FINANCE OF FOREIGN TRADE

M.Com (BANKING)

Semester – III, Paper-VI

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging a head in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining 'A' grade from the NAAC in the year 2016, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 443 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the door step of all the sectors of the society. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even to housewives desirous of pursuing higher studies. Acharya Nagarjuna University has started offering B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004onwards.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers involved respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn be part of country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Academic Coordinators, Editors and Lesson-writers of the Centre who have helped in these endeavors.

Prof. P. RajaSekhar
Vice-Chancellor
Acharya Nagarjuna University

FINANCE OF FOREIGN TRADE

M.Com (BANKING)

316CO21

SEMESTER-III, Paper - VI

Learning Outcomes:
After successful completion of this course, the students will be able to:

1. Acquire knowledge of Overview of Finance of Foreign Trade
2. Know the concepts relating to Balance of Trade, Balance of Payment
3. Understand the Exchange Rates, control and regulation
4. Analyses of the international settlements through banks

Syllabus:

Unit –I: Foreign Trade: Meaning, Commercial Terms used in the delivery goods and for payments.

Unit- II: Balance of Trade, Balance of Payment**:** Role of RBI in financing of foreign trade, Role of Banks in foreign trade.

Unit –III: Methods of international settlements through banks protection against risk in foreign trade –Role of **Export Credit Guarantee Corporation of India** Limited (ECGC)

Unit IV: Exchange Rates: Basic concepts- Types of exchange rates – Calculation of exchange rates – Exchange rate determination Theories, problems on exchange rate.

Unit-V: Exchange control and regulation: Foreign Exchange Regulation Act, 1973. Exchange arithmetic –Nostro and Vostro accounts Spot and forward deals for the purchage and sales of foreign currencies.

FURTHER READINGS:

1. Vadilal Dagh: India's Foreign Trade Jouav Such Foreign Trade and Economic development of under developed countries.
2. Lall G, S. : Financing of Foreign trade and
3. NCAER Export strategy for India
4. Jeevanandam: Foreign Exchange.
5. Jeevanandam: Foreign Exchange arithmetic

CONTENTS

LESSON - 1

FOREIGN TRADE

LEARNING OBJECTIVES :

- To know how it impacts various countries
- To know the importance of foreign trade
- To study types of foreign trade

STRUCTURE :

1.1 Introduction
1.2 The Basic Task Of Financing The Foreign Trade
1.3 Importance Of Foreign Trade
1.4 Reasons For Foreign Trade
1.5 Need For International Business For Firms
1.6 Foreign Trade Policy 2023 Announced: Posted On: 31 Mar 2023 5:13pm By Pib Delhi
1.7 Summary
1.8 Technical Terms
1.9 Self – Assessment Questions
1.10 Suggested Readings

1.1.INTRODUCTION :

a) History of International Trade: International trade has a rich history with the barter system being replaced by mercantilism in the 16th and 17th centuries. The 18th century saw a shift towards liberalism. The beginning of the 19th century marked the move towards professionalism, which diminished by the end of the century. The interest in foreign trade goes back to the emergence of the commercial school in the seventeenth century AD in Continental Europe. It was interested in studying trade as one of the most important sources of private wealth in nations, and the interest increased at this stage to boost the quantity of exports compared to the number of imports in order to contribute to increasing the flow of money to countries, Also coinciding with this stage was the interest in reducing imports, providing market protection, and reducing wage costs in order to support external competition.

A commercial school appeared in France in the eighteenth-century AD, indicating that the main source of wealth is associated with agricultural production, and this school was called the school of naturalists that focuses on agricultural efforts and differs from the commercial school in its ideas.In Britain, the Industrial Revolution contributed to considering production the main source of wealth. This is what the economist and thinker Adam Smith pointed out in the book “The Wealth of Nations”.As for the first intellectual and academic treatment of the idea of foreign trade, it is mainly due to the economist David Ricardo through his interest in developing ‘the theory of comparative advantage’, and it indicates that the costs involved in labor are the main source of internal exchange, which extends later to external exchange.

b) Definition of International trade/Foreign Trade: International trade is the purchase and sale of goods and services by companies in different countries. Consumer goods, raw materials, food, and machinery all are bought and sold in the international marketplace.

International trade allows countries to expand their markets and access goods and services that otherwise may not have been available domestically. As a result of international trade, the market is more competitive. This ultimately results in more competitive pricing and brings a cheaper product home to the consumer. Trading globally gives consumers and countries the opportunity to be exposed to goods and services not available in their own countries, or more expensive domestically. The importance of international trade was recognized early on by political economists such as Adam Smith and David Ricardo. Still, some argue that international trade can actually be bad for smaller nations, putting them at a greater disadvantage on the world stage.

c) Understanding International Trade: International trade was key to the rise of the global economy. In the global economy, supply and demand—and thus prices—both impact and are impacted by global events. Political change in Asia, for example, could result in an increase in the cost of labor. This could increase the manufacturing costs for an American sneaker company that is based in Malaysia, which would then result in an increase in the price charged for a pair of sneakers that an American consumer might purchase at their local mall.

d) Imports and Exports: A product that is sold to the global market is called an export, and a product that is bought from the global market is an import. Imports and exports are accounted for in the current account section of a country's balance of payments. Global trade allows wealthy countries to use their resources—for example, labor, technology, or capital—more efficiently. Different countries are endowed with different assets and natural resources: land, labor, capital, technology, etc. This allows some countries to produce the same good more efficiently; in other words, more quickly and at a lower cost. Therefore, they may sell it more cheaply than other countries. If a country cannot efficiently produce an item, it can obtain it by trading with another country that can. This is known as specialization in international trade.

e) Comparative Advantage: For example, England and Portugal have historically been used, as far back as in Adam Smith's The Wealth of Nations, to illustrate how two countries can mutually benefit by specializing and trading according to their own comparative advantages. In such examples, Portugal is said to have plentiful vineyards and can make wine at a low cost, while England is able to more cheaply manufacture cloth given its pastures are full of sheep. According to the theory of comparative advantage, each country would eventually recognize these facts and stop attempting to make the product that was more costly to generate domestically in favor of engaging in trade. Indeed, over time, England would likely stop producing wine, and Portugal stop manufacturing cloth. Both countries would realize that it was to their advantage to redirect their efforts at producing what they were relatively better at domestically and, instead, to trade with each other in order to acquire the other.

These two countries realized that they could produce more by focusing on those products for which they have a comparative advantage. In such a case, the Portuguese would begin to produce only wine, and the English only cotton. Each country can now create a specialized output of 20 units per year and trade equal proportions of both products. As such, each country now has access to both products at lower costs. We can see then that for both countries, the opportunity cost of producing both products is greater than the cost of specializing. Comparative advantage can contrast with absolute advantage. Absolute advantage leads to unambiguous gains from specialization and trade only in cases wherein each producer has an absolute advantage in producing some good. If a producer lacked any absolute advantage, then they would never export anything. But we do see that countries without any clear absolute advantage do gain from trade because they have a comparative advantage. According to international trade theory, even if a country has an absolute advantage over another, it can still benefit from specialization.

f) Origins of Comparative Advantage: The theory of comparative advantage has been attributed to the English political economist David Ricardo. Comparative advantage is discussed in Ricardo's book On the Principles of Political Economy and Taxation, published in 1817, although it has been suggested that Ricardo's mentor, James Mill, likely originated the analysis and slipped it into Ricardo's book on the sly. Comparative advantage, as we have shown above, famously showed how England and Portugal both benefit by specializing and trading according to their comparative advantages. In this case, Portugal was able to make wine at a low cost, while England was able to cheaply manufacture cloth. Ricardo predicted that each country would eventually recognize these facts and stop attempting to make the product that was more costly to generate. A more contemporary example of comparative advantage is China's comparative advantage over the United States in the form of cheap labor. Chinese workers produce simple consumer goods at a much lower opportunity cost.

The comparative advantage for the U.S. is in specialized, capital-intensive labor. American workers produce sophisticated goods or investment opportunities at lower opportunity costs. Specializing and trading along these lines benefit each country. The theory of comparative advantage helps to explain why protectionism has been traditionally unsuccessful. If a country removes itself from an international trade agreement, or if a government imposes tariffs, it may produce an immediate local benefit in the form of new jobs; however, this is rarely a long-term solution to a trade problem. Eventually, that country will grow to be at a disadvantage relative to its neighbors: countries that were already better able to produce these items at a lower opportunity cost. The U.S. international trade deficit in May 2022 was $85.5 billion, meaning imports exceed exports.

g) Criticisms of Comparative Advantage: Why doesn't the world have open trading between countries? When there is free trade, why do some countries remain poor at the expense of others? There are many reasons, but the most influential is something that economists call rent seeking. Rent seeking occurs when one group organizes and lobbies the government to protect its interests. Say, for example, the producers of American shoes understand and agree with the free-trade argument but also know that cheaper foreign shoes would negatively impact their narrow interests. Even if laborers would be most productive by switching from making shoes to making computers, nobody in the shoe industry wants to lose their job or see profits decrease in the short run. This desire could lead the shoemakers to lobby for special tax breaks for their products or extra duties (or even outright bans) on foreign footwear. Appeals to save American jobs and preserve a time-honored American craft abound—even though, in the long run, American laborers would be relatively less productive and American consumers relatively poorer as a result of such protectionist tactics.

h) Other Possible Benefits of Trading Globally: International trade not only results in increased efficiency but also allows countries to participate in a global economy, encouraging the opportunity for foreign direct investment (FDI). In theory, economies can thus grow more efficiently and become competitive economic participants more easily. For the receiving government, FDI is a means by which foreign currency and expertise can enter the country. It raises employment levels and, theoretically, leads to a growth in the gross domestic product (GDP). For the investor, FDI offers company expansion and growth, which means higher revenues.

i) Free Trade vs. Protectionism: As with all theories, there are opposing views. International trade has two contrasting views regarding the level of control placed on trade between countries.

- **Free Trade:** Free trade is the simpler of the two theories. This approach is also sometimes referred to as laissez-faire economics. With a laissez-faire approach, there are no restrictions on trade. The main idea is that supply and demand factors, operating on a global scale, will ensure that production happens efficiently. Therefore, nothing must be done to protect or promote trade and growth because market forces will do this automatically.
- **Protectionism:** Protectionism holds that regulation of international trade is important to ensure that markets function properly. Advocates of this theory believe that market inefficiencies may hamper the benefits of international trade, and they aim to guide the market accordingly. Protectionism exists in many different forms, but the most common are tariffs, subsidies, and quotas. These strategies attempt to correct any inefficiency in the international market. As international trade opens up the opportunity for specialization, and thus more efficient use of resources, it has the potential to maximize a country's capacity to produce and acquire goods. Opponents of global free trade have argued, however, that international trade still allows for inefficiencies that leave developing nations compromised. What is certain is that the global economy is in a state of continual change. Thus, as it develops, so too must its participants.

j) What Are the Benefits of International Trade for a Business?

The benefits of international trade for a business are a larger potential customer base, meaning more profits and revenues, possibly less competition in a foreign market that hasn't been accessed as yet, diversification, and possible benefits through foreign exchange rates.

k) What Creates the Need for International Trade?

International trade arises from the differences in certain areas of each nation. Typically, differences in technology, education, demand, government policies, labor laws, natural resources, wages, and financing opportunities spur international trade.

l) What Are Common Barriers to International Trade?

The barriers to international trade are policies that governments implement to prevent international trade and protect domestic markets. These include subsidies, tariffs, quotas, import and export licenses, and standardization. The foreign trade of a country refers to its import and export of merchandise from and to other countries under contract of sale. No country in world produces all the commodities it requires. The commodities which country produces in surplus, it exports, while those producing in deficit, its imports. In short, foreign trade refers to exchange of goods and services between two or more different countries. Such trade is also known as international trade. International trade is the exchange of capital, goods, and services across international borders or territories because there is a need or want of goods or services. (see: World economy) In most countries, such trade represents a significant share of gross domestic product (GDP).

m) Types of Foreign Trade: Foreign Trade can be divided into the following three groups:

- **Export Trade**: Export trade is based on the principle of selling one or more types of commodities to a merchant from one country to a trader in another country; outflow of goods from home country to a foreign country.
- **Import Trade**: Import trade is the opposite of export trade, as its principle is based on buying goods from a foreign country and bringing them to the home country.

- **Entrepot Trade**: Entrepot trade is based on the principle of importing some different commodities from a specific country and making some adjustments to them, then re-exporting them to another country.

1.2. THE BASIC TASK OF FINANCING THE FOREIGN TRADE :

The basic task of financing the foreign trade is similar to that of the home trade i.e., to receive payments from the buyers and to make payments to the sellers. This task is largely performed through the instrument of bills of exchange, which are called foreign bills of exchange. Banks play an important role in facilitating the process of receipt of payments in case of foreign trade. But the international character of foreign trade gives rise to a number of problems which render the task of financing complicated. These complexities are as follows:

i. Lack of uniformity in the currencies of the two countries;
ii. Lack of personal contacts between the buyers and the sellers;
iii. Variations in the trade practices and usages in the two countries; and
iv. Different legal and regulatory systems in the two countries.

Hence banks adopt their practices and techniques to suit the needs of financing the foreign trade. Letters of credit play an important role in financing the foreign trade. Reserve Bank of India provides refinance to the banks at concessional rate. Export Import Bank also provides refinance in respect of medium-term export credit and directly extends export credit. Guarantees issued by Export Credit Guarantee Corporation of India facilitate the task of financing the foreign trade. First, we shall study the procedure adopted by banks in this regard.

1.3. IMPORTANCE OF FOREIGN TRADE :

- Foreign trade is one of the important economic activities in the world. As all countries depend on it for their economic systems; which contributes to providing all consumer needs. Foreign trade is one of the important economic activities in the world, as all countries depend on it for their economic systems, which contributes to the provision of all consumer needs.The importance of foreign trade can be summarized according to the following points:
- Foreign trade is a measure of a country's capacity to produce and compete in global markets due to its dependence on available production rates and the countries' capabilities to obtain foreign currencies.
- Foreign trade is considered one of the vital areas in societies, whether they have a developing or developed economic environment, as foreign trade contributes to linking countries together, and helps to enhance the ability to market through the creation of new markets.
- Countries depend on foreign trade in order to increase the balance of hard currencies in their accounts due to the reliance of export and import operations on the use of various currencies.

1.4. REASONS FOR FOREIGN TRADE :

The countries of the world share among each other a set of diversified economic relations, which have been crystallized based on foreign trade, due to the imposition of their influence on the local and global commercial markets. Changes in prices related to international trade also contributed to reinforcing the idea of trade between countries to achieve financial profits. The reasons for the emergence of foreign trade can be summarized as follows:

i. **External economic relations:** The need for external economic relations is the need that has arisen as a result of the unequal distribution of resources that constitute the productive elements among the countries of the world. Examples include: climate conditions, such as the nature of the soil, temperatures, quality of rain, capital, human and mineral resources, the quality of technology, administrative efficiency, and other economic factors affecting the productive conditions of countries. These differences between countries lead to a difference in their capabilities to provide services and goods. The need here affects the desires of countries to obtain products by importing them depending on the exports of other countries' surplus production. Therefore, foreign trade helps every country to utilize its resources efficiently.

ii. **International economic cooperation among nations:** Enhancing international economic cooperation is the effect of international cooperation in promoting the existence of trade exchanges between countries, especially in exceptional economic circumstances. This leads to a decrease in the volume of economic dealings, which results in a lack of relations and ties between countries.As for in normal economic conditions and within the environment of normal transactions, international cooperation of all kinds and in all fields contributes to providing an important role.International economic cooperation is a powerful source for strengthening modern economic relations, developing existing ones, or restoring previous relations while being keen to contribute to their continuation.

iii. **International specialization:** International specialization is the specialization associated with several aspects, such as: geographical factors, such as climate changes, and the difference in the quality of natural resources between countries and their distribution.Therefore, states cannot fully rely on themselves to provide for the needs of their inhabitants as a result of the unjust distribution of wealth among them, which leads to the necessity for each state to specialize in the production of specific types of goods, compatible with their capabilities, nature and economic conditions. Countries generally export low-cost products domestically compared to their high cost abroad, and they also import high-cost products locally compared to their low cost abroad. This economic base is called the comparative advantage, whose emergence depends on the difference between costs.

iv. **The globalization of technological innovation:** Recently, technologies have improved the reliability and efficiency of international trade.The globalization of technological innovation allows countries to have easy access to foreign knowledge and technology and to foster international competition - as a result of the rise of emerging market firms and this strengthens firms' incentives to innovate and adopt foreign technologies.The variation in the levels of production technology used between countries is the difference and variation in the use of the economy's resources. Production conditions are described as being highly efficient in light of the development of technology levels, and vice versa in the event of a decrease or decline in these levels. Factors of production affect the manufacturing process, which leads to a decline in its efficiency, and failure to take advantage of economic resources in the best available way.

v. **Consumer taste heterogeneity:** Consumers are heterogeneous with their marginal willingness to pay for quality. Different people can do the same thing for different reasons. They may also work differently for similar reasons.The variation of tastes about commodity specifications is the impact of consumers on foreign trade, as they seek in every country in which they live to obtain products of high quality in order to achieve the best possible benefits from them, and the impact of this factor on foreign trade increases with the rise in the average private income of individuals.

