1957 when it was founded. Economic integration brings the benefits of greater size, internal efficiency and robustness to the EU economy as a whole and to the economies of the individual Member States. This, in turn, offers opportunities for economic stability, higher growth and more employment – outcomes of direct benefit to EU citizens. In practical terms, EMU means:

- Coordination of economic policy-making between Member States
- Coordination of fiscal policies, notably through limits on government debt and deficit
- An independent monetary policy run by the European Central Bank (ECB)
- Single rules and supervision of financial Institutions within the euro area
- The single currency and the euro area

17. IMF and its Role in Context of Developing Countries

The International Monetary Fund is a global organisation founded in 1944 in the post-war economic settlement which included the Bretton-Woods system of managed exchange rates. J. M. Keynes and Harry Dexter White both played an important role in its development. Its primary aim is to help stabilise exchange rates and provide loans to countries in need. Nearly all members of the United Nations are members of the IMF with a few exceptions such as Cuba, Lichtenstein and Andorra. The IMF is independent of the World Bank although both are United Nations agencies and both are aiming to increase living standards. The World Bank concentrates on long-term loans to developing countries.

Applying its reasoning to all IMF activities, the ODC Task Force also recommended that the Fund stop longer-term lending (beyond 18 months duration) to middle-income countries. This would mean that the Fund's financial role in all developing countries would lie in its regular short-term stand-by arrangements. This is the appropriate role of the IMF. As the Task Force explained, the interest rates of these arrangements would have to be subsidized for the poorest countries. The IMF's short-term lending for stability is itself a crucial contribution to development, since poverty reduction and growth require macroeconomic stability. But the policies required for stabilization can also hurt the poor (for example, by cutting government spending). For this reason, the IMF should enlist the World Bank's help in assessing the likely impact of policies before they are instituted, so that negative impacts are minimized. IMF policy conditions should be focused on reforms necessary to restore economic stability and, in effect, ensure timely repayment of the loans. The conditions should not extend to deeper structural issues, which are unnecessary to fulfil this role. The IMF has another critical role in development: surveillance and policy advice for countries during stability. These functions can

be important contributions to the decision-making in developing countries. With surveillance and policy advice not backed up by long-term lending, the relations between the IMF and client countries would be more transparent, and probably more reassuring to private investors. At present, when a country signs on to an IMF loan, it appears to be accepting the policy conditions only because of the money it will receive from the IMF and the Bank (which does not lend for adjustment to countries without the IMF's approval of the macroeconomic environment). If the IMF's advice were not tied to lending, then a country's policy reforms would be more credible to external investors. By the same logic, the implicit IMF veto on World Bank lending for adjustment should be eliminated.

With regard to the specific policy advice the IMF gives, a number of lessons relevant to development have been learned in the last decade, particularly from recent financial crisis. The IMF should explicitly recognize and incorporate them. They include:

- taking an open, yet cautious approach to controls on inflows of short-term capital;
- acknowledging that exchange rate policy is faddish and that the appropriate exchange rate arrangement will vary by a country's circumstances;
- approaching financial sector liberalization with caution; and
- acknowledging explicitly the potential trade-off between policies that favour economic stability and those that favour growth; countries should be aware of these trade-offs and make their own choices.

18. World Bank and its role in context of Developing Countries

The World Bank Group (WBG) was established in 1944 to rebuild post-World War II Europe under the International Bank for Reconstruction and Development (IBRD). It is one of a variety of organizations seeking to shape the world economy Today, the World Bank functions as an international organization that fights poverty by offering developmental assistance to middle-income and low-income countries. By giving loans and offering advice and training in both the private and public sectors, the World Bank aims to eliminate poverty by helping people help themselves.

Under the World Bank Group, there are complementary institutions that aid in its goals to provide assistance. These funds support a wide range of investments across all sectors, including education, energy, trade and urban development. The organization also facilitates regular interaction among donors and conducts studies on economic issues and social services systems.

World Bank includes a better infrastructure in developing countries, more transparent services, tax reductions, free trade and socially sustainable development. The organization shares its knowledge and findings via reports, including social reviews and poverty assessments. Its policies aim to create a stable macroeconomic environment and promote liberal trade.

The World Bank is looking to expand its lending to developing countries and to provide more loan guarantees for businesses entering new developing markets. Specifically, critics claim that World Bank financing allows projects and policies to avoid being subjected to the scrutiny of financial markets and permits governments to delay enacting the changes necessary to make their countries more attractive to private investors. The World Bank offers loans, grants and other financial products through the International Bank of Reconstruction and Development (IBRD) and the International Development Association. The role of the World Bank is to invest in these countries and provide them with the best global expertise so they can grow and overcome challenges.

19. Special Drawings Rights (SDRs)

Special drawing rights (SDR) refer to an international type of monetary reserve currency created by the International Monetary Fund (IMF) in 1969 that operates as a supplement to the existing money reserves of member countries. An SDR is essentially an artificial currency instrument used by the IMF, and is built from a basket of important national currencies. 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, of the member countries' governments. The makeup of the SDR is re-evaluated every five years. The SDR was formed with a vision of becoming a major element of international reserves, with gold and reserve currencies forming a minor incremental component of such reserves. To participate in this system, a country was required to have official reserves. This consisted of central bank or government reserves of gold and globally accepted foreign currencies that could be used to buy the local currency in foreign exchange markets to maintain a stable exchange rate. The Special Drawing Right (SDR) is a unit of financial reserve developed and put forth by the International Monetary Fund (IMF). Although not an official form of legal tender, SDRs facilitate sizable foreign currency transactions between banks, governments and IMF member nations. SDRs play a key role as an accounting unit for the IMF. The issuance of IMF loans and credit, as well as subsequent repayment, are denominated in SDRs. Whether a member country is seeking financial aid following a natural disaster or wishes to expand existing infrastructure, IMF funding is extended via SDRs.

20. Appreciation, Depreciation, Devaluation & Revaluation of Currency

Currency appreciation is an increase in the value of one currency in relation to another currency. Currencies appreciate against each other for a variety of reasons, including government policy, interest rates, trade balances and business cycles. In a floating rate exchange system, the value of a currency constantly changes based on supply and demand in the forex market. The fluctuation in values allows traders and firms to increase or decrease their holdings and profit off them. Currency appreciation, however, is different from the increase in value for securities. Currencies are traded in pairs. Thus, a currency appreciates when the value of one goes up in comparison to the other. This is unlike a stock whose appreciation in price is based on the market’s assessment of its intrinsic value. Typically, a forex trader trades a currency pair in the hopes of currency appreciation of the base currency against the counter currency. Appreciation is directly linked to demand. If the value appreciates (or goes up), demand for the currency also rises.

Currency depreciation is a fall in the value of a currency in a floating exchange rate system. Currency depreciation can occur due to factors such as economic fundamentals, interest rate differentials, political instability or risk aversion among investors. Countries with weak economic fundamentals such as chronic current account deficits and high rates of inflation generally have depreciating currencies. Currency depreciation, if orderly and gradual, improves a nation’s export competitiveness and may improve its trade deficit over time. But abrupt and sizeable currency depreciation may scare foreign investors who fear the currency may fall further, and lead to them pulling portfolio investments out of the country, putting further downward pressure on the currency. Easy monetary policy and high inflation are two of the leading causes of currency depreciation. In a low interest-rate environment, hundreds of billions of dollars chase the highest yield. Expected interest rate differentials can trigger a bout of currency depreciation. While central banks increase interest rates to combat inflation, too much inflation can threaten stability and cause currency depreciation. Additionally, inflation can lead to higher input costs for export which makes a nation's exports less competitive in global markets, which widens the trade deficit and causes the currency to depreciate.

Devaluation is the deliberate downward adjustment of the value of a country's money relative to another currency, group of currencies, or currency standard. Countries that have a fixed exchange rate or semi-fixed exchange rate use this monetary policy tool. It is often confused with depreciation and is the opposite of revaluation, which refers to the readjustment of a currency's exchange rate. The government issuing the

currency decides to devalue a currency and, unlike depreciation, it is not the result of nongovernmental activities. One reason a country may devalue its currency is to combat a trade imbalance. Devaluation reduces the cost of a country's exports, rendering them more competitive in the global market, which in turn, increases the cost of imports, so domestic consumers are less likely to purchase them, further strengthening domestic businesses. Because exports increase and imports decrease, it favours a better balance of payments by shrinking trade deficits. That means a country that devalues its currency can reduce its deficit because of the strong demand for cheaper exports

A revaluation is a calculated upward adjustment to a country's official exchange rate relative to a chosen baseline. The baseline can include wage rates, the price of gold, or a foreign currency. Revaluation is the opposite of devaluation, which is a downward adjustment. A revaluation can occur on a regular basis, marked by the observable fluctuations in the foreign currency market and the associated exchange rates. In a fixed exchange rate regime, only a decision by a country's government, such as its central bank, can alter the official value of the currency.

As an example, let's say a government has set 10 units of its currency equal to $1 in U.S. currency. To revalue, the government might change the rate to five units per dollar. This results in its currency being twice as expensive when compared to U.S. dollars than it was previously. Before the Chinese government revalued the yuan, it was pegged to the U.S. dollar. After revaluation, it was pegged to a basket of world currencies.

21. Forex Market- Wholesale and Domestic Market

The foreign exchange market (Forex, FX, or currency market) is a global decentralized or over-the-counter (OTC) market for the trading of currencies. This market determines the foreign exchange rate. It includes all aspects of buying, selling and exchanging currencies at current or determined prices. In terms of trading volume, it is by far the largest market in the world, followed by the Credit market. The forex market is made up of banks, commercial companies, central banks, investment management firms, hedge funds, and retail forex brokers and investors.

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

- its huge trading volume, representing the largest asset class in the world leading to high liquidity;
- its geographical dispersion;
- its continuous operation: 24 hours a day except for weekends
- the low margins of relative profit compared with other markets of fixed income

Wholesale Market

The wholesale market involves firms which specialize in buying and selling foreign banknotes with commercial banks and currency exchanges. These currency-trading firms are banknote wholesalers. While the exchange of banknotes between ordinary private customers and banks takes place in a retail market, commercial banks and currency exchanges trade their surpluses of notes between themselves in a wholesale market.

Domestic Market

Domestic market, also referred to as an internal market or domestic trading, is the supply and demand of foreign currency within a single country. The demand for currencies is derived from the demand for a country’s exports, and from speculators looking to make a profit on changes in currency values. The supply of a currency is determined by the domestic demand for imports from abroad.

22. Fisher Effect and International Fisher Effect

The Fisher Effect

The Fisher Effect is an economic theory created by economist Irving Fisher that describes the relationship between inflation and both real and nominal interest rates. The Fisher Effect states that the real interest rate equals the nominal interest rate minus the expected inflation rate. Therefore, real interest rates fall as inflation increases, unless nominal rates increase at the same rate as inflation.

The Basics of the Fisher Effect

The Fisher Effect equation reflects that the real interest rate can be taken by subtracting the expected inflation rate from the nominal interest rate. In this equation, all the provided rates are compounded. The Fisher Effect can be seen each time you go to the bank; the interest rates an investor has on a savings account is really the nominal interest rate. For example, if the nominal interest rate on a savings account is 4% and the expected rate of inflation is 3%, then the money in the savings account is really growing at 1%. The smaller the real interest rate, the longer it will take for savings deposits to grow substantially when observed from a purchasing power perspective.

Nominal Interest Rates and Real Interest Rates

Nominal interest rates reflect the financial return an individual gets when he deposits money. For example, a nominal interest rate of 10% per year means that an individual will receive an additional 10% of his deposited money in the bank. Unlike nominal interest rate, real interest rate considers purchasing power in the equation. In the Fisher Effect, the nominal interest rate is the provided actual interest rate that reflects the monetary growth padded over time to a particular amount of money or currency owed to a financial lender. Real interest rate is the amount that mirrors the purchasing power of the borrowed money as it grows over time.

Importance in Money Supply

The Fisher Effect is more than just an equation: It shows how the money supply affects nominal interest rate and inflation rate as a tandem. For example, if a change in a central bank's monetary policy would push the country's inflation rate to rise by 10 percentage points, then the nominal interest rate of the same economy would follow suit and increase by 10 percentage points as well. In this light, it may be assumed that a change in the money supply will not affect the real interest rate. It will, however, directly reflect changes in the nominal interest rate.

The International Fisher Effect (IFE)

The International Fisher Effect (IFE) is an exchange-rate model that extends the standard Fisher Effect and is used in forex trading and analysis. It is based on present and future risk-free nominal interest rates rather than pure inflation, and it is used to predict and understand present and future spot currency price movements. For this model to work in its purest form, it is assumed that the risk-free aspects of capital must be allowed to free float between nations that comprise a particular currency pair.

23. Purchasing Power Parity (PPP)

Macroeconomic analysis heavily relies on several different metrics to compare economic productivity and standards of living between countries. One popular metric is purchasing power parity (PPP), an economic theory that compares different countries' currencies through a "basket of goods" approach. According to this concept, two currencies are in equilibrium (at par) when a basket of goods is priced the same in both countries, taking into account the exchange rates.

How is PPP calculated?

The simplest way to calculate purchasing power parity between two countries is to compare the price of a "standard" good that is in fact identical across countries. Every year The Economist magazine publishes a light-hearted version of PPP: its "Hamburger Index" that compares the price of a McDonald's hamburger around the world. More sophisticated versions of PPP look at a large number of goods and services. One of the key problems is that people in different countries consumer very different sets of goods and services, making it difficult to compare the purchasing power between countries How PPP Is Used? To make a meaningful comparison of prices across countries, a wide range of goods and services must be considered. But this is difficult to achieve due to the sheer amount of data that must be collected, and the complexity of the comparisons that must be drawn.

So, to facilitate this with greater ease, in 1968, the University of Pennsylvania and the United Nations joined forces to establish the International Comparison Program (ICP). PPPs generated by the ICP, based on a worldwide price survey comparing the prices of hundreds of various goods, help international macroeconomists estimate global productivity and growth. Every three years, the World Bank releases a report that compares various countries, in terms of PPP and U.S. dollars. Both the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) use weights based Opp metrics to make predictions and recommend economic policy, which can have an immediate short-term impact on financial markets. Some forex traders use PPP to find potentially overvalued or undervalued currencies. And investors who hold stock or bonds of foreign companies may survey PPP figures to predict the impact of exchange-rate fluctuations on a country's economy.

The Downfalls of PPP: Short-Term vs. Long-Term Parity Since 1986, The Economist Magazine has playfully tracked the price of McDonald's Corp.'s (MCD) Big Mac burger, across many countries, resulting in the famed "Big Mac Index". In Burger omics -- a prominent 2003 paper that explores the Big Mac Index and PPP, authors Michael R. Pakko and Patricia S. Pollard cited the following factors to explain why PPP theory does not line up with reality: ·

A. Transport Costs: Goods unavailable locally must be imported, resulting in transport costs. Imported goods will consequently sell at relatively higher prices than identical locally-sourced goods. ·

B. Taxes: Government sales taxes such as the VAT can spike prices in one country, relative to another. · Government intervention: Tariffs can dramatically augment the price of imported goods, where the same products in other countries will be comparatively cheaper. ·

C. Non-traded Services: The Big Mac's price factors input costs that are not traded, such as insurance, utility, and labour costs. Therefore, those expenses are unlikely to be at parity internationally. ·

D. Market Competition: Goods might be deliberately priced higher in a country, because a company there may have a competitive advantage over other sellers, either because it has a monopoly, or because it is part of a cartel of companies that manipulate prices.

The Bottom Line: While it's not a perfect measurement metric, purchase power parity does let one compare pricing between countries with differing currencies. Just don't try to buy a hamburger in Luxembourg if you plan on exchanging your money for Russian rubbles.

24. Interest Rate Parity (IRP)

Interest rate parity is a no-arbitrage condition representing an equilibrium state under which investors will be indifferent to interest rates available on bank deposits in two countries. It is a theory in which the interest rate differential between two countries is equal to the differential between the forward exchange rate and the spot exchange rate. It plays an essential role in foreign exchange markets, connecting interest rates, spot exchange rates and foreign exchange rates.

$F_0 = S_0*(1+i_c/1+i_b)$

F_0 = Forward Rate

S_0 = Spot Rate

i_c = Interest rate in country c

i_b =Interest rate in country b

Given foreign exchange market equilibrium, the interest rate parity condition implies that the expected return on domestic assets will equal the exchange rate-adjusted expected return on foreign currency assets. The difference between the forward rate and spot rate is known as swap points. If this difference (forward rate minus spot rate) is positive, it is known as a forward premium; a negative difference is termed a forward discount. A currency with lower interest rates will trade at a forward premium in relation to a currency with a higher interest rate.

There are two types of IRP. 1. Covered 2. Uncovered

The interest rate parity is said to be covered when the no-arbitrage condition could be satisfied through the use of forward contracts in an attempt to hedge against foreign exchange risk. Conversely, the interest rate parity is said to be uncovered when the no-arbitrage condition could be satisfied without the use of forward contracts to hedge against foreign exchange risk.

For example, assume Australian Treasury bills are offering an annual interest rate of 1.75%, while U.S. Treasury bills are offering an annual interest rate of 0.5%. If an investor in the United States seeks to take advantage of the interest rates in Australia, the investor would have to translate U.S. dollars to Australian dollars to purchase the Treasury bill.

Thereafter, the investor would have to sell a one-year forward contract on the Australian dollar. However, under the covered interest rate parity, the transaction would only have a return of 0.5%, or else the no-arbitrage condition would be violated.

25. Exchange Rate Forecasting Models

Economists and investors always tend to forecast the future exchange rates so that they can depend on the predictions to derive monetary value. There are different models that are used to find out the future exchange rate of a currency. However, as is the case with predictions, almost all of these models are full of complexities and none of these can claim to be 100% effective in deriving the exact future exchange rate. Exchange Rate Forecasts are derived by the computation of value of vis-à-vis other foreign currencies for a definite time period. There are numerous theories to predict exchange rates, but all of them have their own limitations.