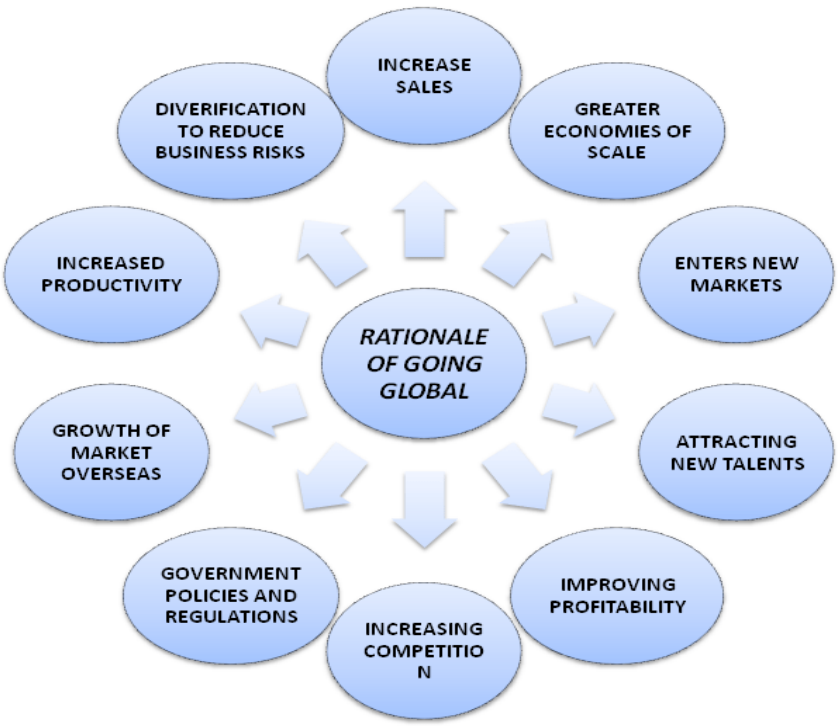
1.5. NEED FOR INTERNATIONAL BUSINESS FOR FIRMS :

The rationale of the companies going global is supported by various reasons. The business expanding globally can enjoy the benefits of generation of more revenue, competing for the new sales or increasing market share, new investment opportunities, diversifying the business, enjoying economies of scale and recruiting the new talent. The following points will clearly explain the reasons for doing international business :

i. **Increase Sales:** The expansion of business at a global scale will increase overall revenue sales and reduce operational costs, through attracting a larger customer base. In addition, through the help of technologies and the revolution of the internet, international commerce has become even more attractive, for smaller businesses. Through having the opportunity to outsource, they are able to reduce costs and improve their business management & operational efficiency.

ii. **Greater Economies of Scale:** Some companies may want to expand their business products, as they are more likely to be accepted around the world. In many industries, expansion through internationalisation may benefit companies through achieving better economies of scale. By producing the goods at a large-scale lead to the declining per unit cost. This will make the product produce at cheaper cost than before and can be made available for sale at reasonable price. Moreover, internationalisation may also serve as an opportunity to differentiate or exploit a new product extension, service, or brand.

iii. **Enters New Markets:** Most of the companies are trying to enhance their markets through entering into new areas after they reach saturation stage in their present markets. Searching of new markets means may enter into new places in the same country or may enter into abroad. In the situation where the firm enter into the new country it must be note the several aspects other than the business tactics like rules and regulation, customs of the new country public, traditions, taboos etc.



iv. **Attracting New Talents:** Going international enables companies to have access to a broader talent pool. Employees that speak multiple languages and are accustomed to different cultures are able to develop connections with a wider customer base. Moreover, it allows companies to create global work teams, that have expertise in local markets and that are able to exploit domestic market resources and raw materials, through connecting with local suppliers.

v. **Improving Profitability:** Improving profit margins is one of the most common reasons for doing international business. When growth strategies are used up on the national level, the next path is often to seek out international growth. Distributing the products in additional countries increases the customer base. This build loyalty across international markets, revenue strengthens and increases as well.

vi. **Increasing Competition:** Competition may become a driving force behind international business. Competitors are an important factor which stimulates international business. Tata Motors became international in response to other automobile companies becoming international. Many companies also take an offensive international competitive strategy by way of counter competition.

vii. **Government Policies & Regulations:** Government policies and regulations attract the manufacturers to internationalize. The governments of many countries including India give a number of incentives and other positive support to domestic firms to go international. **Example:** Indian government provides a number of concessions to the firms engaged in exports to and in manufacturing in foreign countries. After the economic reforms launched in 1991, Indian government has given a lot of incentives to attract foreign investment. Sometimes, as was the case in India, companies may be obliged to earn foreign exchange to finance their imports and to meet certain other foreign exchange requirements like payment of royalty, dividend etc.

Further, in India, companies were allowed to enter certain industries subject to specific export obligation. Some companies move to foreign countries because of environmental laws and other laws. Government policies which limit the scope of business in the domestic market may drive companies to move to other countries.

viii. **Growth of Market Overseas:** The enormous growth potential of many overseas markets drive many companies to expand the market globally. Economic growth of many developing countries has created market opportunities that provide a major incentive for companies to expand globally. In a number of developing countries, both the population and income are growing fast. Growth rate of India has been good and economic reforms have accelerated the growth. Further, economic growth has reduced resistance that might otherwise have developed in response to the entry of foreign firms into domestic economies. It is convenient for a foreign company to enter a domestic economy without taking business away from local firms. Even if the market for several goods in these countries is not very substantial at present, many companies are eager to establish a foothold there, considering their future potential.

ix. **Increased Productivity:** Increased productivity is necessary for the ultimate survival of a firm. This itself may lead a company to increase production. Increase in production facilitates a company to seek export markets. The pressure for global markets is intense when new products require major investments and long periods of development time. The cost of research and development must be recovered in the global market place, as no single national market is likely to be large enough to support investments of this size.

x. **Diversification to Reduce Business Risks:** A diversified export business may reduce sharp fluctuations in the overall activity of a firm. Decline of sales in one market may be counter balanced by a rise in the sales in other markets. Foreign markets even cut fluctuations by providing outlets for excess production capacity. The systematic and growing internationalization of many countries is essentially a part of their business policy or strategic management. The stimulus for internationalization comes from the urge to grow, the need to become more competitive. The need to diversify and to gain strategic advantages of industrialization. For example, many Indian pharmaceutical firms have realized that they have very good growth prospects in the foreign markets. There are a number of corporations which are truly global. Their policies have been framed considering the entire world a single market.

1.6. FOREIGN TRADE POLICY 2023 ANNOUNCED: POSTED ON: 31 MAR 2023 5:13PM BY PIB DELHI :

i. FTP 2023 is a dynamic and open ended Policy that will accommodate the emerging needs: Sh. Piyush Goyal
ii. PM Modi has given the vision to increase exports manifold: Sh Goyal
iii. FTP seeks to take India's exports to 2 trillion dollars by 2030: Sh Goyal
iv. 4 pillars of FTP 2023: Incentive to Remission, Export promotion through collaboration, Ease of doing business and Emerging Areas

Union Minister of Commerce and Industry, Consumer Affairs, Food and Public Distribution and Textiles, Shri Piyush Goyal today launched the Foreign Trade Policy 2023 saying that it is dynamic and has been kept open ended to accommodate the emerging needs of the time. He stated that the policy had been under discussion for a long time and has been formulated after multiple stakeholder consultations. India's overall exports, including services and merchandise exports, has already crossed US$ 750 Billion and is expected to cross US$ 760 Billion this year, he said. The Minister referred to the interaction that Prime Minister, Shri Narendra Modi with the exporters on 06th August, 2021 and encouraged them to increase exports and get more deeply involved in the global value chain. He lauded the vision and guidance of the Prime Minister who believed that given the size of the Indian economy and manufacturing & service sector base, the potential for the country to grow is manifold. He said that this vision is at the core of the policy. The Minister noted that the remarkable achievement in the overall export figure of crossing US$ 760 Billion in these challenging times across the world has been the result of enthusiasm and encouragement pumped in by the Prime Minister. He said that this achievement is in sync with the target set in the roadmap in 2021 after the interaction with the Prime Minister. He stressed that every opportunity for export must be captured and utilised effectively. He also mentioned that in the next 5 months during India’s G20 presidency there should be a massive concentrated outreach with the world both sector-wise and country-wise. The release of the policy was also attended by Union Minister of State for Commerce & Industry, Smt. Anupriya Patel, Commerce Secretary, Shri Sunil Barthwal and Member Customs, Central Board of Indirect Taxes and Customs, Shri Rajiv Talwar. Director General of Foreign Trade, Shri Santosh Kumar Sarangi gave a detailed presentation on the policy.

The Key Approach to the policy is based on these 4 pillars:

(i) Incentive to Remission,
(ii) Export promotion through collaboration - Exporters, States, Districts, Indian Missions,
(iii) Ease of doing business, reduction in transaction cost and e-initiatives and
(iv) Emerging Areas – E-Commerce Developing Districts as Export Hubs and streamlining SCOMET policy.

Foreign Trade Policy (2023) is a policy document : which is based on continuity of time-tested schemes facilitating exports as well as a document which is nimble and responsive to the requirements of trade. It is based on principles of ‘trust’ and ‘partnership’ with exporters. In the FTP 2015-20, changes were done subsequent to the initial release even without announcement of a new FTP responding dynamically to the emerging situations. Hereafter, the revisions of the FTP shall be done as and when required. Incorporating feedback from Trade and Industry would also be continuous to streamline processes and update FTP, from time to time. The FTP 2023 aims at process re-engineering and automation to facilitate ease of doing business for exporters. It also focuses on emerging areas like dual use high end technology items under SCOMET, facilitating e-commerce export, collaborating with States and Districts for export promotion. The new FTP is introducing a one-time Amnesty Scheme for exporters to close the old pending authorizations and start afresh. The FTP 2023 encourages recognition of new towns through “Towns of Export Excellence Scheme” and exporters through “Status Holder Scheme”. The FTP 2023 is facilitating exports by streamlining the popular Advance Authorization and EPCG schemes, and enabling merchanting trade from India.

Process Re-Engineering and Automation: Greater faith is being reposed on exporters through automated IT systems with risk management system for various approvals in the new FTP. The policy emphasizes export promotion and development, moving away from an incentive regime to a regime which is facilitating, based on technology interface and principles of collaboration. Considering the effectiveness of some of the ongoing schemes like Advance Authorisation, EPCG etc. under FTP 2015-20, they will be continued along with substantial process re-engineering and technology enablement for facilitating the exporters. FTP 2023 codifies implementation mechanisms in a paperless, online environment, building on earlier 'ease of doing business' initiatives. Reduction in fee structures and IT-based schemes will make it easier for MSMEs and others to access export benefits.

Duty exemption schemes for export production will now be implemented through Regional Offices in a rule-based IT system environment, eliminating the need for manual interface. During the FY23-24, all processes under the Advance and EPCG Schemes, including issue, re-validation, and EO extension, will be covered in a phased manner. Cases identified under risk management framework will be scrutinized manually, while majority of the applicants are expected to be covered under the 'automatic' route initially.

Towns of Export Excellence: Four new towns, namely Faridabad, Mirzapur, Moradabad, and Varanasi, have been designated as Towns of Export Excellence (TEE) in addition to the existing 39 towns. The TEEs will have priority access to export promotion funds under the MAI scheme and will be able to avail Common Service Provider (CSP) benefits for export fulfillment under the EPCG Scheme. This addition is expected to boost the exports of handlooms, handicrafts, and carpets.

Recognition of Exporters: Exporter firms recognized with 'status' based on export performance will now be partners in capacity-building initiatives on a best-endeavor basis. Similar to the 'each one teach one' initiative, 2-star and above status holders would be encouraged to provide trade-related training based on a model curriculum to interested individuals. This will help India build a skilled manpower pool capable of servicing a $5 Trillion economy before 2030. Status recognition norms have been re-calibrated to enable more exporting firms to achieve 4 and 5-star ratings, leading to better branding opportunities in export markets.

Promoting export from the districts : The FTP aims at building partnerships with State governments and taking forward the Districts as Export Hubs (DEH) initiative to promote exports at the district level and accelerate the development of grassroots trade ecosystem. Efforts to identify export worthy products & services and resolve concerns at the district level will be made through an institutional mechanism – State Export Promotion Committee and District Export Promotion Committee at the State and District level, respectively.District specific export action plans to be prepared for each district outlining the district specific strategy to promote export of identified products and services.

Streamlining SCOMET Policy: India is placing more emphasis on the "export control" regime as its integration with export control regime countries strengthens. There is a wider outreach and understanding of SCOMET (Special Chemicals, Organisms, Materials, Equipment and Technologies) among stakeholders, and the policy regime is being made more robust to implement international treaties and agreements entered into by India.A robust export control system in India would provide access of dual-use High end goods and technologies to Indian exporters while facilitating exports of controlled items/technologies under SCOMET from India.

Facilitating E-Commerce Exports: E-commerce exports are a promising category that requires distinct policy interventions from traditional offline trade. Various estimates suggest e-commerce export potential in the range of $200 to $300 billion by 2030. FTP 2023 outlines the intent and roadmap for establishing e-commerce hubs and related elements such as payment reconciliation, book-keeping, returns policy, and export entitlements. As a starting point, the consignment wise cap on E-Commerce exports through courier has been raised from ₹5Lakh to ₹10 Lakh in the FTP 2023. Depending on the feedback of exporters, this cap will be further revised or eventually removed. Integration of Courier and Postal exports with ICEGATE will enable exporters to claim benefits under FTP. The comprehensive e-commerce policy addressing the export/import ecosystem would be elaborated soon, based on the recommendations of the working committee on e-commerce exports and inter-ministerial deliberations. Extensive outreach and training activities will be taken up to build capacity of artisans, weavers, garment manufacturers, gems and jewellery designers to onboard them on E-Commerce platforms and facilitate higher exports.

Facilitation under Export Promotion of Capital Goods (EPCG) Scheme: The EPCG Scheme, which allows import of capital goods at zero Customs duty for export production, is being further rationalized. Some key changes being added are: Prime Minister Mega Integrated Textile Region and Apparel Parks (PM MITRA) scheme has been added as an additional scheme eligible to claim benefits under CSP(Common Service Provider) Scheme of Export Promotion capital Goods Scheme(EPCG). Dairy sector to be exempted from maintaining Average Export Obligation – to support dairy sector to upgrade the technology. Battery Electric Vehicles (BEV) of all types, Vertical Farming equipment, Wastewater Treatment and Recycling, Rainwater harvesting system and Rainwater Filters, and Green Hydrogen are added to Green Technology products – will now be eligible for reduced Export Obligation requirement under EPCG Scheme

Facilitation under Advance authorization Scheme

Advance authorisation Scheme accessed by DTA units provides duty-free import of raw materials for manufacturing export items and is placed at a similar footing to EOU and SEZ Scheme. However, the DTA unit has the flexibility to work both for domestic as well as export production. Based on interactions with industry and Export Promotion councils, certain facilitation provisions have been added in the present FTP such as

Special Advance Authorisation Scheme extended to export of Apparel and Clothing sector under para 4.07 of HBP on self-declaration basis to facilitate prompt execution of export orders – Norms would be fixed within fixed timeframe.

Benefits of Self-Ratification Scheme for fixation of Input-Output Norms extended to 2 star and above status holders in addition to Authorised Economic Operators at present.

Merchanting trade

To develop India into a merchanting trade hub, the FTP 2023 has introduced provisions for merchanting trade. Merchanting trade of restricted and prohibited items under export policy would now be possible. Merchanting trade involves shipment of goods from one foreign country to another foreign country without touching Indian ports, involving an Indian intermediary. This will be subject to compliance with RBI guidelines, andwon't be applicable for goods/items classified in the CITES and SCOMET list. In course of time, this will allow Indian entrepreneurs to convert certain places like GIFT city etc. into major merchanting hubs as seen in places like Dubai, Singapore and Hong Kong.

Amnesty Scheme: Finally, the government is strongly committed to reducing litigation and fostering trust-based relationships to help alleviate the issues faced by exporters. In line with "Vivaad se Vishwaas" initiative, which sought to settle tax disputes amicably, the governmentis introducing a special one-time Amnesty Scheme under the FTP 2023to address default on Export Obligations. This scheme is intended to provide relief to exporters who have been unable to meet their obligations under EPCG and Advance Authorizations, and who are burdened by high duty and interest costs associated with pending cases.All pending cases of the default in meeting Export Obligation (EO) of authorizations mentioned can be regularized on payment of all customs duties that were exempted in proportion to unfulfilled Export Obligation.The interest payable is capped at 100% of these exempted duties under this scheme. However, no interest is payable on the portion of Additional Customs Duty and Special Additional Customs Duty and this is likely to provide relief to exporters as interest burden will come down substantially.It is hoped that this amnesty will give these exporters a fresh start and an opportunity to come into compliance.

1.7. SUMMARY :

Countries all over the world are undergoing a fundamental shift in the way they produce and market various products and services. The national economies which so far were pursuing the goal of self-reliance are now becoming increasingly dependent upon others for procuring as well as supplying various kinds of goods and services. Due to increased cross border trade and investments, countries are no more isolated. The prime reason behind this radical change is the development of communication, technology, infrastructure etc. Emergence of newer modes of communication and development of faster and more efficient means of transportation have brought nations closer to one another. Countries that were cut-off from one another due to geographical distances and socio-economic differences have now started increasingly interacting with others. This area of study is concentrated on the not only environmental changes, but also economic and behavioral changes of the universal customers.

1.8 . TECHNICAL TERMS :

Exporting : In economics, exporting is the practice of producing a good or service in one country and selling it to consumers in another country.

Importing : An import is a good or service bought in one country that was produced in another. Imports and exports are the components of international trade. If the value of a country's imports exceeds the value of its exports, the country has a negative balance of trade, also known as a

Trade deficit : Trade deficit refers to a situation where the country's import dues exceed the receipts from the exports. Trade deficit arises in the course of international trade when the payments for imports exceed the receipts from export trade..

Continental Europe : Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, and Switzerland.

International economic cooperation : Co- operation in macroeconomic and exchange rate policies generally means redirecting and increasing the economic role of governments. In con- trast, cooperation in international trade involves reducing the interference of governments in private markets.

1.9. SELF – ASSESSMENT QUESTIONS :

1. What are the prime reasons for international business?
2. Why the firms enter into international business?
3. Write different modes of international business.

1.10. SUGGESTED READINGS :

1. Lall G.S. Financing of foreign trade and exchange
2. Jeevanadam Foreign Exchange
3. M.L Jinkhan International Business

Dr. K. SIVAJI

LESSON - 2
THEORIES OF FOREIGN TRADE

LEARNING OBJECTIVES :

- To Understand International trade.
- To Compare and contrast different trade theories.
- To determine international trade theory is most relevant today and it continues to evolve.