Exchange Rate Forecast: Approaches

The two most commonly used methods for forecasting exchange rates are −

- **Fundamental Approach** − This is a forecasting technique that utilizes elementary data related to a country, such as GDP, inflation rates, productivity, balance of trade, and unemployment rate. The principle is that the 'true worth' of a currency will eventually be realized at some point of time. This approach is suitable for long-term investments.
- **Technical Approach** − In this approach, the investor sentiment determines the changes in the exchange rate. It makes predictions by making a chart of the patterns. In addition, positioning surveys, moving-average trend-seeking trade rules, and Forex dealers' customer-flow data are used in this approach.

Exchange Rate Forecast: Models

Some important exchange rate forecast models are discussed below.

A. Purchasing Power Parity (PPP) Model

The purchasing power parity (PPP) forecasting approach is based on the **Law of One** Price. It states that same goods in different countries should have identical prices. For example, this law argues that a chalk in Australia will have the same price as a chalk of equal dimensions in the U.S. (considering the exchange rate and excluding transaction and shipping costs). That is, there will be no arbitrage opportunity to buy cheap in one country and sell at a profit in another.

Depending on the principle, the PPP approach predicts that the exchange rate will adjust by offsetting the price changes occurring due to inflation. For example, say the prices in the U.S. are predicted to go up by 4% over the next year and the prices in Australia are going to rise by only 2%. Then, the inflation differential between America and Australia is: 4% – 2% = 2%

According to this assumption, the prices in the U.S. will rise faster in relation to prices in Australia. Therefore, the PPP approach would predict that the U.S. dollar will depreciate by about 2% to balance the prices in these two countries. So, in case the exchange rate was 90 cents U.S. per one Australian dollar, the PPP would forecast an exchange rate of:

(1 + 0.02) × (US $0.90 per AUS $1) = US $0.918 per AUS $1

So, it would now take 91.8 cents U.S. to buy one Australian dollar.

B. Relative Economic Strength Model

The relative economic strength model determines the direction of exchange rates by taking into consideration the strength of economic growth in different countries. The idea behind this approach is that a strong economic growth will attract more investments from foreign investors. To purchase these investments in a particular country, the investor will buy the country's currency – increasing the demand and price (appreciation) of the currency of that particular country. Another factor bringing investors to a country is its interest rates. High

interest rates will attract more investors, and the demand for that currency will increase, which would let the currency to appreciate.

Conversely, low interest rates will do the opposite and investors will shy away from investment in a particular country. The investors may even borrow that country's low-priced currency to fund other investments. This was the case when the Japanese yen interest rates were extremely low. This is commonly called **carry-trade strategy**. The relative economic strength approach does not exactly forecast the future exchange rate like the PPP approach. It just tells whether a currency is going to appreciate or depreciate.

C. Econometric Models

It is a method that is used to forecast exchange rates by gathering all relevant factors that may affect a certain currency. It connects all these factors to forecast the exchange rate. The factors are normally from economic theory, but any variable can be added to it if required.

For example, say, a forecaster for a Canadian company has researched factors he thinks would affect the USD/CAD exchange rate. From his research and analysis, he found that the most influential factors are: the interest rate differential (INT), the GDP growth rate differences (GDP), and the income growth rate (IGR) differences.

The econometric model he comes up with is −

USD/CAD (1 year) = z + a(INT) + b(GDP) + c(IGR)

Now, using this model, the variables mentioned, i.e., INT, GDP, and IGR can be used to generate a forecast. The coefficients used (a, b, and c) will affect exchange rate and determine its direction (positive or negative).

D. Time Series Model

The time series model is completely technical and does not include any economic theory. The popular time series approach is known as the **autoregressive moving average** (ARMA) process. The rationale is that the past behavior and price patterns can affect the future price behavior and patterns. The data used in this approach is just the time series of data to use the selected parameters to create a workable model. To conclude, forecasting the exchange rate is an ardent task and that is why many companies and investors just tend to hedge the currency risk. Still, some people believe in forecasting exchange rates and try to find the factors that affect currency-rate movements. For them, the approaches mentioned above are a good point to start with.

26. Alternative Currency Translation Methods

In accounting, foreign currency translation is used to remeasure a foreign subsidiary's financial statements denominated in a foreign currency so that they can be presented in the same reporting currency as that of the parent company. Without foreign currency translation, consolidating financial statements between foreign subsidiaries and their home company would be impossible. Foreign currency translation may treat different financial statement items differently in terms of what exchange rates are applied -- current or historical. Balance sheet items are often translated differently than income statement items and current and non-current items may be handled separately as well. Four principal translation methods are available: the current/noncurrent method, the monetary/nonmonetary method, the temporal method, and the current rate method. In practice, there are also variations of each method.

A. Current/Noncurrent Method

At one time, the current/noncurrent method, whose underlying theoretical basis is maturity, was used by almost all U.S. multinationals. With this method, all the foreign subsidiary’s current assets and liabilities are

translated into home currency at the current exchange rate. Each noncurrent asset or liability is translated at its historical exchange rate—that is, at the rate in effect at the time the asset was acquired or the liability was incurred. Hence, a foreign subsidiary with positive local currency working capital will give rise to a translation loss (gain) from a devaluation (revaluation) with the current/noncurrent method, and vice versa if working capital is negative.

The income statement is translated at the average exchange rate of the period, except for those revenues and expense items associated with noncurrent assets or liabilities. The latter items, such as depreciation expense, are translated at the same rates as the corresponding balance sheet items. Thus, it is possible to see different revenue and expense items with similar maturities being translated at different rates.

B. Monetary/Nonmonetary Method

The monetary/nonmonetary method differentiates between monetary assets and liabilities— that is, those items that represent a claim to receive, or an obligation to pay, a fixed amount of foreign currency units—and nonmonetary, or physical, assets and liabilities. Monetary items (for example, cash, accounts payable and receivable, and long-term debt) are translated at the current rate; nonmonetary items (e.g., inventory, fixed assets, and long-term investments) are translated at historical rates.

Income statement items are translated at the average exchange rate during the period, except for revenue and expense items related to nonmonetary assets and liabilities. The latter items, primarily depreciation expense and cost of goods sold, are translated at the same rate as the corresponding balance sheet items. As a result, the cost of goods sold may be translated at a rate different from that used to translate sales.

C. Temporal Method

The temporal method appears to be a modified version of the monetary/nonmonetary method. The only difference is that under the monetary/nonmonetary method, inventory is always translated at the historical rate. Under the temporal method, inventory is normally translated at the historical rate, but it can be translated at the current rate if it is shown on the balance sheet at market values. Despite the similarities, the theoretical bases of the two methods are different. The choice of exchange rate for translation is based on the type of asset or liability in the monetary/nonmonetary method; in the temporal method, it is based on the underlying approach to evaluating cost (historical versus market). Under a historical cost-accounting system, as the United States now has, most accounting theoreticians probably would argue that the temporal method is the appropriate method for translation. Income statement items normally are translated at an average rate for the reporting period. However, cost of goods sold and depreciation and amortization charges related to balance sheet items carried at past prices are translated at historical rates.

D. Current Rate Method

The current rate method is the simplest: All balance sheet and income items are translated at the current rate. This method is widely employed by British companies. With some variation, it is the method mandated by the current U.S. translation standard — Financial Accounting Standard (FASB) 52. Under the current rate method, if a firm’s foreign-currency-denominated assets exceed its foreign-currency denominated liabilities, a devaluation must result in a loss and a revaluation must result in a gain.

27. Financial Accounting Standards No. 8 & 52

Financial Accounting Standard No. 8

International Accounting Standard 8 Accounting Policies, Changes in Accounting Estimates and Errors or IAS 8 is an international financial reporting standard (IFRS) adopted by the International Accounting Standards Board (IASB). It prescribes the criteria for selecting and changing accounting policies, accounting for changes in estimates and reflecting corrections of prior period errors.

The standard requires compliance with IFRSs which are relevant to the specific circumstances of the entity. In a situation where no specific guidance is provided by IFRSs, IAS 8 requires management to use its judgement to develop and apply an accounting policy that is relevant and reliable. Changes in accounting policies and corrections of errors are generally accounted for retrospectively, unless this is impracticable; whereas changes in accounting estimates are generally accounted for prospectively.

Accounting Policies

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial information. Where an IFRS specifically applies to a transaction, event or condition, the accounting policy applied to that item should be determined by reference to that standard. When no standard applies specifically to a transaction, event or condition, management should use its judgement to develop a policy that results in information that is relevant to the economic decision-making needs of users and reliable, such that the financial statements faithfully represent the financial position, performance and cashflows of the entity, reflect the economic substance of transactions, events and conditions, are free from bias, prudent, and complete in all material respects.

In making judgement, management should take into account (in the following order) the requirements in IFRSs dealing with similar and related issues, and the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework. Management may also consider recent pronouncements of other standard-setting bodies, accounting literature and accepted industry practices, to the extent that these do not conflict with IFRSs and the Framework.

Accounting policies should be applied consistently for similar transactions, events or conditions, unless an IFRS requires or permits different accounting policies to be applied to different categories of items. An entity can change an accounting policy only if it is required by an IFRS or results in the financial statements providing reliable and more relevant information. If the change is due to requirement by an IFRS, an entity shall account for the change from the initial application of the IFRS in accordance with the specific transitional provisions (i.e. the standard may specify retrospective application or only prospective application), if any. Where there are no specific transitional provisions in the IFRS requiring the change in accounting policy, or an entity changes an accounting policy voluntarily, it should apply the change retrospectively.

Where a change in accounting policy is applied retrospectively, an entity should adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts for each prior period presented as if the new accounting policy had always been applied. The standard permits exemption from this requirement when it is impracticable to determine either the period-specific effects or cumulative effect of the change.

Changes in Accounting Estimates

A change in accounting estimate is "an adjustment of the carrying amount of an asset or liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not correction of errors."

Changes in accounting estimates are reflected prospectively (that is, from the date of change) by including it in the income statement for the period of the change (if the change affects that period only), or the period of the change and future periods (if the change affects both). However, to the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it is recognised by adjusting the carrying amount of the related asset, liability, or equity item in the period of the change.

Errors

Material prior period errors are corrected retrospectively in the first financial statements issued after their discovery. Correction is made by restating the comparative amounts for the prior period presented in which the error occurred. If the error occurred before the earlier comparative prior period presented, the opening balances of assets, liabilities and equity for the earliest prior period should be restated to reflect correction of the error

Financial Accounting Standard No. 52

Application of this Statement will affect financial reporting of most companies operating in foreign countries. The differing operating and economic characteristics of varied types of foreign operations will be distinguished in accounting for them. Adjustments for currency exchange rate changes are excluded from net income for those fluctuations that do not impact cash flows and are included for those that do. The requirements reflect these general conclusions:

A. The economic effects of an exchange rate change on an operation that is relatively self-contained and integrated within a foreign country relate to the net investment in that operation. Translation adjustments that arise from consolidating that foreign operation do not impact cash flows and are not included in net income.

B. The economic effects of an exchange rate change on a foreign operation that is an extension of the parent's domestic operations relate to individual assets and liabilities and impact the parent's cash flows directly. Accordingly, the exchange gains and losses in such an operation are included in net income.

C. Contracts, transactions, or balances that are, in fact, effective hedges of foreign exchange risk will be accounted for as hedges without regard to their form.

More specifically, this Statement replaces FASB Statement No. 8, Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements, and revises the existing accounting and reporting requirements for translation of foreign currency transactions and foreign currency financial statements. It presents standards for foreign currency translation that are designed to (1) provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity and (2) reflect in consolidated statements the financial results and relationships as measured in the primary currency in which each entity conducts its business (referred to as its "functional currency").

An entity's functional currency is the currency of the primary economic environment in which that entity operates. The functional currency can be the dollar or a foreign currency depending on the facts. Normally, it will be the currency of the economic environment in which cash is generated and expended by the entity. An entity can be any form of operation, including a subsidiary, division, branch, or joint venture. The Statement provides guidance for this key determination in which management's judgment is essential in assessing facts. A currency in a highly inflationary environment (3-year inflation rate of approximately 100 percent or more) is not considered stable enough to serve as a functional currency and the more stable currency of the reporting parent is to be used instead.

The functional currency translation approach adopted in this Statement encompasses:

- Identifying the functional currency of the entity's economic environment
- Measuring all elements of the financial statements in the functional currency

- Using the current exchange rate for translation from the functional currency to the reporting currency, if they are different.
- Distinguishing the economic impact of changes in exchange rates on a net investment from the impact of such changes on individual assets and liabilities that are receivable or payable in currencies other than the functional currency
- Translation adjustments are an inherent result of the process of translating a foreign entity's financial statements from the functional currency to U.S. dollars. Translation adjustments are not included in determining net income for the period but are disclosed and accumulated in a separate component of consolidated equity until sale or until complete or substantially complete liquidation of the net investment in the foreign entity takes place.
- Transaction gains and losses are a result of the effect of exchange rate changes on transactions denominated in currencies other than the functional currency (for example, a U.S. company may borrow Swiss francs or a French subsidiary may have a receivable denominated in kroner from a Danish customer). Gains and losses on those foreign currency transactions are generally included in determining net income for the period in which exchange rates change unless the transaction hedges a foreign currency commitment or a net investment in a foreign entity. Intercompany transactions of a long-term investment nature are considered part of a parent's net investment and hence do not give rise to gains or losses.

28. Currency Hedging

Currency hedging is the use of financial instruments, called derivative contracts, to manage financial risk. It involves the designation of one or more financial instruments as a buffer for potential loss. In hedging, the change in the fair value or cash flows of the derivative will offset, in whole or in part, the change in fair value or cash flows of a hedged item.

Example: Imagine running a company in the United States, say MM Corporation; it has a loan of €50,000 with French Bank. Naturally, such a loan is denominated in the French currency, the euro of course. Hence, the company is subject to the risk of fluctuating exchange rate between two different currencies. As part of MM management, you know that when the dollar devalues against the euro, the company will have to pay more in dollars to settle the obligation. On the contrary, should the euro devalue against the dollar, the company will need a lesser amount in terms of US dollars. To manage this risk of paying more upon maturity date, you entered into a foreign currency forward contract with a third party speculator. On the contract date, the forward contract was set at the current exchange rate. The exchange rate was $1 to €0.93. This means that to settle the loan amounting to €50,000, MM Corporation's payment is pegged at €0.93, or $53,764, regardless of the dollar to euro exchange rate on maturity date. If on the maturity date, the dollar devalues against the euro and the exchange rate is at $1 to €0.90, MM will need more US dollars - $55,556 - to settle the obligation; however, since MM Corporation entered into a foreign currency forward contract, the eventual net cash outflow by MM will only be $53,764, the amount originally pegged. Of course, MM will have to pay French Bank the total amount of $55,556, but the difference of $1,792 will be received by MM from the third party speculator. Conversely, if the euro devalues against the dollar and the exchange rate will be $1 to €1.02, the eventual net cash outflow of MM will still be $53,764. MM will have to pay French Bank $49,020 and MM will have to pay the third party speculator the amount of $4,744.

A hedged item is an asset, liability, firm commitment or a net investment in a foreign operation, that exposes the company to the risk of changes in fair value or future cash flows. In our illustration, the hedged item is actually the loan denominated in foreign currency. The derivative contract, or the hedging instrument, is the foreign currency forward contract, and the related risk is the foreign currency risk.

29. Managing Transaction exposure

Meaning of Transaction Exposure

Transaction exposure is the risk incurred due to the fluctuations in exchange rates before the contract is settled. The foreign exchange rate that changes in cross-currency transactions can adversely affect the involved parties. Once a cross-currency contract has been framed, and a specific amount of money and quantity of goods is fixed, exchange rate fluctuations can change the value of the contract. However, a company that has agreed to a contract but not yet settled it, faces the transaction exposure risk.

Financial Techniques for Managing Transaction Exposure:

A. Forward Contracts

If a firm is required to pay a specific amount of foreign currency in the future, it can enter into a contract that fixes the price for the foreign currency for a future date. This eliminates the chances of suffering due to currency fluctuations.

B. Futures Contracts

Futures contracts are similar to ‘forward contracts. However, futures contracts have standardized and limited maturity dates, initial collateral and contract sizes.

C. Money Market Hedge

In a money market hedge, the forward price is equal to current spot price multiplied by the ratio of the currency’s riskless returns. This also creates the finance for the foreign currency transaction.

D. Options

The options contracts involve an upfront fee and do not oblige the owner to trade currencies at a specified price, time period and quantity.

Operational Techniques for Managing Transaction Exposure:

A. Risk Shifting

The firm can completely avoid transaction exposure by not involving itself in foreign exchange at all. All the transactions can be conducted in the home currency. However, this is not possible for all types of businesses.

B. Currency Risk Sharing

The two parties involved in the deal can have the understanding to share the transaction risk.

C. Leading and Lagging

It involves manipulating currency cash flows in accordance with the fluctuations. Paying off liabilities when the currency is appreciating is known as leading. While collecting receivables when the currency is at a low value in called lagging.

D. Reinvoicing Centers

A reinvoicing center is a single third-party subsidiary used to conduct all intra-company trades. The reinvoicing centers carry out transactions in domestic currency, thereby bearing the losses from the transaction exposures

30. Managing Translation Exposure

Translation Exposure (or Translation Risk) is the risk that a company's equities, assets, liabilities or income will change in value as a result of exchange rate changes. This occurs when a firm denominates a portion of its equities, assets, liabilities or income in a foreign currency. It is also known as "accounting exposure."

Accountants use various methods to insulate firms from these types of risks, such as consolidation techniques for the firm's financial statements and using the most effective cost accounting evaluation procedures. In many cases, translation exposure is recorded in financial statements as an exchange rate gain (or loss).

Hedging Translation Exposure

A. The Balance Sheet Hedge

Balance-sheet hedges are generally employed to minimize translation exposure. A balance-sheet hedge involves the selection of the currency in which exposed assets and liabilities are denominated so that an exchange rate change would make exposed assets equal to exposed liabilities. To attain this objective, a company must maintain the same amount of exposed assets and exposed liabilities in a particular currency. A devaluation would affect both types of balance-sheet accounts equally; thus, the company would suffer neither a gain nor a loss.