STRUCTURE :

2.1 Introduction
2.2 Classification of international trade activities
2.3 Theories of foreign trade or international trade
2.4 Mercantilism Theory
2.5 Absolute cost advantage Theory
2.6 Comparative cost Advantage theory
2.7 Heckscher - Ohlin theory (Factor Proportions theory)
2.8 Modern Firm-Based Theories
2.9 Country Similarity theory
2.10 Product life cycle
2.11 Global Strategic Rivalry theory
2.12 Porter's National Competitive Advantage
2.13 Summary
2.14 Key words
2.15 Self – assessment questions
2.16 Further readings

2.1 INTRODUCTION :

International trade acts as a major contributing factor in global economic activity and a catalyst of economic growth in developing as well as developed countries. Differences in various conditions, like resource availability, natural climatic conditions, cost of production, etc., act as the motive behind trade between the countries. International trade has made it all possible and has provided a large number of employment opportunities as well as several goods and services for the consumer. Not just this, it has been a major reason for the rising living standards of people all over the globe. International trade has been a part of human civilization for a very long time; however, the past few decades have seen rapid development in cross-border trading. Imports and exports have largely contributed to the growth of GDP, and the credit for the same goes to imports and exports.

International trade, economic transactions that are made between countries. Among the items commonly traded are consumer goods, such as television sets and clothing; capital goods, such as machinery; and raw materials and food. Other transactions involve services, such as travel services and payments for foreign patents (*see* service industry). International trade transactions are facilitated by international financial payments, in which the private banking system and the central banks of the trading nations play important roles. International trade and the accompanying financial transactions are generally conducted for the purpose of providing a nation with commodities it lacks in exchange for those that it produces in abundance; such transactions, functioning with other economic policies, tend to improve a nation’s standard of living. Much of the modern history of international relations concerns efforts to promote freer trade between nations. This article provides a historical overview of the structure of international trade and of the leading institutions that were developed to promote such trade.

Historical overview : The barter of goods or services among different peoples is an age-old practice, probably as old as human history. International trade, however, refers specifically to an exchange between members of different nations, and accounts and explanations of such trade begin (despite fragmentary earlier discussion) only with the rise of the modern nation-state at the close of the European Middle Ages. As political thinkers and philosophers began to examine the nature and function of the nation, trade with other countries became a particular topic of their inquiry. It is, accordingly, no surprise to find one of the earliest attempts to describe the function of international trade within that highly nationalistic body of thought now known as mercantilism.

Mercantilism : Mercantilist analysis, which reached the peak of its influence upon European thought in the 16th and 17th centuries, focused directly upon the welfare of the nation. It insisted that the acquisition of wealth, particularly wealth in the form of gold, was of paramount importance for national policy. Mercantilists took the virtues of gold almost as an article of faith; consequently, they never sought to explain adequately why the pursuit of gold deserved such a high priority in their economic plans. A typical illustration of the mercantilist spirit is the English Navigation Act of 1651, which reserved for the home country the right to trade with its colonies and prohibited the import of goods of non-European origin unless transported in ships flying the English flag. This law lingered until 1849. A similar policy was followed in France.

Liberalism- Adam Smith : A strong reaction against mercantilist attitudes began to take shape toward the middle of the 18th century. In France, the economists known as Physiocrats demanded liberty of production and trade. In England, economist Adam Smith demonstrated in his book The Wealth of Nations (1776) the advantages of removing trade restrictions. Economists and businessmen voiced their opposition to excessively high and often prohibitive customs duties and urged the negotiation of trade agreements with foreign powers. This change in attitudes led to the signing of a number of agreements embodying the new liberal ideas about trade, among them the Anglo-French Treaty of 1786, which ended what had been an economic war between the two countries. After Adam Smith, the basic tenets of mercantilism were no longer considered defensible. This did not, however, mean that nations abandoned all mercantilist policies. Restrictive economic policies were now justified by the claim that, up to a certain point, the government should keep foreign merchandise off the domestic market in order to shelter national production from outside competition. To this end, customs levies were introduced in increasing number, replacing outright bans on imports, which became less and less frequent. In the middle of the 19th century, a protective customs policy effectively sheltered many national economies from outside competition. The French tariff of 1860, for example, charged extremely high rates on British products: 60 percent on pig iron; 40 to 50 percent on machinery; and 600 to 800 percent on woolen blankets. Transport costs between the two countries provided further protection. A triumph for liberal ideas was the Anglo-French trade agreement of 1860, which provided that French protective duties were to be reduced to a maximum of 25 percent within five years, with free entry of all French products except wines into Britain. This agreement was followed by other European trade pacts.

Resurgence of protectionism: A reaction in favour of protection spread throughout the Western world in the latter part of the 19th century. Germany adopted a systematically protectionist policy and was soon followed by most other nations. Shortly after 1860, during the Civil War, the United States raised its duties sharply; the McKinley Tariff Act of 1890 was ultra protectionist. The United Kingdom was the only country to remain faithful to the principles of free trade. But the protectionism of the last quarter of the 19th century was mild by comparison with the mercantilist policies that had been common in the 17th century and were to be revived between the two world wars. Extensive economic liberty prevailed by 1913. Quantitative restrictions were unheard of, and customs duties were low and stable. Currencies were freely convertible into gold, which in effect was a common international money. Balance-of-payments problems were few. People who wished to settle and work in a country could go where they wished with few restrictions; they could open businesses, enter trade, or export capital freely. Equal opportunity to compete was the general rule, the sole exception being the existence of limited customs preferences between certain countries, most usually between a home country and its colonies. Trade was freer throughout the Western world in 1913 than it was in Europe in 1970.

2.2 CLASSIFICATION OF INTERNATIONAL TRADE ACTIVITIES :

The activity of international trade has been broadly classified under 3 subheads, namely: i. international trade operations, ii. strategic alliances, and iii. direct foreign investments. They are discussed as follows:

i. **International trade operations:** This category specifically includes the operations constituting international business via import and export, import-export combined operations, and transit. Although the parties, in several instances, might have dissimilar interests, to gain a mutual advantage, they harmonies their differences and arrive at a mutual consensus by prioritizing benefits. These international trade operations are legally considered under the category of bilateral contracts, which consist of international sales contracts as the legal instrument. In most cases, these transactions are short-term, however, the relationships between the parties can be long-term or short-term depending on their choice.

ii. **Strategic alliances:** This category mainly includes activities like franchising, sub-contracting, joint ventures (private or government), etc. It connotes the operation involving cooperation among the various partners from different countries, pertaining to the transfer of technologies globally.

iii. **Foreign direct investment:** The strategy closely resembles the categories of involvement, risk, and profit, each one of them at its maximum potential. It is an alternative to stepping foot into the global market. It comes under the category of cross-border investment, wherein, the interested residents of one economy invest or influence significantly in enterprises based in another country.

2.3 THEORIES OF FOREIGN TRADE OR INTERNATIONAL TRADE :

International trade becomes possible for mutual benefit to the two countries due to the differences in opportunity costs. International trade between two countries can benefit both countries if each country exports the goods in which it has a comparative advantage. However, initially countries used to earn gold through international trade. Theories of international trade tend to explain the nature and movement of international trade. Such theories can be classified into:

Classical Country-Based Theories	Modern Firm-Based Theories
Mercantilism	Country Similarity
Absolute Advantage	Product Life Cycle
Comparative Advantage	Global strategic Rivalry
Heckscher-Ohlin	Porter's National Competitive Advantage

2.4 MERCANTILISM THEORY :

The Mercantilism theory is the first classical country-based theory, which was propounded around the 17-18th century. The Theory is focused on the motto that, on a priority basis, a country must look after its own welfare and therefore, expand exports and discourage imports. The theory also propounded the view that the first thing a nation must focus on is the accumulation of wealth in the form of gold and silver, thus, strengthening the treasure of the nation.

In the 17^{th}-18^{th} Century, the wealth of the nation only consisted of gold or other kinds of precious metals so the theorists suggested that the countries should start accumulating gold and other kinds of metals more and more. The European Nations started doing so. Mercantilists, during this period, stated that all these precious stones denoted the wealth of a nation, they believed that a country will strengthen only if the nation imports less and exported more. They said that this is a favorable balance of trade and that this will help a nation to progress more.

History is evident that by implementing this theory, many nations benefited by strictly following the theory of Mercantilism. Various studies done by economists prove why this theory flourished in the early period. In the early period, i.e., around 1500, new nations and states were emerging and the rulers wanted to strengthen their country in all possible ways, be it the army, wealth, or other developments. The rulers witnessed that by increasing trade they were able to accumulate more wealth and, thus, certain countries became very strong because of the massive amount of wealth they stored. The rulers were focused on increasing the number of exports as much as possible and discouraging imports. The British Imperialist is the perfect example of this theory. They utilized the raw materials of other countries by ruling over them and then exporting those goods and other resources at a higher price, accumulating a large amount of wealth for their own country.

This theory is often called the protectionist theory because it mainly works on the strategy of protecting oneself. Even in the 21st century, we find certain countries that still believe in this method and allow limited imports while expanding their exports. Japan, Taiwan, China, etc. are the best examples of such countries. Almost every country at some point in time follows this approach of protectionist policies, and this is definitely important. But supporting such protectionist policies comes at a cost, like high taxes and other such disadvantages. Import restrictions lead to higher prices of goods and services. Free-trade benefits everyone, whereas, mercantilism's protectionist policies only profit select industries.

2.5 ABSOLUTE COST ADVANTAGE THEORY– AN UNDERSTANDING :

If a company has a lower absolute advantage, it can produce products and services at a lower absolute cost per unit, which uses a small number of inputs, or possibly a more efficient process than another company that produces the same good or service. The unit cost is a crucial measure to determine operational analysis of a company. Analyzing unit cost is an effective way to determine if the company is producing content efficiently. The absolute advantage matters because it determines if a producer can provide goods or services in greater quantity for the same or lower cost than competing producers. Additionally, absolute advantage is an effective basis for gains from trade between companies who produce different goods with different absolute advantages.

Theory of Adom Smith : Adam Smith first developed the idea of absolute advantage in his book, "The Wealth of the Nations." He used this idea to demonstrate how countries that specialize in producing and exporting certain goods gain from trade with other countries. In "Wealth of the Nations," Smith uses labor as the only input. Absolute advantage is determined by comparison of labor productiveness, so it is possible for a party to have no absolute advantage. Adam Smith's theory of absolute cost advantage in international trade was evolved as a strong reaction of the restrictive and protectionist mercantilist views on international trade. The free trade, according to Smith, promotes international division of labour.

As per Adam's every country tends to specialize in the production of that commodity which it can produce most cheaply. Undoubtedly, the slogans of self-reliance and protectionism have been raised from time to time. The free and unfettered international trade can make the countries specialise in the production and exchange of such commodities in case of which they command some absolute advantage, when compared with the other countries.

Adam Smith writes; "Whether the advantage which one country has over another, be natural or acquired is in this respect of no consequence. As long as one country has those advantages, and the other wants them, it will always be more advantageous for the latter, rather to buy of the former than to make." When countries specialize on the basis of absolute advantage in costs, they stand to gain through international trade, just as a tailor does not make his own shoes and shoemaker does not stitch his own suit and both gain by exchanging shoes and suits.

An example: Suppose there are two countries A and B and they produce two commodities X and Y. The cost of producing these commodities is measured in terms of labour involved in their production. If each country has at its disposal 2 man-days and 1 man-day is devoted to the production of each of the two commodities, the respective production in two countries can be shown through the hypothetical Table 2.1.

TABLE 2.1. Absolute Cost Differences in Two Countries

Country	Units of Labour (Man-days)	Commodities X	Commodities Y	Ratio of Exchange
A	1	20	10	1 Unit of X = 0·5 Unit of Y
B	1	10	20	1 Unit of X = 2 Units of Y

In country A, 1 man-day of labour can produce 20 units of X but 10 units of Y. In country B, on the other hand. 1 man-day of labour can produce 10 units of X but 20 units of Y. It signifies that country A has an absolute advantage in producing X while country B enjoys absolute advantage in producing commodity Y. Country A may be willing to give up 1 unit of X for having 0.5 unit of Y. At the same time, the country B may be willing to give up 2 units of Y to have I unit of X. If country A specialises in the production and export of commodity X and country B specialises in the production and export of commodity Y. both the countries stand to gain.

The absolute cost advantage of country A in the production of X and that of B in the production of Y can also be expressed as below:

$$\frac{\text{20 units of X in A}}{\text{10 units of X in B}} > 1 > \frac{\text{10 units of Y in A}}{\text{20 units of Y in B}}$$

It is possible to explain the cost difference in two countries A and B concerning the commodities X and Y geometrically through Fig. 2.1.

Production Possible Curvy

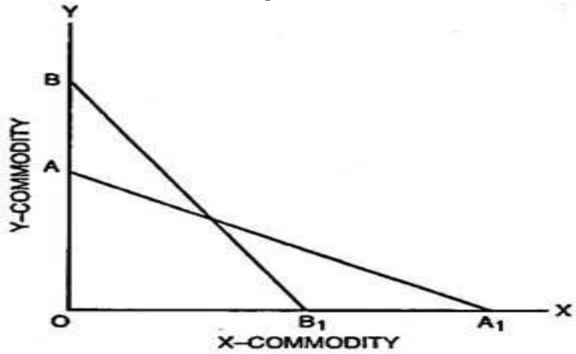


Fig. 2.1

In Fig. 2.1, AA_1 is the production possibility curve of country A. Given the techniques and factor endowments, if all the resources are employed in the production of X commodity, it can produce OA_1 quantity of X. On the contrary, if all resources are used in the production of Y, country A can produce OA quantity of Y. BB_1 is the production possibility curve of country B.

In case of this country, if all resources are employed in the production of X commodity, OB_1 quantity can be produced. Alternatively, if all the resources are used in the production of Y, it is possible to produce OB quantity of Y. The slope of production possibility curve is measured by the ratio of labour productivity in X to labour productivity in Y in each country.

Slope of $AA_1 = L_{XA}/L_{YA}$

Slope of $BB_1 = L_{XB}/L_{YB}$

Since slope of AA_1 is less than the slope of BB_1, it signifies that country A has absolute cost advantage in the production of X commodity, while country B has the absolute cost advantage in the production of Y commodity. The gains from trade for the two trading countries can be shown through Table 2.2.

TABLE 2.2. Gain From Trade

Country	Before Trade		After Trade		Gain from Trade	
	X	Y	X	Y	X	Y
A	20	10	40	–	+20	–10
B	10	20	–	40	–10	+20
World Production	30	30	40	40	+10	+10

Before trade, Country A produces 20 units of X and 10 units of Y. After trade, as it specializes in the production of X commodity, the total output of 40 units of X is turned out by A and it produces no unit of Y. Country B produces 10 units of X and 20 units of Y before trade. After trade it specializes in Y and produces 40 units of Y and no unit of X. The gain is production of X and Y commodity each is of 10 units. The gain from trade for country A is +20 units of X and -10 units of Y so that net gain to it from trade is +10 units of X. Similarly net gain to country B is +10 units of Y.

According to Adam Smith, the surplus of production in a country over what can be absorbed in the domestic market can be disposed of in the foreign markets. It was basically this desire that led Mercantilists and subsequent theorists to place much emphasis on the international trade. This doctrine implies that the foreign trade results in the fullest utilization of the idle productive capacity that is likely to exist in the absence of trade. This implication makes a clear departure from the assumption held in the comparative cost approach that the resources are fully employed even before trade. What trade does is to bring about a more efficient allocation of them.

Criticisms : This theory has certain weaknesses.
This theory assumes that each exporting country has an absolute cast advantage in the production of a specific commodity. This assumption may not hold true, when a country has no specific line of production in which it has an absolute superiority. Most of the backward countries with inefficient labour and machinery may not be enjoying absolute advantage in any line of activity. So, the principle of absolute cost advantage cannot provide complete and satisfactory explanation of the basis on which trade proceeds among the different countries.

i. Adam Smith simply indicated the fundamental basis on which international trade rests. The absolute cost advantage had failed to explore in any comprehensive manner the factors influencing trade between two or more countries.
ii. This doctrine can have serious adverse repercussions on the growth process of the backward countries. These countries do not sell their surplus produce in foreign markets but are constrained to export despite domestic shortages for the reasons of neutralizing their balance of payments deficit.

2.6 COMPARATIVE COST ADVANTAGE THEORY :

The principle of comparative costs is based on the differences in production costs of similar commodities in different countries. Production costs differ in countries because of geographical division of labor and specialization in production. Each country specializes in the production of that commodity in which its comparative cost of production is the least.

Therefore, when a country enters into trade with some other country, it will export those commodities in which its comparative production costs are less, and will import those commodities in which its comparative production costs are high. This is basis of international trade, according to Ricardo.

Assumptions of The Theory : The Ricardian doctrine of comparative advantage is based on the following assumptions:

1. There are only two countries, say A and B and Labor is the only factor of production.
2. They produce the same two commodities, X and Y and Tastes of customers are similar in both countries.
3. Prices determined by cost of labor only and Commodities are produced under the law of constant returns.
4. Trade between the two countries takes place on the basis of the barter system with free trade between the two countries.
5. No transport costs are involved in carrying trade between the two countries.

This two-country, two-commodity model can be analyzed through below Table

TABLE 2.3. Labour Cost of Production

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 labor than in country B. In relative terms, however, country A has comparative advantage in specializing in the production and export of commodity X while country B will specialize 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.

The absolute differences in costs can be measured as:
$a_1/a_2 < 1 < a_3/a_4$

It shows that country A has absolute advantage in producing X and country B has an absolute advantage in commodity Y.

The comparative differences in costs can be measured as:

$a_1/a_2 < a_3/a_4 < 1$
The above table satisfies the condition specified for comparative difference in costs;
$a_1/a_2 < 1 < a_3/a_4 < 1$
$12/16 < 10/12 < 1$
In case $a_1/a_2 = a_3/a_4$, there are equal differences in costs and there is no possibility of trade between the two countries.

In the below diagram AA_1 and BB_1 are the production possibility curves pertaining to countries A and B. Given the same amount of productive resources, A can produce larger quantities of both the commodities than the country B. It means country A has absolute cost advantage over B in respect of both the commodities. If the curve BC_1 is drawn parallel to AA_1; the curve BC_1 can represent the production possibility curve of country A. If country A gives up OB quantity of Y and diverts resources to the production of X, it can produce OC_1 quantity of X, which is more than OB_1. It means the country A has comparative cost advantage in the production of X-commodity. From the point of view of B, it can produce the same quantity OB of Y, if it gives up the production of smaller quantity OB_1 of X. If signifies that country B has less comparative disadvantage in the production of Y commodity. Accordingly, country A will specialize in the production and export of X commodity, while country B will specialize in the production and export of Y-commodity.

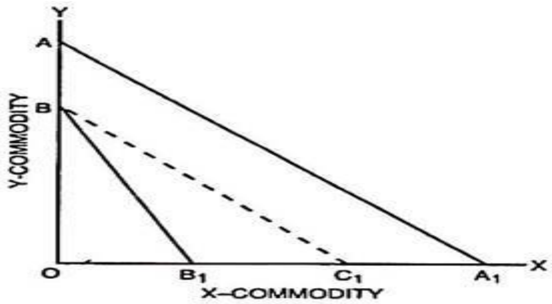


Fig. 2.2

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 2.3, country A specializes in the production of X commodity, while country B specializes 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.

2.7 HECKSCHER-OHLIN THEORY (FACTOR PROPORTIONS THEORY) :

The theories founded by Smith and Ricardo were not efficient enough for the countries, as they could not help the countries determine which of the products would benefit the country. The theory of Absolute Advantage and Comparative Advantage supported the idea of how a free and open market would help countries determine which products could be efficiently produced by the country. However, the theory proposed by Heckscher and Ohlin dealt with the concept of comparative advantage that a country can gain by producing products that make use of the factors that are present in abundance in the country. The main basis of their theory is on a country's production factors like land, labor, capital, etc. They proposed that the approximate cost of any factor of resource is directly related to its demand and supply. Factors which are present in abundance as compared to demand will be available at a cheaper cost, and factors which are in great demand and less availability will be expensive. They proposed that countries produce goods and export the ones for which the resources required in their production are available in a much greater quantity. Contrary to this, countries will import goods whose raw materials are in shorter supply in their own country as compared to the one from which they are importing.

For example, India has a large number of laborer's, so foreign countries establish industries that are labor-intensive in India. Examples of such industries are the garment and textile industries. The core premises of the Heckscher-Ohlin model are;

i. The model explains how resources are imbalanced throughout the world.
ii. Naturally, resources are not evenly distributed across the world, some parts of the world have certain resources in abundance while some have other resources in abundance.
iii. Since each country has its own unique natural resources and specialized area of production, mathematically, a country will export resources it has in abundance.
iv. The Heckscher-Ohlin model is not limited to natural resources or commodities, it also accounts for factors of production such as labor, land and capital and how they affect exportation.
v. The Heckscher-Ohlin model helps to find a trade balance between the two countries involved in international trade.

Real World Example of The Heckscher-Ohlin Model : The Heckscher-Ohlin Model can be studied extensively in the real-world trade between different countries. For example, while some countries are the largest exporters of oil and petroleum products, some have coal in abundance, some cotton, some precious metals, while others have agricultural products in abundance.

The Heckscher-Ohlin model explains the imbalance of natural resources throughout the world and gives an explanation of why countries export the resource they have at most. For example, OPEC countries are the largest exporters of oil, this does not mean they do not have other natural resources such as coal, metal, and others, but they have oil reserves in abundance, wherein lies their strength. The Heckscher-Ohlin model also amplifies the benefits of international and how exporting resources that are naturally abundant in some countries help other countries.

2.8 MODERN FIRM-BASED THEORIES :

The emergence of modern or firm-based theories is marked after the period of World War II. The founders of these theories were mainly professors of business schools and not economists. These theories majorly came up after the rising popularity of multinational companies. The Country based classical theories were mainly focused on the country, however, the modern or firm-based theories address the needs of companies. The following are the modern or firm-based theories propounded by various business school professors:

2.9 COUNTRY SIMILARITY THEORY :

Steffan Linder, a Swedish economist, was the founder of this theory. The theory marked its emergence in the year 1961 and explained the concept of in-train industry trade. Linder suggested that countries that are in a similar phase of development will probably have similar preferences.

The suggestion proposed by Linder was that companies first produce goods for their domestic consumption and later expand production, thereby exporting those products to other countries where customers have similar preferences. Linder suggested that most of the trade in manufactured goods, in most circumstances, will be between countries with similar per capita incomes, and that the in-train industry trade will thus be common among them. This theory is generally more applicable in understanding trade where buyers mainly decide on the basis of brand names and product reputations.

2.10 PRODUCT LIFE CYCLE :

This theory was propounded by Raymond Vernon, a business professor at Harvard Business School, in the 1960s. The theory that originated in the field of marketing proposed that a product life cycle has three stages, namely, new product, maturing product, and standardised product. The theory has a presumption that the production of a new product will completely arise in the country where it was invented.

This theory, up to a good extent, helps in explaining the sudden rise and dominance of the United States in manufacturing. This theory also explained the stages of computers, from being in the new product stage in the 1970s and thereby entering into their maturing stage in the 1980s and 1990s. In today’s scenario, computers are in a standardised stage and are mostly manufactured in low-cost countries in Asia. However, this theory has not been able to explain the current trading pattern where products are being invented and manufactured in almost all parts of the world.

2.11 GLOBAL STRATEGIC RIVALRY THEORY :

Paul Krugman and Kelvin Lancaster were the founders of this theory. This theory emerged around the 1980s. The theory majorly focused on multinational companies and their strategies and efforts to gain a comparative advantage over other similar global firms in their industry. This theory acknowledges the fact that firms will face global competition and prove their superiority.

They must surely develop a competitive advantage over each other. The ways through which the firms can gain competitive advantage were termed as barriers to entry for that particular industry. These barriers are basically the obstacles that a firm will face globally when they enter the market. The barriers that companies and firms may try to optimize are:

1. Mainly research and development,
2. The ownership of intellectual property rights,
3. Economies of scale,
4. Unique business processes or methods,
5. Extensive experience in the industry, and

6. The control of resources or favourable access to raw materials.

2.12 PORTER'S NATIONAL COMPETITIVE ADVANTAGE :

The theory emerged in the 1990s with the aim of explaining the concept of national competitive advantage. The theory proposes that a nation's competitiveness majorly depends upon the capability and capacity of the industry to come up with innovations and upgrades. This theory attempted to explain the reason behind the excessive competitiveness of some nations as compared to others.

The main determinants proposed in this theory were local market resources and capabilities, local market demand conditions, local suppliers and complementary industries, and local firm characteristics. The theory also mentioned the crucial role of government in forming the competitive advantage of the industry.

2.13 SUMMARY :

For years, theories concerning international trade have been the subject of intense research and debate. Growing international trade has its own pros and cons. The analysis of the system of international trade by way of various theories has enabled a systematic framework for better understanding.

International trade contributes to the economic growth of a country, thereby increasing the standard of living of its people, creating employment opportunities, a greater variety of choices for consumers, etc. The development of trade theories has seen a major shift from the view of restricting free trade as stated in the theory of mercantilism to the various modern theories providing a better understanding to facilitate smooth international trade with increasing benefits.

2.14 KEY WORDS :

Comparative cost The principle of comparative costs is based on the differences in production costs of similar commodities in different countries. Production costs differ in countries because of geographical division of labour and specialisation in production.

- **Absolute cost :** Absolute advantage is when a producer can provide a good or service in greater quantity for the same cost, or the same quantity at a lower cost, than its competitors.
- **Strategic alliances :** A strategic alliance is an arrangement between two companies to undertake a mutually beneficial project while each retains its independence. The agreement is less complex and less binding than a joint venture, in which two businesses pool resources to create a separate
- **Business entity :** The entity name is the name used by a business to enter into contracts and make other legal or administrative commitments. On the other hand, the business name is the name your business operates under and shares with its clients, customers and employees.
- **Mercantilism :** Mercantilism, also called "commercialism," is a system in which a country attempts to amass wealth through trade with other countries, exporting more than it imports and increasing stores of gold and precious metals. It is often considered an outdated system.
- **Labor-intensive :** The term "labor-intensive" refers to a process or industry that requires a large amount of labor to produce its goods or services. The degree of labor intensity is typically measured in proportion to the amount of capital required to

produce the goods or services: the higher the proportion of labor costs required, the more labor-intensive the business.

- **Product life cycle :** A product life cycle is the length of time from a product first being introduced to consumers until it is removed from the market. A product's life cycle is usually broken down into four stages; introduction, growth, maturity, and decline.

2.15 SELF – ASSESSMENT QUESTIONS :

1. What are the differences between absolute and comparative cost advantage theories?
2. Brief the comparative cost advantage theory with its merits.
3. Is modern theory superior than other theories? – comment.
4. Write a note on mercantilism theories on international business.
5. Narrate the theory of global strategic rivalry theory.

2.16 FURTHER READINGS :

1. International economics – by M.L. Jinkahan
2. International business – by P. Subbarao

Dr. K. SIVAJI

LESSON - 3

COMMERCIAL TERMS USED IN THE DELIVERY OF GOODS

LEARNING OBJECTIVES:

- To study international trade
- To know the commercial terms used in foreign trade
- To learn different categories of incoterms

STRUCTURE :

3.1 Introduction
3.2 Modes Of Delivery Of Goods
3.3 International Commercial Terms – Incoterms
3.4 Maritime-Only Terms
3.5 Classification Of Incoterms
3.6 Each Incoterm Contains A Set Of Rules Of Interpretation For The Obligations Of Both The Seller (A1-A10) And The Buyer (B1-B10) Covering The Following Issues
3.7 Exw Incoterm (Ex Works)
3.8 Fca Incoterm (Free Carrier)
3.9 Basic Features Of Incoterms Used For Sea And Inland Waterway Transport
3.10 Summary
3.11 Key Wards
3.12 Self – Assessment Questions
3.13 Further Readings

3.1 INTRODUCTION :

The delivery of goods signifies the voluntary transfer of possession from one person to another. The objective or the end result of any such process which results in the goods coming into the possession of the buyer is a delivery process. For example, A, the seller of a car hands it over to B, the buyer; it is a case of actual delivery of the goods. 2. Symbolic Delivery: Where the goods are bulky and heavy and it is not possible to physically hand them over to the buyer, delivery thereof may be made by indicating or giving a symbol.

What is Delivery of Goods? Delivery of Goods in the Sale of Goods Act is defined as a voluntary transfer of possession from one person to another. Thus, to effect a valid delivery, goods from one person to another must be transferred willingly and not by means of fraud, theft, or force, etc. Mere possession of goods does not amount to delivery of goods.

3.2 MODES OF DELIVERY OF GOODS :

Delivery of goods may be made in any of the following three ways:

i. **Actual Delivery** : Also known as physical delivery, actual delivery takes place when the goods are physically handed over by the seller or his/her authorized agent to the buyer or his/her agent authorized to take possession of the goods. For example, A, the seller of a car hands it over to B, the buyer; it is a case of actual delivery of the goods.

ii. Symbolic Delivery : Where the goods are bulky and heavy and it is not possible to physically hand them over to the buyer, delivery thereof may be made by indicating or giving a symbol. Here the goods itself are not delivered, but the means of obtaining possession of goods is delivered. For example, delivering the keys of the warehouse where the goods are stored, or the keys of a purchased car to its buyer, bill of lading which will entitle the holder to receive the goods on arrival of the ship.

iii. Constructive Delivery : In this case neither physical nor symbolic delivery is made. In constructive delivery the individual possessing the products recognizes that he holds the merchandise for the benefit of, and at the disposal of the purchaser. Constructive delivery is also called adornments.

iv. Constructive delivery may be effected in the following three ways : Where the seller, after having sold the goods, agrees to hold them as bailee for the buyer. Where the buyer, who is already in possession of the goods as bailee of the seller, holds them as his own, after the sale, and Where a third party, for example, a carrier/transporter, who holds the goods, as bailee for the seller, agrees and acknowledges holding them for the buyer

3.3 INTERNATIONAL COMMERCIAL TERMS – INCOTERMS :

INCOTERMS (International Commercial Terms) are a set of trade term definitions developed by the International Chamber of Commerce (ICC) and recognised internationally. They’re the language you’ll need when you’re trading abroad.

i. What are INCOTERMS? : INCOTERMS (International Commercial Terms) are an internationally recognised set of trade term definitions developed by the International Chamber of Commerce (ICC). The terms define the trade contract responsibilities and liabilities between a buyer and a seller. They cover who is responsible for paying freight costs, insuring goods in transit and covering any import/export duties, for example. They are invaluable as, once importer and exporter have agreed on an INCOTERM, they can trade without discussing responsibilities for the costs and risks covered by the term.

ii. Commonly used INCOTERMS : Full details of all the INCOTERMS and their definitions are available from the International Chamber of Commerce. EXW - Ex Works

a. The seller makes the goods available at his or her premises. The buyer is responsible for uploading. This applies to any mode of transport, but should only be used for domestic transactions, because the seller has only to 'provide the buyer'… assistance in obtaining any export licence, or other official authorisation. The seller also has no obligation to load the goods. In addition the buyer has limited obligations to provide the seller with proof of export. For international trade, FCA, below, is more appropriate.

iii. FCA - Free Carrier : The seller must 'deliver the goods to the carrier nominated by the buyer at the named place'. This term is suited for international sales with minimum obligations for the seller. Its advantage over EXW is that the seller is responsible for any export licensing and Customs export clearance, which eases the problem of proof of export, and the seller must load the goods (which is usually the case). There is a new focus on 'FCA ... seller's premises' as the appropriate term for international sales when the seller wants to limit their obligations to the loading of the goods and export clearance.

❖ **CPT Carriage Paid To :** (… named place of destination). The seller pays for carriage. This term is used for all kinds of shipments. Risk is transferred from the seller to the buyer upon handing over of the goods to the first carrier at the place of shipment in the country of export.

- **CIP - Carriage and Insurance Paid :** (...named place of destination) - any mode of transport. The seller must 'deliver to the first carrier at the named place'. It's strongly recommended that the parties define the place of delivery (in the seller's country) as well as the place of destination (in the buyer's country) due to the fact that risk passes to the buyer at the named place of delivery in the seller's country. 'When CPT or CIP terms are used, the seller fulfils their obligation to deliver when it hands the goods over to the carrier, and not when the goods reach the place of destination.' So these are ' shipment contracts' not ' arrival contracts'. Therefore, it is strongly recommended that the place of delivery, in the seller's country, is identified as precisely as possible in the contract.
- **DAT – Delivered at Terminal:** (...named terminal at destination). The seller pays for carriage to a nominated 'terminal' or 'point', except for costs related to import clearance. The seller also assumes all risks up to the point that the goods are unloaded at the terminal.
- **DAP** would be inappropriate in these circumstances as the seller has only to place the goods 'ready for unloading'. DAP - Delivered At Place (...named place of destination). This is appropriate to both domestic and international sales. The seller delivers when 'the goods are placed at the disposal of the buyer ready for unloading by the buyer ... at the named place'. All import Customs formalities and costs are the responsibility of the buyer.
- **DDP - Delivered Duty Paid :** (...named place of destination). This applies to any mode of transport. The seller must deliver the goods to the buyer, cleared for import, and not unloaded at the named place of destination.

3.4 MARITIME-ONLY TERMS :

These are only used for conventional sea or inland waterway transport.

- FAS - Free Alongside Ship (...named port of shipment). If the goods are containerised, use the FCA term.
- FOB - Free On Board (...named port of shipment). The seller must deliver the goods by 'placing them on board the vessel ... at the loading point'. The FCA term should be used where the goods are handed over to the carrier before they are on board the vessel – goods in containers, for example.
- CFR - Cost and Freight (...named port of destination).
- CIF - Cost Insurance and Freight (...named port of destination). The seller must deliver the goods by 'placing them on board the vessel'. Where the goods are handed over to the carrier before they are on board the vessel – goods in containers, for example, the CPT or CIP term should be used. When CFR or CIF terms are used, the seller fulfils its obligation to deliver when it hands the goods over to the carrier and not when the goods reach the place of destination. So it's important that the port of shipment is identified as precisely as possible in the contract.

Useful links: International Chamber of Commerce : Lloyds Business Banking International Services- Back to top- Importing- Your step by step guide to importing success.- Importing guide Guide to help you through importing. Exporting- Explore the key steps to exporting and the risks to consider. Exporting guide Guide to help you and your business with exporting- International Trade Portal: A powerful insight platform, with practical support that helps you trade internationally with your chosen market. International Trade Portal Information about our International Trade Portal- Important legal information-

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3.5 CLASSIFICATION OF INCOTERMS :

The Incoterms are divided into four principal categories: E, F, C and D.Category E (Departure), which contains only one trade term, i.e. EXW (Ex Works).

Category F (Main Carriage Unpaid), which contains three trade terms :

- **FCA (Free Carrier) :** Free Carrier, or FCA Incoterms, is a commonly used trade term that signifies that the seller is required to drop off the shipment to a named destination or seller's premise, as outlined by the buyer. From here, it is transferred to the shipping carrier by the buyer
- **FAS (Free Alongside Ship) :** What is Free Alongside Ship (FAS)? An Incoterms® rule, applicable only to ocean or waterway transport, under which the seller is responsible for clearing the goods for export and placing them alongside the vessel at the named port of delivery.
- **FOB (Free on Board) :** Free on Board (FOB) is a shipment term that defines the point in the supply chain when a buyer or seller becomes liable for the goods being transported. The FOB (Free On Board) price is the price of goods at the frontier of the exporting country or price of a service provided to a non-resident. It includes the values of the goods or services at the basic price, the transport and distribution services up to the frontier, the taxes minus the subsidies.