When an MNC has several subsidiaries, a variety of funds-adjustment techniques can be used to reduce its translation loss. These techniques require the company to adopt the following two basic strategies:

1. The company must decrease soft-currency assets and increase soft-currency liabilities.

2. The company must increase hard-currency assets and decrease hard-currency liabilities.

Hard currencies are those currencies that are likely to appreciate; soft currencies are those currencies that are likely to depreciate. Most techniques for hedging an impending local-currency (soft-currency) devaluation reduce local-currency assets and/or increase local-currency liabilities to generate local-currency cash. In order to reduce translation exposure, these local-currency funds must be converted into hard currency assets. This conversion can be accomplished, either directly or indirectly, by a variety of funds-adjustment techniques. Direct funds-adjustment techniques include pricing exports in hard currencies and imports in the local currency, investing in hard-currency securities, and replacing hard-currency loans with local-currency loans.

B. Indirect Funds Adjustment Methods

A variety of indirect funds-adjustment methods can be used to reduce foreign-currency exposure:

1. Exposure Netting

MNCs can net certain exposures from different operations around the world so that they may hedge only their net exposure. For example, when an MNC has both receivables and payables in a given foreign currency, these receivables and payables can be offset through netting, which will reduce the amount of foreign-exchange exposure. Exposure netting is a method of offsetting exposures in one currency with exposures in the same or another currency in such a way that gains or losses on the first exposure will be offset by losses or gains on the second exposure. Unlike the simple case of exposure netting on a currency-by-currency basis that we discussed above, MNCs have a portfolio of currency positions. If MNCs want to apply exposure netting aggressively, it helps to centralize their exposure management function in one location.

2. Leading and Lagging

Leading and lagging is another operational technique that MNCs can use to reduce foreign-exchange exposure. Leading means to pay or collect early, whereas lagging means to pay or collect late. MNCs should lead soft-currency receivables and lag hard-currency receivables to avoid the loss from the depreciation of the soft

currency and to obtain the gain from the appreciation of the hard currency. For the same reason, MNCs will try to lead hard currency payables and to lag soft-currency payables.

3. Transfer Pricing

Transfer prices are prices of goods and services sold between related parties, such as a parent and its subsidiary. Transfer prices are frequently different from arm's length prices (fair market prices) so that they can be used to avoid foreign-currency exposure. For example, an MNC can remove funds from soft-currency countries by charging higher transfer prices on goods sold to its subsidiaries in those countries. For the same reason, an MNC can keep funds at those subsidiaries in hard-currency countries by charging lower prices on goods sold to its subsidiaries in those countries. Governments usually assume that MNCs manipulate their transfer prices to avoid financial problems or to improve financial conditions. Thus, most governments set up policing mechanisms to review the transfer pricing policies of MNCs.

31. Measuring and Managing Economic Exposure

Meaning of Economic Exposure

Economic exposure, also known as operating exposure refers to an effect caused on a company's cash flows due to unexpected currency rate fluctuations. Economic exposures are long-term in nature and have a substantial impact on a company's market value. Economic exposure can prove to be difficult to hedge as it deals with unexpected fluctuations in foreign exchange rates. As the foreign exchange volatility rises, the economic exposure increases and vice versa.

Measuring Economic Exposure

The following are the two factors that help in determining economic exposure:

- Economic exposure is higher for firms having both, product prices and input costs sensitive to currency fluctuations. It is lower when costs and prices are not sensitive to currency fluctuations.
- Economic exposure is higher for firms which do not adjust its markets, product mix, and source of inputs in accordance with currency fluctuations. Flexibility in adapting to currency rate fluctuations indicates lesser economic exposure.

Managing Economic Exposure

The risk of economic exposure can be hedged either by operational strategies or currency risk mitigation strategies.

A. Operational Strategies

The following are the operational strategies which can be used to alleviate the risk of economic exposure:

1. Diversifying Production Facilities and Markets For Products

Diversifying the production facilities and sales to a number of markets rather than concentrating on one or two markets would mitigate the risk inherent. However, in such cases, the companies have to forgo the advantage earned by economies of scale.

2. Sourcing Flexibility

Companies may have alternative sources for acquiring key inputs. The substitute sources can be utilized in case the exchange rate fluctuations make the inputs expensive from one region.

3. Diversifying Financing

A company can have access to capital markets in a number of major regions. This enables the company to gain flexibility in raising capital in the market with the cheapest cost of funds.

B. Currency Risk Mitigation Strategies

The following are the currency risk mitigation strategies which can be used to alleviate the risk of economic exposure:

1. Matching Currency Flows

This is the simplest form of mitigating economic exposure by matching foreign currency inflows and outflows. For example, if a European company has significant inflows in US dollars and is looking to raise debt, it should consider borrowing in US dollars.

2. Currency Risk-Sharing Agreements

An agreement is framed between the two parties involved in the purchase and sales contract. The agreement states that the parties must share the risk arising from the exchange rate fluctuations. The agreement consists of a price adjustment clause which states that the base price of the transaction will be adjusted in case of currency rate fluctuations.

3. Back-to-Back Loans

This method, also known as credit swap involves two companies located in different countries entering into an arrangement to borrow each other's currency for a fixed period of time. Once the defined period is over, the currencies are repaid.

4. Currency Swaps

The currency swap method is similar to the back-to-back loan's method, however, does not reflect on the balance sheet. This method involves two firms who borrow currencies in the world market where each can benefit from the best rates and then swap the proceeds.

32. American Depositary Receipt (ADR)

An American depositary receipt (ADR) is a negotiable certificate issued by a U.S. depository bank representing a specified number of shares (even as little as one share) in a foreign company's stock. The ADR trades in the U.S. as any stock would. ADRs represent a feasible, liquid way for U.S. investors to purchase stock in companies abroad. The foreign firms also benefit from ADRs, as they make it easier to attract American investors—without having to go through the hassle and expense of listing themselves on stock exchanges in the U.S. ADRs are denominated in U.S. dollars, with the underlying security held by a U.S. financial institution overseas. To offer ADRs, U.S. banks simply purchase shares from the company on a foreign exchange, holds them as inventory, and issues the ADR for trading domestically. ADRs are listed on either the NYSE, AMEX or Nasdaq, but they are also sold over-the-counter (OTC).

American depositary receipts come in two basic categories: sponsored and unsponsored. A sponsored ADR is issued by a bank on behalf of the foreign company; the two enter into a legal arrangement, which usually involves the foreign company paying the costs of issuing the ADR and retaining control over it, and the bank handling the transactional arrangements. Sponsored ADRs fit into one of three categories, called levels; the higher the level, the greater the degree to which the foreign company has to comply with the U.S. Securities and Exchange Commission (SEC) regulations and American accounting procedures. An unsponsored ADR is issued by a bank without any involvement, participation or even permission by the

foreign company whose stock it represents. Theoretically, there could be several unsponsored ADRs for the same foreign company, issued by different U.S. banks (and offering different dividends). With sponsored programs, there is only one ADR, issued by the bank working with the foreign company. One main practical difference between the two ADRs lies in where they can be purchased: All but the lowest level of sponsored ADRs register with the SEC and trade on major U.S. stock exchanges, while unsponsored ADRs trade solely over-the-counter. Also, unsponsored ADRs never include voting rights.

33. Global Depository Receipt (GDR)

A global depositary receipt (GDR) is a bank certificate issued in more than one country for shares in a foreign company. A global depositary receipt (GDR) is very similar to an American depositary receipt (ADR). It is a type of bank certificate that represents shares in a foreign company, such that a foreign branch of an international bank then holds the shares. The shares themselves trade as domestic shares, but, globally, various bank branches offer the shares for sale. Private markets use GDRs to raise capital denominated in either U.S. dollars or euros. Investors trade GDRs in multiple markets, which they generally refer to as capital markets as they are considered to be negotiable certificates. Investors use capital markets to facilitate the trade of long-term debt instruments and for generating capital. GDR transactions in the international market tend to have lower associated costs than some other mechanisms that investors use to trade in foreign securities.

Companies issue GDRs to attract interest by foreign investors. GDRs provide a lower-cost mechanism in which these investors can participate. These shares trade as though they are domestic shares, but investors can purchase the shares in an international marketplace. A custodian bank often takes possession of the shares while the transaction processes, ensuring both parties a level of protection while facilitating participation. Brokers who represent the buyer manage the purchase and sale of GDRs. Generally, the brokers are from the home country and are sellers within the foreign market. The actual purchase of the assets is multi-staged, involving a broker in the investor's homeland, a broker located within the market associated with the company that has issued the shares, a bank representing the buyer, and the custodian bank.

If an investor desires, brokers can also sell GDRs on their behalf. An investor can sell them as-is on the proper exchanges, or the investor can convert them into regular stock for the company. Additionally, they can be cancelled and returned to the issuing company.