Category C (Main Carriage Paid), Which Contains Four Trade Terms :

i. **CPT (Carriage paid to):** When goods are bought or sold “Carriage Paid To” (CPT) it means that the Seller delivers the goods to a destination previously agreed to by the seller and the buyer. It can also be the handoff to the prefered carrier of the buyer. Carriage Paid To (CPT) is an international trade term that means the seller delivers the goods at their expense to a carrier or another person nominated by the seller. The seller assumes all risks, including loss, until the goods are in the care of the nominated party.

ii. **CIP (Carriage and Insurance paid to):** In Carriage and Insurance Paid To (CIP), the seller assumes all risk until the goods are delivered to the first carrier at the place of shipment—not the place of destination. Once the goods are delivered to the first carrier, the buyer is responsible for all risks. The term “carriage and insurance paid to

(CIP)" signifies that the seller will pay freight and insurance in sending goods to someone chosen by the seller at a mutually agreeable location. The seller must insure the goods being sent for 110% of their contract value.

iii. **CFR (Cost and Freight):** Under CFR terms (short for "Cost and Freight"), the seller is required to clear the goods for export, deliver them onboard the ship at the port of departure, and pay for transport of the goods to the named port of destination. The risk passes from seller to buyer when the seller delivers the goods onboard the ship. The Incoterm in this blog is one of the Incoterms specifically for transport over water: Cost and Freight (CFR). When goods are bought or sold Cost and Freight (CFR) it means that the Seller is responsible for the delivery of the goods to a ship and loading the goods onto the ship.

iv. **CIF (Cost, Insurance and Freight):** Cost, insurance, and freight (CIF) is an international shipping agreement, which represents the charges paid by a seller to cover the costs, insurance, and freight of a buyer's order while the cargo is in transit. Cost, insurance, and freight only applies to goods transported via a waterway, sea, or ocean. The seller covers the cost of shipping, and insurance. The seller also obtains the necessary documentation, licenses, and inspections that may be required. The buyer assumes full responsibility for the goods as soon as they reach the destination port under a CIF agreement.

Category D (Arrival), Which Contains Three Trade Terms :

- **DAP (Delivered at Place) :** Under the Delivered At Place (DAP) Incoterms rules, the seller is responsible for delivery of the goods, ready for unloading, at the named place of destination. The seller assumes all risks involved up to unloading. Unloading is at the buyer's risk and cost. DAP simply means that the seller takes on all the risks and costs of delivering goods to an agreed-upon location. This means they are responsible for anything associated with packaging, documentation, export approval, loading charges, and ultimate delivery.
- **DPU (Delivered at Place Unloaded) :** Delivered at Place Unloaded (DPU) (formerly referred to as DAT for "Delivered at Terminal") requires the seller to deliver the goods at the disposal of the buyer after they've been unloaded from the arriving means of transport. With the DPU Incoterm, the seller assumes all costs and risks until the goods are unloaded at the agreed named place at destination. In this case, the buyer is responsible for import customs formalities. DPU can apply to any mode of transport or multiple modes of transport.
- **DDP (Delivered Duty Paid) :** Delivered duty paid (DDP) is a delivery agreement whereby the seller assumes all responsibility for transporting the goods until they reach an agreed-upon destination. It is an incoterm, or a standardized contract for international shipments. Delivery Duty Paid (DDP) shipping is where the seller takes all responsibility for fees and risks of shipping goods until they are delivered to an agreed place by the buyer and seller.

The four above-mentioned categories can also be classified as per the means of transportation:

Incoterms for any mode of transport :

- **EXW :** Ex Works (EXW) is a shipping arrangement in which a seller makes a product available at a specific location, but the buyer has to pay the transport costs. EXW (Ex Works) means that the seller delivers when it places the goods at the disposal of the buyer at the seller's premises or at another named place (i.e., works, factory, warehouse, etc.). The seller does not need to load goods or clear them for export.

- **FCA :** FCA full form is Fellow Chartered Accountant. The terms Fellow Chartered Accountant (FCA) and Associate Chartered Accountant (ACA) are not interchangeable because they are both members of the Indian Council of Chartered Accountancy (ICAI) at distinct levels. Great place to work, flexible working approach, opportunities to enhance skills. The management is very helpful. There is also a sense of job security and provides excellent benefits.
- **CPT :** The full form of CPT is the Common Proficiency Test. It is an entry-level exam conducted for enrollment in the Charted Accountancy course by the Institute of Chartered Accountants of India. It is also recognized as CA-CPT.,
- **CIP :** abbreviation for Continuous Improvement Programme: a system designed to help a company continuously find ways in which to help employees work more effectively: Under CIP anyone can suggest ways to do a specific task better, faster, more safely, or more efficiently.
- **DPU :** A DPU, or data processing unit, is a programmable processor designed to efficiently handle data-centric workloads such as data transfer, reduction, security, compression, analytics, and encryption, at scale in data centers.
- **DAP :** IFFCO's DAP (Diammonium phosphate) is a concentrated phosphate-based fertilizer. Phosphorus is an essential nutrient along with Nitrogen and plays a vital role in the development of new plant tissues and the regulation of protein synthesis in crops.
- **DDP :** Delivery Duty Paid (DDP) shipping is where the seller takes all responsibility for fees and risks of shipping goods until they are delivered to an agreed place by the buyer and seller.22 2022

Incoterms only for sea and inland waterway transport :

- **FAS :** Definitions of FAS. a congenital medical condition in which body deformation occurs or facial development or mental ability is impaired because the mother drinks alcohol during pregnancy. synonyms: fetal alcohol syndrome. type of: syndrome. a pattern of symptoms indicative of some disease.

- **FOB :** FOB means Free On Board and is when the seller takes care of all shipping documentation and delivers the goods to the ship. Once aboard, the transportation risk passes from the seller to the buyer. In FOB shipping point agreements, the seller pays all transportation costs and fees to get the goods to the port of origin. Once the goods are at the point of origin and on the transportation vessel, the buyer is financially responsible for costs to transport the goods such as customs, taxes, and fees.

- **CFR :** The Code of Federal Regulations (CFR) is the codification of the general and permanent rules published in the Federal Register by the executive departments and agencies of the Federal Government. The Code of Federal Regulations (CFR) contains the official text of agency regulations and is updated once a year. The CFR is updated by amendments published in the Federal Register.

- **CIF :** CIF (Cost, Insurance, & Freight) is an international shipping agreement and one of many important Incoterms®. It represents the charges a seller pays to cover the costs, insurance, and freight of a buyer's order while the cargo is in transit. FOB. CIF stands for cost, insurance and freight. It stands for free on board. Under the CIF agreement, the reseller's responsibility is that of goods in transit until the buyer receives the goods. Under FOB agreements, the responsibility of the goods in transit is that of the buyer.

3.6 EACH INCOTERM CONTAINS A SET OF RULES OF INTERPRETATION FOR THE OBLIGATIONS OF BOTH THE SELLER (A1-A10) AND THE BUYER (B1-B10) COVERING THE FOLLOWING ISSUES :

- **A1/B1 – General Obligations**: A Practice Note providing an overview of the general obligations of the seller and buyer set out in Articles A1 and B1 for each of the 11 individual shipping terms included in the Incoterms® 2020 Rules that are used by sellers and buyers to allocate certain responsibilities and risk in international sale of goods contracts. The individual shipping terms include EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAP (Delivered at Place), DPU (Delivered at Place Unloaded), DDP (Delivered Duty Paid), FAS (Free Alongside Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost, Insurance and Freight).
- **A2/B2 – Delivery**: A Practice Note providing an overview of the delivery obligations set out in Articles A2 and B2 for each of the 11 individual shipping terms included in the Incoterms® 2020 Rules that are used by sellers and buyers to allocate certain responsibilities and risk in international sale of goods contracts. The individual shipping terms include EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAP (Delivered at Place), DPU (Delivered at Place Unloaded), DDP (Delivered Duty Paid), FAS (Free Alongside Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost, Insurance and Freight).
- **A3/B3 – Transfer of risks**: A Practice Note providing an overview of the transfer of risk requirements set out in Articles A3 and B3 for each of the 11 individual shipping terms included in the Incoterms® 2020 Rules that are used by sellers and buyers to allocate certain responsibilities and risk in international sale of goods contracts. The individual shipping terms include EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAP (Delivered at Place), DPU (Delivered at Place Unloaded), DDP (Delivered Duty Paid), FAS (Free Alongside Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost, Insurance and Freight).
- **A4/B4 – Carriage:** A Practice Note providing an overview of the obligations of the seller or buyer to make or arrange the contract of carriage set out in Articles A4 and B4 for each of the 11 individual shipping terms included in the Incoterms® 2020 Rules that are used by sellers and buyers to allocate certain responsibilities and risk in international sale of goods contracts. The individual shipping terms include EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAP (Delivered at Place), DPU (Delivered at Place Unloaded), DDP (Delivered Duty Paid), FAS (Free Alongside Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost, Insurance and Freight).
- **A5/B5 – Insurance**: A Practice Note providing an overview of the cargo insurance obligations set out in each of the 11 individual shipping terms included in the Incoterms® 2020 Rules that are used by sellers and buyers to allocate certain responsibilities and risk in international sale of goods contracts. The individual shipping terms include EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAP (Delivered at Place), DPU (Delivered at Place Unloaded), DDP (Delivered Duty Paid), FAS (Free Alongside

Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost, Insurance and Freight). This Note also discusses some of the issues that the seller and buyer must consider when purchasing cargo insurance whether or not the individual shipping terms require either party to obtain insurance.

- **A6/B6 – Delivery/transport document :** Article A6/B6, the delivery/transport document, allows the buyer and seller to agree that the buyer will instruct the carrier to issue an on-board bill of lading to the seller once the goods have been loaded on board.

- **A7/B7 – Export/import clearance:** A Practice Note providing an overview of the export and import clearance requirements set out in Articles A7 and B7 for each of the 11 individual shipping terms included in the Incoterms® 2020 Rules that are used by sellers and buyers to allocate certain responsibilities and risk in international sale of goods contracts. The individual shipping terms include EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAP (Delivered at Place), DPU (Delivered at Place Unloaded), DDP (Delivered Duty Paid), FAS (Free Alongside Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost, Insurance and Freight).
- **A8/B8 – Checking/packaging/marking,:** A Practice Note providing an overview of the obligations of the seller and buyer set out in Articles A8 and B8 relating to checking the quality, measuring, weighing, counting, packaging, and marking the goods for each of the 11 individual shipping terms included in the Incoterms® 2020 Rules, used by sellers and buyers to allocate certain responsibilities and risks in international sale of goods contracts. The individual shipping terms include EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAP (Delivered at Place), DPU (Delivered at Place Unloaded), DDP (Delivered Duty Paid), FAS (Free Alongside Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost, Insurance and Freight).
- **A9/B9 – Allocation of costs:** A Practice Note providing an overview of the allocation of transportation and other costs to the seller or buyer set out in Articles A9 and B9 for each of the 11 individual shipping terms included in the Incoterms® 2020 Rules that are used by sellers and buyers to allocate certain responsibilities and risk in international sale of goods contracts. The individual shipping terms include EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAP (Delivered at Place), DPU (Delivered at Place Unloaded), DDP (Delivered Duty Paid), FAS (Free Alongside Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost, Insurance and Freight).
- **A10/B10 – Notices**: A Practice Note providing an overview of the notice requirements set out in Articles A10 and B10 for each of the 11 individual shipping terms included in the Incoterms® 2020 Rules that are used by sellers and buyers to allocate certain responsibilities and risks in international sale of goods contracts. The individual shipping terms include EXW (Ex Works), FCA (Free Carrier), CPT (Carriage Paid To), CIP (Carriage and Insurance Paid To), DAP (Delivered at Place), DPU (Delivered at Place Unloaded), DDP (Delivered Duty Paid), FAS (Free Alongside Ship), FOB (Free on Board), CFR (Cost and Freight), and CIF (Cost, Insurance and Freight).

Basic Features of Incoterms Used for All Modes of Transport

3.7 EXW INCOTERM (EX WORKS) :

The EXW Incoterm imposes only minimum obligations on the seller. More particularly, the seller is simply required to deliver the goods to the buyer at a named place of delivery which is usually the seller's place of business, but can be any particular location such as a warehouse, factory, etc., and within the agreed time specified in the contract. It is not required for the seller to load the goods on any specific vehicle or to clear the goods for export. If the place of delivery is not specified in the contract, or if several place of delivery can be envisaged, "*the seller may select the point that best suits its purpose*."In principle, until the goods have not been delivered as specified in the sale contract, the seller bears all risks of loss or damage to the goods. Once delivered, such risk is automatically shifted to the buyer. The same is true for any costs relating to the goods – until the delivery of the goods, the costs are to be borne by the seller; after their delivery, by the buyer. Several authors suggest that the EXW Incoterm is better suited for domestic (and not international) trade and point out that it is *"*Commonly used in courier shipments when the courier picks up the shipment from client's premises and loads courier's own truck. Payment terms for EXW transactions are generally cash in advance and open account.*"*

As mentioned in the ICC Guide to Incoterms 2010, parties sometimes insert a term "*loaded*" following the reference to EXW Incoterm, i.e., EXW loaded, into their sales contract. Such an addition is normally intended to extend responsibility to loading operations. However, without further clarification, it is rather difficult to say whether such a term means *"loaded at seller's risk" or "loaded at buyer's risk"* and is subject to interpretation in case of dispute. In this respect, if "*loaded*" is meant to extend the liability to the seller, the parties may consider inserting the FCA Incoterm (*see* below), and not EXW, into their contract. However, they should bear in mind that the FCA Incoterm requires that the obligation to clear the goods for export be borne by the seller as well.

3.8 FCA INCOTERM (FREE CARRIER) :

Under the FCA Incoterm, the delivery of goods occurs as follows:

- ❖ When the named place of delivery is the seller's premises, the goods are deemed to be delivered when they are loaded on the transportation vehicle arranged by the buyer;
- ❖ When the named place of delivery is elsewhere, e.g., a warehouse or factory, etc., the goods are deemed to be delivered when the following requirements are met: after having been loaded on the seller's transportation vehicle, they reach the named place, are ready for unloading from the seller's transportation vehicle and are placed at the disposal of the carrier nominated by the buyer.
- ❖ Regarding the carrier, it is usually *"*a firm that itself transports goods or passengers for hire, rather than simply arranging for such transport. Examples are a shipping line, airline trucking firm, or railway. In the FCA term, however, the carrier can by any person who by contract 'undertakes to perform or procure' such services*"*.

In 2020, several new obligations were added to the FCA Incoterm. For example, the parties may agree that the buyer instructs the carrier to issue the transport document (bill of landing) with the on-board notation to the seller. In turn, the seller undertakes to send this document to the buyer, "*who will need the bill of landing in order to obtain discharge of the goods from the carrier*."

The FCA Incoterm further requires the seller to clear the goods for export, where applicable. However, the seller has no obligation to clear the goods for import. No insurance obligation is placed either on the seller or the buyer.

Cpt Incoterm (Carriage Paid To) : Under the CPT Incoterm, the delivery of the goods occurs when they are delivered by the seller to the carrier at the agreed place or are procured by the seller so delivered. In this respect, the seller has an obligation to contract, at its expense, for the carriage of the goods from the point of delivery to the place of destination of the goods. The existence of the contract of carriage has no impact on the transfer of risk from the seller to the buyer which occurs at the point of delivery, i.e., by handing over the goods to the carrier.However, if the seller incurs costs relating to unloading of goods at the place of destination under the contract of carriage, it must bear them, unless otherwise agreed. The CPT Incoterm also requires that the seller clear the goods for export, where applicable, and assume all risk related thereto. However, the seller has no such obligation for import. Neither the seller, nor the buyer, is required to conclude an insurance contract.

Cip Incoterm (Carriage And Insurance Paid To) : Under the CIP Incoterm, the seller has the same obligations as under the CPT Incoterm, i.e., to hand over the goods to the carrier contracted by the seller and to clear the goods for export. with the addition of an obligation to contract for insurance in order to cover against the buyer's risk/damage to the goods from the place of delivery to, at least, the place of destination.

Regarding insurance, it shall be made in conformity with Clauses (A) of the Institute Cargo Clauses, or similar clauses, and shall cover, at a minimum, the contractual price plus 10%. Prior to the 2020 revision of the Incoterms, only a minimum insurance coverage pursuant to Clauses (C) of the Institute Cargo Clauses was required. However, even today, the parties can agree on a lower coverage.Once contracted, the seller has an obligation to provide the insurance policy or certificate to the buyer.

Dap Incoterm (Delivered At Place) : This Incoterm is normally used in cases when the parties do not wish that the seller bear the risk and cost of unloading, contrary to the DPU Incoterm (*see* below). Under the DAP Incoterm, the goods are deemed delivered by the seller to the buyer when they are put at the disposal of the buyer on the transportation vehicle ready for unloading at the place of destination or an agreed point within such place, if any. Contrary to the CPT/CIP Incoterms, the place of delivery and the place of destination are the same under the DAP Incoterm. Therefore, the seller bears the risk until it has put the goods at the disposal of the buyer at the place of destination as described above. Although it has an obligation to conclude a contract of carriage or arrange at its costs for the carriage of the goods and to clear the goods for export (not import), the seller is not required to unload the goods from the transportation vehicle at the place of destination. In addition, neither the seller, nor the buyer, is required to subscribe an insurance contract.

Dpu Incoterm (Delivered At Place Unloaded) : The DPU Incoterm represents a new feature of the 2020 Incoterms which has replaced the DAT Incoterm (Delivered at Terminal) established under the 2010 Incoterms which, in turn, had replaced DEQ Incoterm (Delivered ex Quay) established under the 2000 Incoterms. According to the DPU Incoterm, the delivery of the goods by the seller to the buyer occurs when the goods are unloaded from the transportation vehicle and put at the disposal of the buyer at the place of destination or at the agreed point within the place of destination, if any. It is the only Incoterm "*that requires the seller to unload goods at destination*."Again, the place of delivery and the place of destination are the same under the DPU Incoterm. Therefore, the seller bears the risk until it has unloaded the goods at the place of destination.

In addition, the seller undertakes to conclude a contract for carriage or arrange carriage at its own expense. It also has an obligation to clear the goods for export. However, no such obligation is imposed for import. The buyer is required to assist the seller in obtaining relevant documentation for export clearance formalities, at the seller's expenses. Contrary to the CIP Incoterm, the seller (or the buyer) has no obligation to contract insurance under the DPU Incoterm.

Ddp Incoterm (Delivered Duty Paid) : Under the DDP Incoterm, the goods are supposed to be delivered by the seller to the buyer if they are placed at the disposal of the buyer, cleared for import, on the arriving transportation vehicle, ready for unloading at the place of destination or an agreed point within such place, if any.The DDP Incoterm imposes the maximum responsibility on the seller as it is the only Incoterm requiring import clearance by the seller.As in the case of the other Incoterms, the DDP Incoterm requires that the seller conclude the contract of carriage or otherwise arrange the carriage at its expense. No insurance contract is, however, required from the seller/the buyer.

3.9 BASIC FEATURES OF INCOTERMS USED FOR SEA AND INLAND WATERWAY TRANSPORT

Fas Incoterm (Free Alongside Ship) :

According to the FAS Incoterm, the seller delivers the goods when it either places them alongside the ship/vessel nominated by the buyer at the named port of shipment or it procures the goods so delivered.The risk/damage to the goods is transferred from the seller to the buyer when the goods are alongside the ship. The seller undertakes to clear the goods for export, not import.

The seller is under no obligation to conclude a contract of carriage. In turn, it is the buyer who bears all expenses regarding the carriage of the goods from the named port of shipment. Consequently, the FAS Incoterm is not suited for cases when the goods are only to be handed over to the carrier, e.g., at a container terminal, before they are placed alongside the ship. For this scenario, the above-mentioned FAS Incoterm is more appropriate.

Furthermore, the seller has an obligation to clear the goods for export (not import). It is not required to conclude any insurance.

Fob Incoterm (Free On Board) : Under the FOB Incoterm, the goods are deemed to be delivered by the seller to the buyer when they are delivered on board the ship nominated by the buyer at the named port of shipment or the seller procures the goods so delivered. Therefore, the risk of loss/damage to the goods is shifted onto the buyer once the goods areplaced-on board the ship. The seller shall clear the goods for export, not import.As in the case of the FSA Incoterm, the seller has no obligation to conclude a contract of carriage. All expenses regarding the carriage of the goods from the named port of shipment shall be borne by the buyer.No insurance is required under the FOB Incoterm to be concluded by the seller or the buyer.

Fr Incoterm (Cost And Freight) : According to the CFR Incoterm, the seller delivers the goods to the buyer by placing them on board the ship or procuring them so delivered.Therefore, the risk of loss of/damage to goods is shifted on the buyer when the goods are place on board of vessel at the port of delivery, and not the port of destination as in the case of the above-referenced FOB Incoterm. Regardless of the transfer of risk at the port of delivery, the seller has an obligation to conclude a contract of carriage of the goods until the port of destination. The seller also must bear all costs related to unloading at the port of destination resulting from the contract of carriage, unless agreed otherwise. It also has an obligation to clear the goods for export, not import. No insurance contract is required from the seller or the buyer.

Cif Incoterm (Cost, Insurance And Freight) : The regime of the CIF Incoterm is very similar to the one under the CFR Incoterm:the goods are to be delivered under the CIF Incoterm when the seller places them on board the ship or procures them so delivered; although the transfer of risk takes place at the port of delivery, the seller has an obligation to conclude a contract of carriage of the goods until the port of destination; the seller must bear all costs related to unloading at the port of destination resulting from the contract of carriage, unless agreed otherwise; the seller has an obligation to clear the goods for export, not import. The principal difference between CIF and CFR resides in the requirement under the CIF Incoterm for the seller to conclude insurance covering against the buyer's risk of loss of/damage to the goods from the port of shipment to, at least, the port of destination. However, contrary to the CIP Incoterm (see above), the seller is required to obtain a minimum insurance according to Clauses (C) of the Institute Cargo Clauses, or other clause (not Clauses (A) of the Institute Cargo Clauses as required for the CIP Incoterm).

3.10 SUMMARY :

The use of Incoterms in international trade is a widespread phenomenon, and disputes frequently arise due to confusion concerning them. Prior to inserting an Incoterm into a contract, it is essential for the parties to make sure that the Incoterm meets all their expectations and needs regarding the following issues: Is transport to be made by sea/inland waterway means or not? Who should bear the majority of the risk of loss/damage to the goods – the seller or the buyer? At what point in time in the delivery to the place of destination should risk be shifted from the seller onto the buyer? Is there a need to use the services of a carrier? If so, who should have an obligation to conclude a contract of carriage – the seller or the buyer? Should the seller be responsible for the unloading of the goods? Is there a need to subscribe an insurance contract?

3.11 KEY WARDS :

FAS : Definitions of FAS. a congenital medical condition in which body deformation occurs or facial development or mental ability is impaired because the mother drinks alcohol during pregnancy. synonyms: fetal alcohol syndrome. type of: syndrome. a pattern of symptoms indicative of some disease.

CPT: The Current Procedural Terminology (CPT®) codes offer doctors and health care professionals a uniform language for coding medical services and procedures to streamline reporting, increase accuracy and efficiency.

FCA: The Financial Conduct Authority is the conduct regulator for around 50000 financial services firms and financial markets in the UK and the prudential ...

FOB: "Free on board" is what FOB stands for. It is a designation which indicated that the liability and ownership of the goods have been transferred from a seller to a buyer. This means that if the goods get damaged or destroyed during the shipping, the seller is not liable.

CPT: The Current Procedural Terminology (CPT®) codes offer doctors and health care professionals a uniform language for coding medical services and procedures to streamline reporting, increase accuracy and efficiency.

CIP: Certified Intelligence Professional: a professional qualification in the US for someone whose job is to discover and study the activities of their company's competitors: The academy has beefed up its CIP program and now offers continuing-education units universally recognized by employers.

CFR: The Code of Federal Regulations (CFR) contains the official text of agency regulations and is updated once a year. The CFR is updated by amendments published in the Federal Register.

CIF: CIF (Cost, Insurance, & Freight) is an international shipping agreement and one of many important Incoterms®. It represents the charges a seller pays to cover the costs, insurance, and freight of a buyer's order while the cargo is in transit.

DAP: It is perfect for any agriculture crop to provide full phosphorus nutrition throughout crop growth and development, as well as a starter dose of nitrogen and low sulphur. It can be applied in autumn for tilling and in spring during sowing, as well as for pre-sowing cultivation.

DUP: "Dupe" is commonly used as a synonym/abbreviation for "duplicate" in informal communications.

DDP: Delivery Duty Paid (DDP) shipping is where the seller takes all responsibility for fees and risks of shipping goods until they are delivered to an agreed place by the buyer and seller.

3.12 SELF – ASSESSMENT QUESTIONS :

1. What are the basic features of incoterms used for sea and inland water transport?
2. What is the classification of incoterms?

3.13 FURTHER READINGS :

1. J. Coetzee, Incoterms: Development and Legal Nature – A Brief Overview, 13 *Stellenbosch Law Review*.
2. Incoterms 2020, ICC Rules for the Use of Domestic and International Trade Terms,
3. Incoterms 2020, ICC Rules for the Use of Domestic and International Trade Terms,
4. D. M. Stapleton, V. Pande, D. O'Brien, EXW, FOB or FCA? Choosing the right Incoterms and why it matters to maritime shippers,
5. D. M. Stapleton, V. Pande, D. O'Brien, EXW, FOB or FCA ? Choosing the right Incoterms and why it matters to maritime shippers.

Dr. K. SIVAJI

LESSON - 4

VARIOUS METHODS FOR PAYMENT IN FOREIGN TRADE

LEARNING OBJECTIVES :

- to study various payment methods in foreign trade
- to know the pros and cons of each type of payment method
- to learn documents required for foreign trade

STRUCTURE :

4.1 Introduction
4.2 Two Centuries Later Trade Debates Still Resonate
4.3 Methods Of Payment In Foreign Trade
4.4 Documents Used In Payment For Foreign Trade
4.5 Letter Of Credit (L/C)
4.6 Certificate Of Origin Of Goods (Coo)
4.7 Inspection Certificate
4.8 Packing List
4.9 Consular Invoice
4.10 Insurance Document
4.11 Summary
4.12 Key Words
4.13 Self – Assessment Questions
4.14 Further Readings

4.1 INTRODUCTION :

India's foreign trade mainly takes place via sea routes. Large mountain ranges stop trade via land for India and India has to depend on Pakistan for trade via land routes. However, as political rivalry exists between the two countries, India has to resort to maritime routes for foreign trade.

Nations are almost always better off when they buy and sell from one another. If there is a point on which most economists agree, it is that trade among nations makes the world better off. Yet international trade can be one of the most contentious of political issues, both domestically and between governments. When a firm or an individual buys a good or a service produced more cheaply abroad, living standards in both countries increase. There are other reasons consumers and firms buy abroad that also make them better off—the product may better fit their needs than similar domestic offerings or it may not be available domestically. In any case, the foreign producer also benefits by making more sales than it could selling solely in its own market and by earning foreign exchange (currency) that can be used by itself or others in the country to purchase foreign-made products.

Still, even if societies as a whole gain when countries trade, not every individual or company is better off. When a firm buys a foreign product because it is cheaper, it benefits—but the (more costly) domestic producer loses a sale. Usually, however, the buyer gains more than the domestic seller loses. Except in cases in which the costs of production do not include such social costs as pollution, the world is better off when countries import products that are produced more efficiently in other countries.

Those who perceive themselves to be affected adversely by foreign competition have long opposed international trade. Soon after economists such as Adam Smith and David Ricardo established the economic basis for free trade, British historian Thomas B. Macaulay was observing the practical problems governments face in deciding whether to embrace the concept: “Free trade, one of the greatest blessings which a government can confer on a people, is in almost every country unpopular.”

4.2 TWO CENTURIES LATER TRADE DEBATES STILL RESONATE :

a) **Why countries trade:** In one of the most important concepts in economics, Ricardo observed that trade was driven by comparative rather than absolute costs (of producing a good). One country may be more productive than others in all goods, in the sense that it can produce any good using fewer inputs (such as capital and labor) than other countries require to produce the same good. Ricardo’s insight was that such a country would still benefit from trading according to its comparative advantage—exporting products in which its absolute advantage was greatest, and importing products in which its absolute advantage was comparatively less (even if still positive).

b) **Comparative advantage:** Even a country that is more efficient (has absolute advantage) in everything it makes would benefit from trade. **Consider an example**: Country A: One hour of labor can produce either three kilograms of steel or two shirts. Country B: One hour of labor can produce either one kilogram of steel or one shirt. Country A is more efficient in both products. Now suppose Country B offers to sell Country A two shirts in exchange for 2.5 kilograms of steel. To produce these additional two shirts, Country B diverts two hours of work from producing (two kilograms) steel. Country A diverts one hour of work from producing (two) shirts. It uses that hour of work to instead produce three additional kilograms of steel. Overall, the same number of shirts is produced: Country A produces two fewer shirts, but Country B produces two additional shirts.

However, more steel is now produced than before: Country A produces three additional kilograms of steel, while Country B reduces its steel output by two kilograms. The extra kilogram of steel is a measure of the gains from trade. Though a country may be twice as productive as its trading partners in making clothing, if it is three times as productive in making steel or building airplanes, it will benefit from making and exporting these products and importing clothes. Its partner will gain by exporting clothes—in which it has a comparative but not absolute advantage—in exchange for these other products (see box). The notion of comparative advantage also extends beyond physical goods to trade in services—such as writing computer code or providing financial products.

Because of comparative advantage, trade raises the living standards of both countries. Douglas Irwin (2009) calls comparative advantage “good news” for economic development. “Even if a developing country lacks an absolute advantage in any field, it will always have a comparative advantage in the production of some goods,” and will trade profitably with advanced economies.

Differences in comparative advantage may arise for several reasons. In the early 20th century, Swedish economists Eli Heckscher and Bertil Ohlin identified the role of labor and capital, so-called factor endowments, as a determinant of advantage. The Heckscher-Ohlin proposition maintains that countries tend to export goods whose production uses intensively the factor of production that is relatively abundant in the country. Countries well endowed with capital—such as factories and machinery—should export capital-intensive products, while those well endowed with labor should export labor-intensive products. Economists today think that factor endowments matter, but that there are also other important influences on trade patterns (Baldwin, 2008).

Recent research finds that episodes of trade opening are followed by adjustment not only across industries, but within them as well. The increase in competition coming from foreign firms puts pressure on profits, forcing less efficient firms to contract and making room for more efficient firms. Expansion and new entry bring with them better technologies and new product varieties. Likely the most important is that trade enables greater selection across different types of goods (say refrigerators). This explains why there is a lot of intra-industry trade (for example, countries that export household refrigerators may import industrial coolers), which is something that the factor endowment approach does not encompass.

There are clear efficiency benefits from trade that results in more products not only more of the same products, but greater product variety. For example, the United States imports four times as many varieties (such as different types of cars) as it did in the 1970s, while the number of countries supplying each good has doubled. An even greater benefit may be the more efficient investment spending that results from firms having access to a wider variety and quality of intermediate and capital inputs (think industrial optical lenses rather than cars). By enhancing overall investment and facilitating innovation, trade can bring sustained higher growth.

Indeed, economic models used to assess the impact of trade typically neglect influences involving technology transfer and pro-competitive forces such as the expansion of product varieties. That is because these influences are difficult to model, and results that do incorporate them are subject to greater uncertainty. Where this has been done, however, researchers have concluded that the benefits of trade reforms such as reducing tariffs and other nontariff barriers to trade are much larger than suggested by conventional models.

c) **Why trade reform is difficult :** Trade contributes to global efficiency. When a country opens up to trade, capital and labor shift toward industries in which they are used more efficiently. That movement provides society a higher level of economic welfare. However, these effects are only part of the story. Trade also brings dislocation to those firms and industries that cannot cut it. Firms that face difficult adjustment because of more efficient foreign producers often lobby against trade. So do their workers. They often seek barriers such as import taxes (called tariffs) and quotas to raise the price or limit the availability of imports. Processors may try to restrict the exportation of raw materials to depress artificially the price of their own inputs. By contrast, the benefits of trade are spread diffusely and its beneficiaries often do not recognize how trade benefits them. As a result, opponents are often quite effective in discussions about trade.

d) **Trade policies:** Reforms since World War II have substantially reduced government-imposed trade barriers. But policies to protect domestic industries vary. Tariffs are much higher in certain sectors (such as agriculture and clothing) and among certain country groups (such as less developed countries) than in others. Many countries have substantial barriers to trade in services in areas such as transportation, communications, and, often, the financial sector, while others have policies that welcome foreign competition.

Moreover, trade barriers affect some countries more than others. Often hardest hit are less developed countries, whose exports are concentrated in low-skill, labor-intensive products that industrialized countries often protect. The United States, for example, is reported to collect about 15 cents in tariff revenue for each $1 of imports from Bangladesh (Elliott, 2009), compared with one cent for each $1 of imports from some major western European countries. Yet imports of a particular product from Bangladesh face the same or lower tariffs than do similarly classified products imported from western Europe. Although the tariffs on Bangladesh items in the United States may be a dramatic example, World Bank economists calculated that exporters from low-income countries face barriers on average half again greater than those faced by the exports of major industrialized countries (Kee, Nicita, and Olarreaga, 2006).

The World Trade Organization (WTO) referees international trade. Agreements devised since 1948 by its 153 members (of the WTO and its predecessor General Agreement on Trade and Tariffs) promote nondiscrimination and facilitate further liberalization in nearly all areas of commerce, including tariffs, subsidies, customs valuation and procedures, trade and investment in service sectors, and intellectual property. Commitments under these agreements are enforced through a powerful and carefully crafted dispute settlement process.

Under the rules-based international trading system centered in the WTO, trade policies have become more stable, more transparent, and more open. And the WTO is a key reason why the global financial crisis did not spark widespread protectionism. However, as seen most recently with the Doha Round of WTO trade negotiations, the institution faces big challenges in reaching agreements to open global trade further. Despite successes, restrictive and discriminatory trade policies remain common. Addressing them could yield hundreds of billions of dollars in annual global benefits. But narrow interests have sought to delay and dilute further multilateral reforms. A focus on the greater good, together with ways to help the relatively few that may be adversely affected, can help to deliver a fairer and economically more sensible trading system.

4.3 METHODS OF PAYMENT IN FOREIGN TRADE :

To succeed in today’s global marketplace and win sales against foreign competitors, exporters must offer their customers attractive sales terms supported by the appropriate payment methods. Because getting paid in full and on time is the ultimate goal for each export sale, an appropriate payment method must be chosen carefully to minimize the payment risk while also accommodating the needs of the buyer. As shown in figure 1, there are five primary methods of payment for international transactions. During or before contract negotiations, you should consider which method in the figure is mutually desirable for you and your customer.