34. Euro Bonds

A Eurobond is denominated in a currency other than the home currency of the country or market in which it is issued. These bonds are frequently grouped together by the currency in which they are denominated, such as euro-dollar or euro-yen bonds. Issuance is usually handled by an international syndicate of financial institutions on behalf of the borrower, one of which may underwrite the bond, thus guaranteeing purchase of the entire issue.

The popularity of Eurobonds as a financing tool reflects their high degree of flexibility as they offer issuers the ability to choose the country of issuance based on the regulatory market, interest rates and depth of the market. They are also attractive to investors because they usually have small par values and high liquidity. The term Eurobond refers only to the fact the bond is issued outside of the borders of the currency's home country; it does not mean the bond was issued in Europe or denominated in the euro currency.

35. Foreign Bonds

A foreign bond is a bond issued in a domestic market by a foreign entity in the domestic market's currency as a means of raising capital. For foreign firms doing a large amount of business in the domestic market, issuing foreign bonds, such as bulldog bonds, Matilda bonds and samurai bonds, is a common practice. Since investors

in foreign bonds are usually the residents of the domestic country, investors find the bonds attractive because they can add foreign content to their portfolios without the added exchange rate exposure. Because investing in foreign bonds involves multiple risks, foreign bonds typically have higher yields than domestic bonds. Foreign bonds carry interest rate risk. When interest rates rise, the market price or resale value of a bond falls. For example, say an investor owns a 10-year bond paying 4% and interest rates increase to 5%. Few investors want to take on the bond without a price cut for offsetting the difference in income.

Foreign bonds also face inflation risk. Buying a bond at a set interest rate means the real value of the bond is determined by the amount of inflation taken away from the yield. If an investor purchases a bond with a 5% interest rate during a time when inflation is 2%, the investor's real payout is the difference of 3%

36. Issues in Foreign Investment Analysis/International Investment – Portfolio Management

The analysis of a foreign project raises two issues other than those dealing with the interaction between the investment and financing decisions:
A. Should cash flows be measured from the viewpoint of the project or that of the parent? and
B. Should the additional economic and political risks that are uniquely foreign be reflected in cash-flow or discount rate adjustments?

A. A substantial difference can exist between the cash flow of a project and the amount that is remitted to the parent firm because of tax regulations and exchange controls. In addition, project expenses such as management fees and royalties are returns to the parent company. Furthermore, the incremental revenue contributed to the parent of the multinational corporation by a project can differ from total project revenues if, for example, the project involves substituting local production for parent company exports or if transfer price adjustments shift profits elsewhere in the system. According to economic theory, the value of a project is determined by the net present value of future cash flows back to the investor. Thus, the parent MNC should value only those cash flows that are, or can be, repatriated net of any transfer costs (such as taxes) because only accessible funds can be used for the payment of dividends and interest, for amortization of the firm's debt, and for reinvestment.

Three-Stage Approach

A three-stage analysis is recommended for simplifying project evaluation. In the first stage, project cash flows are computed from the subsidiary's standpoint, exactly as if the subsidiary were a separate national corporation. The perspective then shifts to the parent company. This second stage of analysis requires specific forecasts concerning the amounts, timing, and form of transfers to headquarters, as well as information about what taxes and other expenses will be incurred in the transfer process. Finally, the firm must take into account the indirect benefits and costs that this investment confers on the rest of the system, such as an increase or decrease in export sales by another affiliate. Estimating Incremental Project Cash Flows. Essentially, the company must estimate a project's true profitability. True profitability is an amorphous concept, but basically it involves determining the marginal revenue and marginal costs associated with the project. In general, as mentioned earlier, incremental cash flows to the parent can be found only by subtracting worldwide parent company cash flows (without the investment) from post investment parent company cash flows.

The second set of adjustments involves incorporating the project's strategic purpose and its impact on other units. These strategic considerations embody the factor. Although the principle of valuing and adjusting incremental cash flows is itself simple, it can be complicated to apply. Its application is illustrated in the case of taxes.

Tax Factors
Because only after-tax cash flows are relevant, it is necessary to determine when and which taxes must be paid on foreign-source profits.

B. Political and Economic Risk Analysis
All else being equal, firms prefer to invest in countries with stable currencies, healthy economies, and minimal political risks, such as expropriation. All else is usually not equal, however, and so firms must assess the consequences of various political and economic risks for the viability of potential investments. The three main methods for incorporating the additional political and economic risks, such as the risks of currency fluctuation and expropriation, into foreign investment analysis are (A) shortening the minimum payback period, (B) raising the required rate of return of the investment, and (C) adjusting cash flows to reflect the specific impact of a given risk.

A. Adjusting the Discount Rate or Payback Period: The additional risks confronted abroad are often described in general terms instead of being related to their impact on specific investments. This rather vague view of risk probably explains the prevalence among multinationals of two unsystematic approaches to account for the added political and economic risks of overseas operations. One is to use a higher discount rate for foreign operations; another is to require a shorter payback period. For instance, if exchange restrictions are anticipated, a normal required return of 15% might be raised to 20%, or a five-year payback period might be shortened to three years. Neither of the aforementioned approaches, however, lends itself to a careful evaluation of the actual impact of a particular risk on investment returns. Thorough risk analysis requires an assessment of the magnitude and timing of risks and their implications for the projected cash flows.

B. Adjusting Expected Values: The recommended approach is to adjust the cash flows of a project to reflect the specific impact of a given risk, primarily because there is normally more and better information on the specific impact of a given risk on a project's cash flows than on its required return. The cash-flow adjustments presented in this chapter employ only expected values; that is, the analysis reflects only the first moment of the probability distribution of the impact of a given risk. Although this procedure does not assume that shareholders are risk-neutral, it does assume either that risks such as expropriation, currency controls, inflation, and exchange rate changes are unsystematic or that foreign investments tend to lower a firm's systematic risk. In the latter case, adjusting only the expected values of future cash flows will yield a lower bound on the value of the investment to the firm. Most firms evaluating foreign investments discount most likely (modal) rather than expected (mean) cash flows at a risk-adjusted rate. If an expropriation or currency blockage is anticipated, then the mean value of the probability distribution of future cash flows will be significantly below its mode. From a theoretical standpoint, of course, cash flows should always be adjusted to reflect the change in expected values caused by a particular risk; however, only if the risk is systematic should these cash flows be further discounted.

C. Exchange Rate Changes and Inflation: The present value of future cash flows from a foreign project can be calculated using a two- stage procedure: (1) Convert nominal foreign currency cash flows into nominal home currency terms, and (2) discount those nominal cash flows at the nominal domestic required rate of return. In order to assess the effect of exchange rate changes on expected cash flows from a foreign project properly, one must first remove the effect of offsetting inflation and exchange rate changes. It is worthwhile to analyze each effect separately because different cash flows may be differentially affected by inflation.

37. Optimal International Allocation of Funds

Allocating your investments among different asset classes is a key strategy to help minimize risk and potentially increase gains. Funds allocation is the strategy of dividing your investment portfolio across various asset classes like stocks, bonds and money market securities. The options typically fall within three classes: stocks, bonds and cash. Within these three classes are subclasses or alternatives that can include: Large-cap stock, Mid-cap stock, Small-cap stocks, International securities, Emerging markets, Fixed-income securities, Money market, Real estate investment trusts.

The main goal of allocating your funds is to minimize risk while meeting an expected level of return. Equities have the highest potential return, but also the highest risk. On the other hand, Treasury bills have the lowest risk because they are backed by the government, but they also provide the lowest potential return. This is the risk-return trade-off. Keep in mind that high-risk choices are better suited for investors who have a high-risk tolerance and who have a longer time horizon to recover from losses. As each asset class has varying levels of return and risk, investors should consider their risk tolerance, investment objectives, time horizon and available capital as the basis for their asset composition. Investors with a long-time horizon and larger sums to invest may feel more comfortable with high-risk, high-return options. In contrast, investors with smaller sums and shorter time spans may feel more comfortable with low-risk, low-return allocations.

To make the asset allocation process easier for clients, many investment companies create a series of model portfolios, each comprising different proportions of asset classes. These portfolios of different proportions satisfy a particular level of investor risk tolerance.

In general, these model portfolios range from conservative to very aggressive:
A. Conservative Portfolios: Conservative model portfolios generally allocate a large percent of the total portfolio to lower-risk securities such as fixed-income and money market securities. The main goal of a conservative portfolio is to protect the principal value of your portfolio. As such, these models are often referred to as "capital preservation portfolios."
B. Moderately Aggressive Portfolios: Moderately aggressive model portfolios are often referred to as balanced portfolios as the asset composition is divided almost equally between fixed-income securities and equities in order to provide a balance of growth and income. Since moderately aggressive portfolios have a higher level of risk than conservative portfolios, this strategy is best for investors with a longer time horizon (generally more than five years) and a medium level of risk tolerance.
C. Aggressive Portfolios: Aggressive portfolios mainly consist of equities, so their value tends to fluctuate widely. If you have an aggressive portfolio, your main goal is to obtain long-term growth of capital. As such, the strategy of an aggressive portfolio is often called a "capital growth" strategy. To provide some diversification, investors with aggressive portfolios usually add some fixed-income securities.
D. Very Aggressive Portfolios: Very aggressive portfolios consist almost entirely of equities. As such, with a very aggressive portfolio, your main goal is aggressive capital growth over a long-time horizon. Since these portfolios carry a considerable amount of risk, the value of the portfolio will vary widely in the short term.