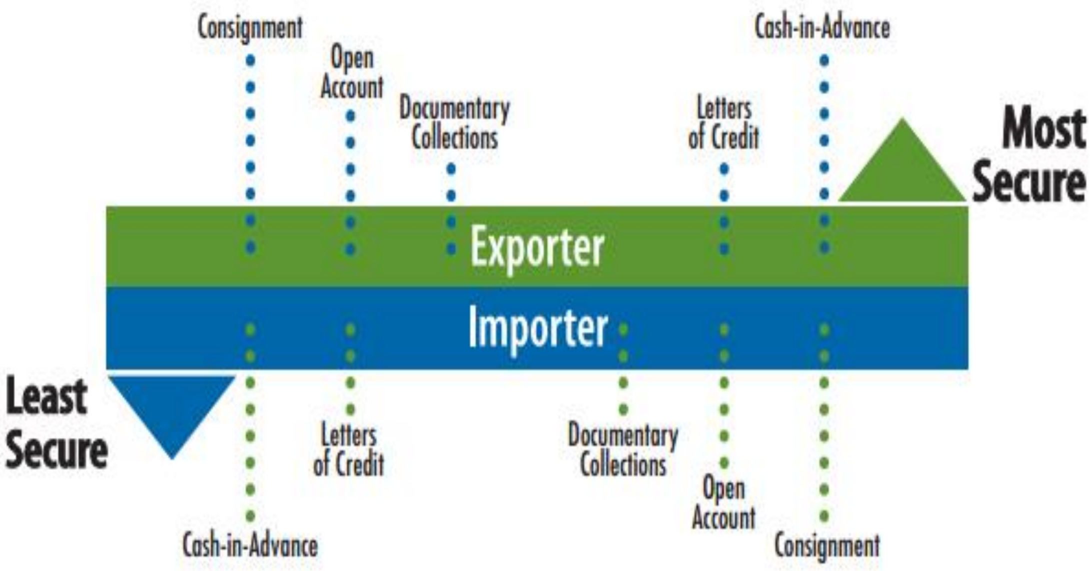
Key Points :

i. International trade presents a spectrum of risk, which causes uncertainty over the timing of payments between the exporter (seller) and importer (foreign buyer).
ii. For exporters, any sale is a gift until payment is received.
iii. Therefore, exporters want to receive payment as soon as possible, preferably as soon as an order is placed or before the goods are sent to the importer.
iv. For importers, any payment is a donation until the goods are received.
v. Therefore, importers want to receive the goods as soon as possible but to delay payment as long as possible, preferably until after the goods are resold to generate enough income to pay the exporter.

Payment Terms (or) Methods : 1 Cash In Advance 2 Letter Of Credit 3 Documentary Collection, 4 Open Account, .5 Consignments

Cash-in-Advance : With cash-in-advance payment terms, an exporter can avoid credit risk because payment is received before the ownership of the goods is transferred. For international sales, wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters. With the advancement of the Internet, escrow services are becoming another cash-in-advance option for small export transactions. However, requiring payment in advance is the least attractive option for the buyer, because it creates unfavorable cash flow. Foreign buyers are also concerned that the goods may not be sent if payment is made in advance. Thus, exporters who insist on this payment method as their sole manner of doing business may lose to competitors who offer more attractive payment terms. Learn more about **Cash-in-Advance**

Figure 1: Payment Risk Diagram



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With cash in advance terms of payment in international trade, exporters can eliminate the credit risk because payment is received before the products are shipped to the customer. For international sales, wire transfers and credit cards are the most commonly used cash in advance export payment method.

Pros : i. This export payment method is beneficial for exporters as they would receive full payments securely before shipment. II. No risk of non-payment from the foreign buyer is associated.

Cons: i. Foreign buyers may be concerned about the risk of not receiving good quality products after the payment is made in advance. ii. Exporters who consider cash in advance payment method in international trade may lose out on business opportunities to competitors who offer more attractive payment terms in exports.

Letters of Credit: Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents. The buyer establishes credit and pays his or her bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. An LC also protects the buyer since no payment obligation arises until the goods have been shipped as promised. Learn more about Letters of Credit.

This is one of the safest and most commonly opted modes of payment in international trade. In this, the customer's bank gives a written commitment to the exporter, which is called as a Letter of Credit (LC). It states a commitment by the bank on behalf of the importer that the payment will be settled to the exporter as per the timeline mentioned and will be subject to agreed terms and conditions.

Pros: Beneficial to the exporter as they are satisfied with creditworthiness of the customer's foreign bank prior to the shipment of products.
Cons: This is a time-consuming process and involves payment and fees.

Documentary Collections : A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents that its buyer needs to the importer's bank (collecting bank), with instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. D/Cs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance). The collection letter gives instructions that specify the documents required for the transfer of title to the goods. Although banks do act as facilitators for their clients, D/Cs offer no verification process and limited recourse in the event of non-payment. D/Cs are generally less expensive than LCs. Learn more about Documentary Collections.

In this term of payment in international trade, both parties involve their respective banks to complete the payment. The remitting bank represents the exporter while the collecting bank works on the behalf of the customer or importer. Once the exporter ships products to the importer, they need to submit the shipping documents and collect orders to the remitting bank. Documents are sent from remitting bank to the collecting bank along with instructions of payment. This is then passed to the buyer on which the payment from the collecting bank is transferred to the remitting bank. Finally, the exporter receives the amount from the remitting bank.

Pros: This export payment method is more economical than Letters of Credit. Buyer is associated.
Cons: Here, there is no verification of the importer. With no commitment of payment from importer's bank, there is no protection against cancellations of products by the importer.

Open Account: An open account transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60 or 90 days. Obviously, this is one of the most advantageous options to the importer in terms of cash flow and cost, but it is consequently one of the highest risk options for an exporter. Because of intense competition in export markets, foreign buyers often press exporters for open account terms since the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may lose a sale to their competitors. Exporters can offer competitive open account terms while substantially mitigating the risk of non-payment by using one or more of the appropriate trade finance techniques covered later in this Guide. When offering open account terms, the exporter can seek extra protection using export credit insurance.

An open account payment method in international trade is where the goods are shipped to the importer before the payment is due. Payment is agreed on the fixed credit period which can extend typically to 30, 60 or 90 days.

Pros : As the importer has the power to set the credit period, this enables cash flow management. For exporters, this mode of payment in international trade can help attract customers in the competitive market.

Cons : Open account methods involve high risk for exporters. To minimize the risk, this payment mode is usually beneficial for buyers and sellers who have an already established and trusting relationship.

Consignment : Consignment in international trade is a variation of open account in which payment is sent to the exporter only after the goods have been sold by the foreign distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold. Clearly, exporting on consignment is very risky as the exporter is not guaranteed any payment and its goods are in a foreign country in the hands of an independent distributor or agent. Consignment helps exporters become more competitive on the basis of better availability and faster delivery of goods. Selling on consignment can also help exporters reduce the direct costs of storing and managing inventory. The key to success in exporting on consignment is to partner with a reputable and trustworthy foreign distributor or a third-party logistics provider. Appropriate insurance should be in place to cover consigned goods in transit or in possession of a foreign distributor as well as to mitigate the risk of non-payment.

The growing use of internet and technology has eased the process of running businesses not just domestically but internationally as well. In terms of payment methods, several new options are now being used not just by customers but by sellers, manufacturers, etc as well. International trade involves legal processes and inspections as per the regulations of both exporting and importing countries. Thus, to make deals more secure and insured, it is important to evaluate and consider the right mode of payment that are mutually desirable for both parties.

The consignment mode of payment in international trade is the variation of open account in which the payment is sent to the exporter after the products have been sold by the foreign or third-party distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages and sells goods to the exporter who retains title to the goods until they are sold.

Pros: This method is more competitive and reduces the direct cost of storing and managing inventory.
Cons: There is a lack of access to the end management of merchandise and no guarantee of payment after the sales to the exporter.

4.4 DOCUMENTS USED IN PAYMENT FOR FOREIGN TRADE :

In an international trade transaction, there is a time lag between the transfer of goods by the exporter to the importer, and transfer of payment by the importer to exporter. To protect both parties from counter-party risk, a number of documents are created and used.1. Bill of Exchange 2. Bill of Lading 3. Letter of Credit 4. Certificate of origin of goods 5. Inspection certificate 6. Packing weight list 7. Consular invoice 8. Insurance document. Each of these is discussed in the following section:

Bill of Exchange : It is an agreement signed by the buyer of the goods to pay the seller a certain sum of money on a specified future date. Each international trade transaction generates its own bill of exchange. The bill is drawn by the exporter and sent to the importer. Once the importer accepts the bill and returns it to the exporter, the importer is legally bound to make payment, and the bill is legal evidence of a contractual obligation for payment. A bill of exchange is a negotiable instrument.

The exporter can hold the bill till its maturity, transfer it to another party through endorsement, or get the bill discounted with a bank. The advantage of discounting is that the exporter gets cash well ahead of the date on which he was due to get the payment from the importer. The holder therefore can be the exporter, another party (to whom it has been endorsed) or a bank (if it is discounted). There are different types of bills of exchange.

- **Banker's Acceptance (Bank Bill):** It is a bill of exchange accepted by a bank. When an exporter draws a bill of exchange on an importer, and the bill is accepted by the importer's bank, it is called a Banker's Acceptance. A bank earns fee for a Banker's Acceptance, since it takes on the credit risk.
- **Clean Bill:** When a bill of exchange is not accompanied by any documents that are generated in an international trade transaction, it is called a Clean bill.
- **Documentary Bill:** When a bill of exchange is accompanied by documents that are generated in an international trade transaction it is called a Documentary bill. The documents include the commercial invoice, Bill of Lading, warranty of title, Letter of Credit, Certificate of origin of goods, Inspection certificate, Packing weight list, Export declaration, Consular invoice, and the insurance document. A warranty of title is given by the exporter to the importer, in which the exporter attests that the title to the goods is good and hence the transfer is legally rightful. Usually, all bills in an international trade are documentary bills.
- **Sight Bill:** It is a bill of exchange that can be presented by the holder of the bill to the importer for payment on any day before the maturity date. It is also called a Demand bill.
- **Usance Bill:** It is a bill of exchange that can be presented by the holder of the bill to the importer for payment only on the maturity date. If the bill states that the importer has to pay the holder only after a specified period (such as 30 days), the importer will make payment only on the due date. A usance bill is also called a Time bill, or a Tenor bill.

There are two dates from which this specified period is calculated :

- If the specified period is calculated from the date appearing on the bill, it is called an after-date usance bill.
- If the specified period is calculated from the date on which the bill was accepted by the importer, the bill is called an after-sight usance bill.

Documents against Acceptance (D/A) Bill : It is a bill of exchange in which all documents are released on acceptance of the bill. D/A stands for 'documents against acceptance'. If the bill of exchange specifies that all documents pertaining to the shipment of goods will be handed over to the importer when he accepts the bill, it is called a D/A bill.

As soon as the importer accepts the bill and sends it to the importer's bank, the bank releases all documents pertaining to the shipment of goods to the importer (such as the Bill of Lading, Certificate of origin of goods, Inspection certificate, Packing weight list, Export declaration, Consular invoice, and Insurance document). Once the importer is in possession of these documents, he has the right of ownership over the goods. The holder of a D/A bill faces the risk of non-payment, since the importer has possession and ownership of the goods before making payment for the goods.

Documents against Payment (DIP) Bill : If the bill of exchange specifies that all documents pertaining to the goods will be handed over to the importer only when he pays the amount mentioned in the bill, it is called a D/P bill. D/P stands for documents against payment. The holder of a D/P bill does not face the risk of non-payment.

Bill of Lading : Also known as BOL or B/L, a Bill of Lading is evidence of a contract between the carrier (transporter) and the exporter to deliver the goods to a designated party (the importer, called the named consignee) at a specified destination in the importer's country.

It is an extremely important document in international trade, and has the following features :

- It is a document to title of the goods being transported.
- It is a receipt for the goods.
- It is an acknowledgement that the carrier (shipping company) has received the goods to be delivered to the importer.
- It describes the goods received for transportation, the name of the port where they were loaded and the name of the port where they will be unloaded.
- The holder of a Bill of Lading has the title to the goods. The exporter gives the Bill of Lading (through his bank) to the importer who can take possession of the goods from the carrier when the goods reach his country only by submitting it.

The Different Types of Bills of Lading are Discussed Below:

- **Clean Bill:** If the goods received by the carrier (shipping company), are undamaged and in good condition, the carrier does not note the Bill of Lading. This is known as a Clean B/L.
- **Foul Bill:** If the goods were received in a damaged condition, the carrier (shipping company) notes this on the bill. This is known as a Foul or Dirty or Claused Bill of Lading. The exporter's bank or the importer's bank (or both) can reject such a B/L.
- **On Board Bill:** When the carrier (shipping company) issues a Bill of Lading after the goods have been loaded onto the ship, it is called an 'On Board' B/L.
- **Received for Shipment Bill:** When the carrier (shipping company) issues a Bill of Lading on receipt of the goods but before loading has commenced, it is called a Received for Shipment' B/L. Once the goods have been loaded, it is stamped as On Board.
- **Straight Bill:** It is also called a consignment bill. It is a Bill of Lading that mentions a specific party (the importer) to whom the goods will be delivered by the carrier. The bill is non-negotiable, and is not transferable by endorsement and delivery. Therefore, mere possession of the bill by any party other than the importer does not confer title to the goods. The Straight bill states that the carrier has undertaken to hand over the goods to the importer when the latter presents identification to that effect.
- **Order Bill:** The exporter may not want title of the goods to pass to the importer when he holds the document. Therefore, the Bill of Lading states that the goods are made deliverable to the exporter himself, or the shipping company or 'order' (this may be the importer's bank) As a result, title to the goods does not pass on to the importer unless the bill is endorsed by the holder (who is the exporter himself, or the shipping company, or the importer's bank, as the case may be). This is known as an Order B/L. Here, the shipping company has to notify the importer that the goods have arrived in

the importer's country. The importer has to present the endorsed Bill of Lading, and only then will he be permitted to take possession.

- **Port-to-Port Bill:** If the goods have to be transported by more than one carrier (multi-modal transport) until the goods reach the importer's country, then all the carriers are responsible for the safe delivery of the goods to the destination. The Bill of Lading given by the first carrier to the exporter, is enough to fix the responsibility for transportation by subsequent transporters. This is known as a Port-to-Port B/L
- **Airway Bill:**It is a non-negotiable bill for transport of goods by air. It does not transfer title to the goods to the holder. There are a few differences between a Bill of Exchange and a Bill of Lading. The Bill of Exchange originates from the exporter. It is drawn by the exporter on the importer. When the importer accepts the bill, he is legally obligated to make payment in accordance with the terms of the bill. On the other hand, a Bill of Lading originates from the transporter. It is a document evidencing receipt of goods by the transporter. It imposes a legal obligation on the transporter to transport the goods to the destination specified.

4.5 LETTER OF CREDIT (L/C) :

An L/C is an undertaking given by the importer's bank (called issuing bank) acting upon the request of the importer, that it will make payment to a beneficiary (the exporter). An L/C involves a minimum of four parties – the importer, importer's bank(issuing bank), exporter and the exporter's bank (advising bank).

An L/C imposes the superior creditworthiness of the importer's bank over that of the importer, and protects the exporter from credit risk and risk of non-payment.

Different Types Of L/Cs :

- **Clean L/C:** If the issuing bank agrees to make payment to the exporter under the terms of the L/C without any documents relating to the international trade transaction being presented to it, the L/C is called a clean L/C.
- **Documentary L/C:** If the issuing bank will release payments only when the exporter submits all relevant documents, it is called a documentary L/C.
- **Fixed L/C:** The L/C limit gets reduced as and when Bills of Exchange are presented by the exporter for payment. It is also called non-revolving L/C. If the L/C was opened for Rs. 1 million, and a bill of exchange for the Rs. 400,000 was presented by the bank to the exporter, then the L/C gets reduced to Rs. 600,000.
- **Revolving L/C:** The L/C limit gets renewed after payment is released by the issuing bank. Taking the above example of an L/C opened for Rs. 1 million, if a bill of exchange for Rs. 400,000 was presented by the bank to the exporter, then the L/C gets restored to the original amount of Rs. 1 million. This is called restoration of utilized amount. A new L/C does need to be opened even when the entire Rs. 1 million is used up. The number of utilizations and the time period is specified in the L/C. The bank's advantage from a revolving L/C is that it will not have to incur costs (and therefore has cost savings) on making changes (called 'amendments') in a non-revolving L/C.
- **Confirmed L/C:** Though the issuing bank guarantees payment to the exporter under an L/C, the exporter might want his bank to offer further guarantee that he will receive the payment. A confirmed L/C is one in which the advising bank (exporter's bank) gives an additional undertaking to make the payment.
- **Unconfirmed L/C:** It is an L/C that does not carry the additional guarantee by the advising bank.

- **Transferable L/C:** The exporter informs his bank that the payment should be made by the issuing bank to a specified third party (the new beneficiary), and this is noted on the L/C. Such an L/C is called a transferable L/C or a transferred credit.
- **Non-Transferable L/C:** The exporter cannot transfer the beneficiary status to someone else. If nothing is mentioned in the L/C, it is deemed to be non-transferable. Countervailing credit is the term used when the exporter's bank issues a separate L/C in favour of the new beneficiary.
- **Revocable L/C:** If the issuing bank has the right to cancel or amend the L/C any time after its issue without informing the exporter of the cancellation, it is called a revocable L/C or a revocable credit. For the exporter, a revocable L/C carries the risk of cancellation, and offers him no safety. So it is rarely used in international trade.
- **Irrevocable L/C:** If the issuing bank cannot cancel or change the L/C after it has been issued unless the exporter agrees to the cancellation or the changes as the case maybe, it is called an irrevocable L/C The International Chamber of Commerce published Uniform Customs and Practices (UCP) for an L/C in 1933. The UCP rules are used all over the world and have led to standardization of practices. They were amended in 1951, 1962, 1974, 1983, 1993, and 2006. The latest rules, called UCP 600 came into effect in July 2007. Since an L/C is standardized and can be structured to be irrevocable, transferable, and confirmed, it is a very popular method of short-term finance in international trade.

4.6 CERTIFICATE OF ORIGIN OF GOODS (COO) :

The certificate of origin is an instrument that establishes the origin of goods imported into a country. The rules of 'origin' were framed by the WTO. Sometimes the importer's country may ban the import of goods from specific countries. If the country of origin is not on the 'banned' list of countries, the certificate of origin enables the importer to bring the goods into his country. Similarly, if the importer's country gives tariff concessions to goods imported from specified countries, the COO is proof that the goods are eligible for this tariff reduction, since they have been imported from one of the specified countries.