You can modify the proportions to suit your own individual investment needs. How you fine-tune the models above can depend on your future needs for capital and what kind of investor you are. Fund allocation is a fundamental investing principle because it helps investors maximize profits while minimizing risk. The different fund allocation strategies described above cover a wide range of investment styles, accommodating varying risk tolerance, time frames and goals. Once you've chosen an appropriate fund allocation strategy, remember to conduct periodic reviews of your portfolio to ensure you're maintaining your intended allocation and are still on track to your long-term investment goals.

38. Adjusted Present Value (APV) Method

The adjusted present value is the Net Present Value (NPV) of a project or company if financed solely by equity plus the Present Value (PV) of any financing benefits, which are the additional effects of debt. By taking into account financing benefits, APV includes tax shields such as those provided by deductible interest. It is calculated as follows:

Adjusted Present Value (APV) = Present Value of Investment Outlay + Present Value of Operating Cash Flows + Present Value of Interest Tax Shield + Present Value of Interest Subsidies

Adjusted Present Value (APV) = Unlevered Firm Value + Net Effect of Debt

The adjusted present value approach is very similar to the Discounted Cash Flow method of valuation. So similar, in fact, that they will yield approximately the same results if the financing structure of a company is consistent. The method is especially effective in any situation in which the tax implications of a deal heavily affect the outcome, such as with a leveraged buyout. When compared to the more common methods of valuation, the adjusted present value method is newly created.

The adjusted present value helps to show an investor the benefits of tax shields resulting from one or more tax deductions of interest payments or a subsidized loan at below-market rates. For leveraged transactions, APV is preferred. In particular, leveraged buyout situations are the most effective situations in which to use the adjusted present value methodology. The value of a debt-financed project can be higher than just an equity-financed project, as the cost of capital falls when leverage is used. Using debt can actually turn a negative NPV project into one that's positive. NPV uses the cost of equity as the discount rate, while APV uses the weighted average cost of capital as the discount rate.

39. Factors Affecting/Determining Country Risk

Country risk refers to the uncertainty associated with investing in a particular country, and more specifically degree to which that uncertainty could lead to losses for investors. This uncertainty can come from any number of factors including political, economic, exchange-rate, or technological influences. Country risk is the degree to which political and economic unrest affect the securities of issuers doing business in a particular country.

Different Types of Country Risk:

1. Political Risk

Political risk determines a country's political stability, either internally or externally. For instance, a recent military coup would increase a nation's internal political risk for businesses as rules and regulations suddenly shift. Other risks in this category could include war, terrorism, corruption and excessive bureaucracy (i.e. host government red tape is preventing certain fund transfers or other transactions). Political risk can affect a country's attitude to meeting its debt obligations and may cause sudden changes in foreign exchange market.

2. Sovereign Risk

There is some crossover between political and sovereign risk, although the latter – also known as sovereign default risk – primarily examines debt. Specifically, this risk category measures the build-up of debt that is the obligation of a government or its agencies (or that is guaranteed by the government), and how much said government is anticipated to fulfil these obligations. For example, if a government agency refuses to carry out debt refunding, this could impact local lenders and lead to losses. This would of course have roll-on effects to local businesses and anyone undertaking trade with them.

3. Location or Neighbourhood Risk

Location risk, also known as Neighbourhood risk, may not be the direct fault of the country with which your clients are dealing, but instead is caused by trouble elsewhere. This can have spill over effects on other sovereign nations, creating turmoil in the foreign market or putting pressure on local lenders and businesses.

Neighbourhood risk can be caused by:

- Geographic Neighbours.
- Trading Partners.
- Co-Members of Certain Institutions or Organisations.
- Strategic Allies.
- Nations with Similar Perceived Characteristics.

4. Economic Risk

Economic risk encompasses a wide range of potential issues that could lead a country to renege on its external debts or that may cause other types of currency crisis (i.e. recession). A major factor here is economic growth – the health of a nation's GDP and the outlook for its future. For instance, if a country relies on a few key exports and the prices for these are dropping, this creates a negative outlook and may increase the economic risk for foreign trading partners.

Acts of government may also impact economic risk, such as intervention in the money market or policy changes that cause tax instability. One other factor is issues with foreign currency exchange, for instance a shortage in certain currencies or a devaluation of the exchange rate. Predicted loss created by sudden changes in exchange rate are generally covered under the exchange risk factor.

5. Exchange Rate Risk

Any predicted loss created by sudden changes in exchange rate are generally covered under the exchange risk factor. This is another all-encompassing term as fluctuations in the foreign exchange can be caused by a wide variety of factors. Economic and political factors such as those mentioned above can be significant drivers of exchange risk, although currency reserves, interest rates and inflation are also potential factors.

One example of political change that can harm economic risk is a change in currency regime, for example from fixed regime to floating.

6. Transfer Risk

Another country risk assessment factor is transfer risk. This is where the host government becomes unwilling or unable to permit foreign currency transfers out of the nation. Sweeping controls such as these may be a side effect of a nation in crisis attempting to prevent creditor panic turning into significant capital outflow. A major example of this occurring is the Malaysia credit controls after the 1997-98 Asian currency crisis.

7. Subjective Risk

Subjective risk is not a term that is used everywhere, but it measures factors that are common to most risk assessments – and could greatly impact foreign business owners trading with a host nation. Subjective risk is about attitudes, and can include social pressures and consumer opinions – whether to certain types of goods or certain types of enterprise.

Analysing Factors affecting Country Risk

Methods used to assess country risk can be grouped into two categories:

Quantitative Analysis: The use of ratios and statistics to determine risks, such as the debt-to-GDP ratio or the beta coefficient of the MSCI index for a given country. International investors can find this information in reports from rating agencies, magazines like the Economist, and through various other online sources.

Qualitative Analysis: The use of subjective analysis to determine risks, such as breaking political news/opinion or realistic market rumours. International investors can find this information in financial publications like Economist /Wall Street Journal, and on international news aggregators like Google News.

40. Measuring Political Risks and Factors Affecting Political Risks

Several sometimes-overlapping government functions can have an impact on business. In many industrialized countries, government's role as a regulator is especially extensive, resulting in legislation related to the environment, health and safety, employment, trade unions, and consumers. A government can also serve as a restrictor of business activity (tariffs and trade quotas), a redistributor of business income (taxation and social welfare policies), a customer (procurement), and a sponsor (subsidies and other corporate welfare).

Some says that political risk analysis displays an inherent bias, according to which any government intervention in the economy is negative. It is in any case meaningful to locate the particular relationships between multinational business and national governments or other political actors when assessing the actual political risk. The particular cultural and historical context may also influence political risk—for example, in cases in which energy or mineral companies are associated with earlier colonial projects in Africa or the Middle East. The most familiar relationship between business and political authorities is a cooperative arrangement, in which negotiations are ongoing and a normal part of operations. A second kind of relationship is collaborative, consisting of privately-owned companies with a strong governmental presence or joint ventures between private businesses and public-sector companies.

An authoritative relationship exists when a multinational corporation and a government are at loggerheads. In most cases, a government can impose new rules, which may result in divestment by the company. Two other relationships are far less frequent. A home government may use a multinational company to promote its political objectives. Alternatively, in the case of subversion, a multinational company may actively work to undermine a host government, sometimes with the covert encouragement of the company's home government. In the latter two cases, the conduct of business can also constitute a source of political risk.

Risks to business in a country may ensue not only from actions by the government in that country but also from actions by governments in other countries. Opposition groups and other domestic stakeholders and the particular political circumstances in a country may also become linked to political risk. In some countries, owing to the power or authority of informal networks linked to the government, such groups, rather than the government itself, may be the main source of political risk to a particular business.

Although expropriation is the most obvious and extreme form of political risk, there are other significant political risks, including currency or trade controls, changes in tax or labour laws, regulatory restrictions, and requirements for additional local production. The common denominator of such risks is not hard to identify: government intervention into the workings of the economy that affects, for good or ill, the value of the firm. Although the consequences usually are adverse, changes in the political environment can provide opportunities as well.

A number of commercial and academic political risk forecasting models are available today. Some prominent ones include Business Environment Risk Intelligence (BERI), Political Risk Services (PRS), Control Risks'

Country Risk Forecasts, Deutsche Bank Eurasia Group Stability Index, as well as ratings provided by Economist Intelligence Unit (EIU), Euromoney, Institutional Investor, Standard & Poor's Rating Group, and Moody's Investors Services. These models normally supply country risk indices that attempt to quantify the level of political risk in each nation. Most of these indices rely on some measure(s) of the stability of the local political regime.

A. Political Stability: Measures of political stability may include the frequency of changes of government, the level of violence in the country (e.g., violent deaths per 100,000 population), the number of armed insurrections, the extent of conflicts with other states, and so on. For example, the Deutsche Bank Eurasia Group Stability Index measures risk according to long-term conditions that affect stability (structural scores) and temporal assessment on impacts of policies, events, and developments each month. The basic function of these stability indicators is to determine how long the current regime will be in power and whether that regime also will be willing and able to enforce its foreign investment guarantees. Most companies believe that greater political stability means a safer investment environment.

B. Economic Factors: Other frequently used indicators of political risk include economic factors such as inflation, balance-of-payments deficits or surpluses, and the growth rate of per capita GDP. The intention behind these measures is to determine whether the economy is in good shape or requires a quick fix, such as expropriation to increase government revenues or currency inconvertibility to improve the balance of payments. In general, the better a country's economic outlook, the less likely it is to face political and social turmoil that will inevitably harm foreign companies.

C. Subjective Factors: More subjective measures of political risk are based on a general perception of the country's attitude toward private enterprise: whether private enterprise is considered a necessary evil to be eliminated as soon as possible or whether it is actively welcomed. The attitude toward multinationals is particularly relevant and may differ from the feeling regarding local private ownership. Consider, for example, the former Soviet Union and other Eastern European countries that actively sought products, technology, and even joint ventures with Western firms while refusing to tolerate (until the early 1990s) domestic free enterprise. In general, most countries probably view foreign direct investment in terms of a cost/benefit trade-off and are not either for or against it in principle.

D. Political Risk and Uncertain Property Rights: Models such as POR are useful insofar as they provide an indication of the general level of political risk in a country. From an economic standpoint, political risk refers to uncertainty over property rights. If the government can expropriate either legal title to property or the stream of income it generates, then political risk exists. Political risk also exists if property owners may be constrained in the way they use their property. This definition of political risk encompasses government actions ranging from outright expropriation to a change in the tax law that alters the government's share of corporate income to laws that change the rights of private companies to compete against state-owned companies. Each action affects corporate cash flows and hence the value of the firm.

E. Capital Flight: A useful indicator of the degree of political risk is the seriousness of capital flight. Capital flight refers to the export of savings by a nation's citizens because of fears about the safety of their capital. By its nature, capital flight is difficult to measure accurately because it is not directly observed in most cases. Nevertheless, one can usually infer the capital outflows, using balance-of-payments figures—particularly the entry labelled ''errors and omissions.'' The World Bank methodology estimates capital flight as ''the sum of gross capital inflows and the current account deficit, less increases in foreign reserves.''5 These estimates indicate that capital flight represents an enormous outflow of funds from developing countries. Capital flight occurs for several reasons, most of which have to do with inappropriate economic policies: government is regulations, controls, and taxes that lower the return on domestic investments. In countries in which inflation is high and domestic inflation hedging is difficult or impossible, investors may hedge by shifting their savings to foreign currencies deemed less likely to depreciate. They may also make the shift when domestic interest

rates are artificially held down by their governments or when they expect a devaluation of an overvalued currency. Yet another reason for capital flight could be increases in a country's external debt, which may signal the likelihood of a fiscal crisis.

F. Culture: Often overlooked is the role of culture, for it is culture that shapes the behavior that determines economic outcomes. As with individuals, so with nations. Conversely, cultures that adopt the values and practices of a modern industrial society, including free markets, meritocracy, pragmatism, the rule of law, an orientation toward the future, an emphasis on education, and an interest in science and technology, are more likely to succeed.

41. Managing Political Risks

All companies operating internationally need effective ways to identify, measure and deal with political risk. They also need to integrate political risk management into their normal business processes, and not side-line it whenever this suits their short-term goals. Senior management should also strongly support the company's risk management program and should give it enough resources to do its job. There is no one-size-fits-all solution to political risk management—how a company makes it work will depends on factors such as its size, industry, foreign markets and financial strength.

Managing Political Risk (The Political Risk Management Process)

A. Identify Political Risk Exposure;
B. Measure Risk Exposure and its Potential Impacts;
C. Mitigate its Effects; and
D. Monitor Political Risk Exposure Over Time

A. Identifying Political Risk Exposure

To identify political risk exposure, a company must first collect all the relevant information, then assess and rank potential risks. Risk affects different companies in different ways so a business must evaluate the information in context.

1. Collecting Information: The risk manager gathers pertinent information about each type of political risk the company faces, or is likely to face, in the target country. The objective here is to find out how political conditions or factors may affect the company's goals in the market.
2. Identifying Specific Risks: Once all the information is collected, the risk manager then identifies the political risks that most threaten the company's goals in the country. Seizure of assets might be a low-ranked hazard for an exporter, but a serious one if a company is considering a major investment or bringing valuable equipment into an emerging market to perform contract work.

B. Measure Risk Exposure and its Potential Impacts

The risk manager uses the scenario results he or she develops to rank the risks and measure the company's exposure to each one. This involves attaching numbers to each risk wherever possible, thus reflecting the potential impacts of the firm's exposure. These might be expected financial losses, maximum probable losses, market share changes or loss of customers. The measurements will help determine whether the risk level of a market is above or below the company's tolerance, so that senior management can decide the conditions under which it should enter the market.

C. Mitigate its Effects

There are two parts to risk mitigation: first, reducing the probability of a risk event and, second, reducing its effects if it becomes a reality.

1. Reducing the probability of political risk the ideal way to deal with a serious political risk is to neutralize it entirely, but this is rarely possible. A second option, avoiding the risk, means leaving the market or never going there in the first place. For businesses that want to enter a market or remain in it, consequently, the only realistic option is to reduce the probability of political risks.
2. Reducing the impact of risk events If a potential risk becomes a real-world event, the company's risk management program must include ways to reduce its effects. The techniques used by exporters and investors can overlap.

D. Monitor Political Risk Exposure Over Time

Once the risk manager has established how the risk management process will work in practice, he or she can assign responsibilities and set up routines for reporting, evaluation and review. There should be formal channels for regularly reporting political risk issues, both upward to senior management and downward to the personnel who manage the company's export or affiliate operations. These routines and channels should become part of normal business operations, and the manager must make sure that they don't fall into disuse as time passes.

42. Post Expropriation Policies

In certain circumstances, governments have a legitimate need and the right to take private property for public purposes. In environmental emergencies, public authorities may need, in the interest of public health, to resettle people whose property is located in irreparably contaminated areas. To develop infrastructure, such as roads and power stations, governments may need to acquire land to place these assets.

The following policy practices and criteria ought to be considered during expropriation:

A. **Defining the Ability to Expropriate Private Property:** The laws that permit the confiscation of property and whether they expressly limit the conditions under which the government may expropriate private property for public purposes and whether legal standards exist for determining when an expropriation event has occurred.
B. **Implementation of Expropriation Laws and Practices:** The policy framework for investment user should examine the policy practices and constraints that may compromise the implementation of timely, adequate and effective compensation for expropriation
C. **Independent Channels to Review or Contest Expropriation Decisions:** The PFI user needs to examine the mechanisms available and processes for contesting expropriation decisions.

43. International Cash Management Techniques

A. Pooling

Pooling (also known as interest allocation) is a bank service that, on a daily basis, offsets debit and credit balances of a company's separate accounts to calculate a net balance. The bank pays interest on a positive overall position or charges interest on a negative net balance. Because the individual balances never physically move and there is no commingling of funds, this is also referred to as notional pooling. Pooling is a calculation performed entirely on the books of the bank. It can significantly cut the costs of borrowing for a company and improve returns on any cash surpluses. All balances have to be within the same bank network, which also contributes to rationalization of the banking structure. There is usually a requirement that the subsidiaries be reallocated debit or credit interest on an "arm's-length" basis, i.e., at or close to market rates. Pooling provides a good tool for cash managers to manage intercompany liquidity.

B. Netting

Netting is a process that allows entities to offset total receivables against total payables. The concept has already been discussed in the context of clearing and settlement systems. Each entity either receives or pays the net amount to the netting centre in their local currency. The process is as follows:

- Before Netting: Even if each subsidiary does only one trade with each of the others, there are 12 transactions occurring. Each subsidiary sells in its own currency, so there are four entities managing a foreign exchange exposure and paying foreign exchange commissions on the total amount of the gross payables. The full value of the funds in transit results in a loss of availability of two to four days.
- After Netting. Each subsidiary is involved in a single transaction in its own currency, either to receive from or pay to the netting center the net amount due. The transactions have been reduced to four, which represents a 67% offset ratio. Only one entity, netting center, is involved in purchasing foreign exchange.

C. Leading

Leading refers to accelerating the timing of a transaction. If a receivable is in a currency that is depreciating, leading brings the transaction date forward to minimize the devaluation. A cash manager might also lead a payable in a currency that is appreciating, to minimize the cost of the transaction.

D. Lagging

Lagging is the delaying of the timing of a payment. If a receivable is in a currency that is strengthening, lagging delays the transaction date to maximize the appreciation. A cash manager might also lag a payable in a currency that is weakening to minimize the cost.

Leading and lagging are also used as liquidity management tools; for example, when cash rich subsidiaries lead payments to subsidize the cash poor divisions or cash poor units are allowed to lag their payments. However, this technique needs to be applied in a very controlled fashion to avoid the complications created by inter-company lending and the resulting withholding tax issues.

----------X----------