TWO CATEGORIES OF COO :

- A preferential COO extends tariff concessions. Developed countries use it to give tariff concessions to developing countries. For example, India's trade agreement with Singapore requires a COO to claim tariff concessions.
- A non-preferential COO does not give any tariff concessions, but merely provides evidence of origin.
- So important is the COO in Free Trade Agreements (FTAs), that several paragraphs in an FTA contain details about the COO issue process, the validity of a COO, and the care that a country should take in issuing COOs. MERCUSOR was a treaty signed in 1991 by four countries—Argentina, Brazil, Paraguay and Uruguay—to improve their inter country trade. It now has ten Latin American signatory countries—Argentina, Brazil, Bolivia, Chile, Columbia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela.

India's free trade agreement with MERCUSOR contains the following provisions with respect to the COO:

- The COO is valid for only one importing operation concerning one or more goods.
- The original COO should be included in the documentation to be presented at the customs authorities of the importing signatory party.

- The issue and control of COO is the responsibility of a government office in each signatory party.

- The Origin Certificate shall be issued not later than five working days after the request presentation. It is valid for a period of 180 days from the date of its issue.

4.7 INSPECTION CERTIFICATE :

This is issued by an independent third party (such as an independent inspection agency, or the supplier of the goods) stating that the goods have been inspected and conform to the quality/specification/other contractual terms.

4.8 PACKING LIST :

When the goods are in packages, the packing list gives details of the goods in each package.

4.9 CONSULAR INVOICE :

It is an invoice that describes the goods being transported. The exporter authenticates the accuracy of the invoice by appearing before the Importer country's Consul who is stationed in the exporter's country.

4.10 INSURANCE DOCUMENT :

To protect goods in transit from loss or damage from the time they leave the exporter's warehouse and until they reach the importer's warehouse, the goods are insured by the importer. The insurance cover must specify the value insured (such as CIF), the risks covered, the date from which the insurance cover is effective, and the currency in which the insurance document is expressed. All details regarding the goods in the insurance document must conform to those given in other documents such as the bill of Lading, or the consular invoice.

4.11 SUMMARY :

When it comes to international trade, the process of buying and selling can be prolonged, and often complicated. So, it's understandable to feel relieved after concluding a sale with the other party and agreeing on a price. But agreeing on a price is only one part of the payment process. You still need to agree on how payment will be made, and when. This is where payment terms come in. Payment terms are the conditions that parties in international trade agree on to complete payment. They are often referred to as the methods of payment that exporters and importers can utilize to finalize their trade deal. Payment terms deal with many important issues relating to the trade deal. These include whether payment will be made before delivery, who retains ownership of the goods before delivery, and how payment will be made.

4.12 KEY WORDS :

- **D/A bill:** A document against acceptance (D/A) is an international trade agreement between an exporter and an importer. Exporters send this document to banks.

- **Clean L/C - Clean:** A letter of credit that requires the beneficiary to present only a draft or a receipt for specified funds before receiving payment. - Confirmed: An L/C guaranteed by both the issuing and advising banks of payment so long as seller's documents are in order, and the L/C terms are met.

- **Revolving L/C:** A Revolving LC is a type of Letter of Credit between two trading parties set over a particular period of time – it is intended to cover shipments over an extended period. It is used for repeated shipments of the same product between the same purchaser (importer) and supplier (exporter).
- **Straight bill:** A straight bill of lading is generally accepted to be one that makes the goods deliverable to a named consignee and either contains no words importing transferability or contains words negating transferability (such as "non-transferable").
- **Foul bill:** Foul bill of lading. A receipt for goods issued by a carrier with an indication that the goods were damaged or short in quantity when received.

4.13 SELF – ASSESSMENT QUESTIONS :

1. What are the documents used in foreign trade?
2. Write a note on the role of bill of exchange in foreign trade.
3. What are the different types of bills of lading?

4.14 FURTHER READINGS :

1. Payment Methods and Finance for International Trade – by Sang man kim
2. Principles of International Trade and Payments - Peter Briggs
3. Money, banking international trade and public finance - by M.L. Seth

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LESSON - 5

BALANCE OF TRADE

AIMS AND OBJECTIVES :

After studying this chapter, you will be able:

- To Know about the Balance of Trade
- To understand various Types of balance of trade
- To compare Between Trade Balance and Balance of Payments

STRUCTURE :

5.1 INTRODUCTION :

Trade offers many advantages, such as increasing quality of life and fueling economic growth. However, trade can be used politically through embargoes and tariffs to manipulate trade partners. It also comes with language barriers, cultural differences, and restrictions on what can be imported or exported. Additionally, intellectual property theft becomes an issue because regulations and enforcement methods change across borders.

Because countries are endowed with different assets and natural resources, some may produce the same good more efficiently and sell it more cheaply than others. Countries that trade can take advantage of the lower prices available in other countries. Here are some other benefits of trade: i. It increases a nation's global standing ii. It raises a nation's profitability iii. Creates jobs in import and export sectors iv. Expands products variety v. Encourages investment in a country globally vi. Criticisms of Trade

Types of Trade: Generally, there are two types of trade—domestic and international. Domestic trades occur between parties in the same countries. International trade occurs between two or more countries. A country that places goods and services on the international market is exporting those goods and services. One that purchases goods and services from the international market is importing those goods and services.

Domestic trade : Domestic trade refers to the exchange of goods or services within an individual country or territory. In this type of trade scenario, the market is constrained by the borders of that country, so that all products must be bought and sold by people living within the domestic market. Domestic trade is the opposite of international trade, where goods are sold freely between different countries. Both domestic and international trade play an important role in the modern economy, both at the local and global levels.

Throughout early history, people were limited to domestic trade due to a lack of access to international markets. As transportation improved, many countries turned from a purely domestic market to an international one, which introduced new products into the region. Examples of this include the Silk Road, as well as early voyages to seek out spices, salt and gold. Today, a simple domestic market is likely to be found only in small villages or underdeveloped nations. Most larger countries rely on a mix of domestic and international trade to grow the economy and maximize product selection.

For businesses, domestic trade offers a number of advantages over international trade. Transaction costs associated with making sales tend to be much lower for domestic markets due to a lack of tariffs and customs duties. Transportation costs are also much lower, and goods can be put on the market more quickly because they have a shorter distance to travel.

Domestic trade also provides benefits to society as a whole. Buying local goods helps to keep money within a country, where it contributes to long- and short-term growth. It also encourages investment and development within the country, and eliminates the country's dependence on foreign lands. This means that political issues or wars will have less of an effect on the economy than they otherwise would. For example, countries with few manufacturing plants are likely to struggle during wartime, as they will have difficulty obtaining equipment and weapons from a country they may be feuding with.

International Trade: International trade results in increased efficiency and allows countries to benefit from foreign direct investment (FDI) by businesses in other countries. FDI can bring foreign currency and expertise into a country, raising local employment and skill levels. For investors, FDI offers company expansion and growth, eventually leading to higher revenues.

Features of Foreign Trade (Export/ Import) :

1. Import dependency (our country foreign trade depend on import because of high demand and low supply),
2. Import capital goods and industrial goods,
3. Export of readymade garments (RMG), RMG and Knitwear 74% export,
4. Export of agricultural raw materials and products,
5. Unfavorable balance of payment (More import but less export),
6. Operate most business by sea/ocean,
7. More import from Asia (China, Singapore, India) and export in Western countries (USA, England),
8. Government initiation and control (By TCB and EPB govt control foreign trade and operate helpful initiative),
9. Export of jute and jute goods,
10. Export of manpower,
11. Private initiative,
12. Diversity of import goods (necessary goods and unnecessary luxurious goods).
13. Effect of free trade economy (for open market economy unnecessary luxurious goods are imported in our country, and our country’s money went to another country)
14. Business with all countries.

International trade occurs when countries put goods and services on the international market and trade with each other. Without trade between different countries, many modern amenities people expect to have would not be available. In international trade, the comparative advantage theory states that trade benefits all parties. Most classical economists advocate for free trade, but some development economists believe protectionism has advantages. When two countries trade, they can each have a comparative advantage and benefit each other. For instance, imagine a country that has limited natural resources. One day, a shepherd stumbled upon an abundant cheap and renewable energy source only occurring within that country's borders that could provide enough clean energy for its neighboring countries for centuries. As a result, this country would suddenly have a comparative advantage it could market to trading partners.

Comparative Advantage : Comparative advantage is one country's ability to produce something better and more efficiently than others. Whatever the item is, it becomes a powerful bargaining tool because it can be used as a trade incentive for trading partners. Imagine a neighboring country has a booming lumber trade and can manufacture building supplies much cheaper than the country with the new energy source, but it consumes a lot of energy to do so. The two countries have comparative advantages that can be traded beneficially for both.

Example of Comparative Advantage : While the law of comparative advantage is a regular feature of introductory economics, many countries try to shield local industries with tariffs, subsidies, or other trade barriers. One possible explanation comes from what economists call rent-seeking. Rent-seeking occurs when one group organizes and lobbies the government to protect its interests. For example, business owners might pressure their country's government for tariffs to protect their industry from inexpensive foreign goods, which could cost the livelihoods of domestic workers. Even if the business owners understand trade benefits, they could be reluctant to sacrifice a lucrative income stream. Moreover, there are strategic reasons for countries to avoid excessive reliance on free trade. For example, a country that relies on trade might become too dependent on the global market for critical goods. Some development economists have argued for tariffs to help protect infant industries that cannot yet compete on the global market. As those industries grow and mature, they are expected to become a comparative advantage for their country.

What is Balance of Trade? :

The balance of trade (BOT) is defined as the difference between the value of exports and the value of imports of a country. The figure that is derived shows how economically stable a nation is. It is one of the significant components of any economy’s current asset as it measures a country’s net income earned on global investments.

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The existing account also takes into consideration all payments across country borders. Essentially, the trade balance is easy to measure as all goods and services pass through the customs office and are thus recorded.
Balance of trade refers to the difference in value between the country's imports and exports of goods and services over time . A trade surplus or deficit is not always an economy's health final indicator. One must consider it along with the business cycle and other economic indicators. A trade deficit is a more favorable trade balance depending on the country's business cycle stage.. Some countries are opposed to trading deficits. They adopt mercantilism to control them.

A country's trade balance equals the value of its exports minus its imports. Exports are goods or services made domestically and sold to a foreigner. That includes a pair of jeans you mail to a friend overseas. It could also be signage a corporate headquarter transfers to its foreign office. A favorable balance of trade, also known as a trade surplus, occurs when a country exports more goods than it imports. This means that the country is earning more from its exports than it is spending on its imports, and it is generally seen as a sign of economic strength. Balance of Trade deficit. If the value of imports is greater than the value of exports we say a country has a trade deficit. This can occur for various reasons such as: Falling comparative advantage in manufactured goods. Overvalued exchange rate – causing exports to be more expensive and imports cheaper. Balanced trade is a condition in which an economy runs neither a trade surplus nor a trade deficit. A balanced trade model is an alternative to a free trade one because a model that obliges countries to match imports and exports to ensure a zero balance of trade would require various interventions in the market to secure this outcome.

Balance of Trade Explained : The balance of trade is one of the significant components for any economy's **current asset** as it measures a country's net income earned on global investments. Current Assets can be defined as a firm's ability to convert the value of all assets into cash within a year. It can range from businesses like retail, Pharmaceuticals, or oil, depending upon its nature. If a company has cash, short-term investments, and cash equivalents, it will generate better returns by using such Assets. Even the value of a firm, the financial health of a firm is determined by a company's current assets. Using such Assets makes it a great way to evaluate a firm's ability to provide funding to its operations.

An economy with a **trade surplus** lends money to deficit countries, whereas an economy with a large trade deficit borrows money to pay for its goods and services. In addition, in some cases, the trade balance may correlate to a country's political and economic stability, reflecting the amount of foreign investment. Therefore, most nations view this as a favorable trade balance. The trade surplus is a growth indicator that signifies the up liftment of any economy. It is also known as the positive trade balance and is calculated as the difference between an economy's export value and import value. It occurs when the outcome is positive, whereas a trade deficit occurs when the result is negative. The Bureau of Economic Analysis offers information on the United States' trade balances.

When exports are less than imports, it is known as a trade deficit. Countries usually regard this as an unfavorable trade balance. However, there are instances when a surplus or favorable trade balance is not in the country's best interests. For a balance of trade examples, an emerging market, in general, should import to invest in its **infrastructure**. Infrastructure is critical to the economic stability of a country or business. It mainly consists of physical components that necessitate proper funding, oversight, and regulation. Building and establishing these structures involve a great deal of initial investment. However, the resulting benefits add to the regional and organizational economy, making the return worth the investment.

Infrastructure networks can be visible, like bridges, railroads, power transmission lines, etc., or hidden, such as underground drinking water and gas pipelines. These arrangements help make daily requirements accessible to everyone in an area. For example, a freight train transports food, water, clothes, etc., making these essential commodities available to people in different cities or towns.
Common **debit** items include **foreign aid**, imports, domestic spending abroad, and domestic investments abroad. In contrast, credit items include foreign spending in the domestic economy, exports, and foreign investment in the domestic economy.

5.2 WHAT IS A TRADE DEFICIT? :

Trade deficit is said to take place when the imports done by a country exceed that of the exports done by a country in a fiscal year. The trade deficit is also termed as the negative balance of trade. Trade deficit is a way of measuring the extent to which international trade is happening between the countries of the world. Trade deficit can be calculated for different types and categories of goods and services and for international transactions such as current account, financial account and capital account. Trade deficit is said to occur when there is a negative balance in an international transaction account. These international accounts like balance of payments keep track of all the transactions of monetary nature between the residents and non-residents.

A trade deficit occurs when a country's imports exceed its exports during a given time period. It is also referred to as a negative balance of trade (BOT).

The balance can be calculated on different categories of transactions: goods (a.k.a., “merchandise”), services, goods and services. Balances are also calculated for international transactions—current account, capital account, and financial account.

A trade deficit occurs when a country's imports exceed its exports during a given period. Balances are calculated for several categories of international transactions. Trade deficits can be shorter or longer term.. Implications of a trade deficit depend on impacts on production, jobs, national security and how the deficits are financed.

Understanding Trade Deficits :

- ❖ A trade deficit occurs when there is a negative net amount or negative balance in an international transaction account. The balance of payments (international transaction accounts) records all economic transactions between residents and non-residents where a change in ownership occurs.
- ❖ A trade deficit or net amount can be calculated on different categories within an international transaction account. These include goods, services, goods and services, current account, and the sum of balances on the current and capital accounts.
- ❖ The sum of the balances on the current and capital accounts equals net lending/borrowing.
- ❖ This also equals the balance on the financial account plus a statistical discrepancy. The financial account measures financial assets and liabilities, in contrast to purchases and payments in the current and capital accounts.
- ❖ The most relevant balance depends on the question being asked and the country about which it is being asked. In the U.S., the International Transaction Accounts are published by the Bureau of Economic Analysis.

- The current account includes goods and services, plus primary and secondary income payments.
- Primary income includes payments (financial investment returns) from direct investment (greater than 10% ownership of a business), portfolio investment (financial markets), and other.
- Secondary income payments include government grants (foreign aid) and pension payments, and private remittances to households in other countries (e.g., sending money to friends and relatives).
- The capital account includes exchanges of assets such as insured disaster-related losses, debt cancellation, and transactions involving rights, like mineral, trademark, or franchise.
- The balance of the current account and capital account determines the exposure of an economy to the rest of the world, whereas the financial account (tracking financial assets, rather than products or income flows) explains how it is financed. In principle, the sum of the balances of the three accounts should be zero, but there is a statistical discrepancy because of source data used for the current and capital accounts is different from the source data used for the financial account.
- Trade deficits occur when a country lacks efficient capacity to produce its own products – whether due to lack of skill and resources to create that capacity or due to preference to acquire from another country (such as to specialize in its own goods, for lower cost or to acquire luxuries).

Causes of Trade Deficit :

The causes of trade deficit are as follows:

1. When a country does not produce everything, it needs and imports products from other countries and pays import taxes, it causes a trade deficit. This is known as the current action deficit.
2. It can also occur when companies are involved in the manufacturing of products in a foreign country. The raw materials required for manufacturing are exports, while the finished goods imported to the country are imports.

Impact of Trade Deficit :

The impacts of the trade deficit are as follows:

1. Initially, it increases the standard of living, as residents have access to large varieties of products.
2. If the trade deficit persists, then the government needs to find more foreign exchange to bridge the gap, which leads to the weakening of the local currency.
3. A higher trade deficit makes it necessary for finding investors of foreign origin to reduce the import-export gap.
4. A higher trade deficit leads to jobs being outsourced to foreign countries as more imports lead to fewer job opportunities.
5. Demand for imported goods leads to a decline in demand for locally made goods, which leads to the closing of factories and the associated job losses.

Advantages of Trade Deficits : The most obvious benefit of a trade deficit is that it allows a country to consume more than it produces. In the short run, trade deficits can help nations to avoid shortages of goods and other economic problems. In some countries, trade deficits correct themselves over time. A trade deficit creates downward pressure on a country's currency under a floating exchange rate regime. With a cheaper domestic currency, imports become more expensive in the country with the trade deficit. Consumers react by reducing their consumption of imports and shifting toward domestically produced alternatives. Domestic currency depreciation also makes the country's exports less expensive and more competitive in foreign markets. Trade deficits can also occur because a country is a highly desirable destination for foreign investment. For example, the U.S. dollar's status as the world's reserve currency creates a strong demand for U.S. dollars. Foreigners must sell goods to Americans to obtain dollars. According to the U.S. Treasury Department, foreign investors held over four trillion dollars in Treasuries as of October 2019. Other nations had to run cumulative trade surpluses with the U.S. totaling over four trillion dollars to buy those Treasuries. The stability of developed countries generally attracts capital, while less developed countries must worry about capital flight.

The advantages of having the trade deficit are as follows:

1. It allows a country to consume more than its production capacities.
2. It helps nations to avoid any shortfall in goods.
3. It provides the countries with a comparative advantage when such countries are involved in the trade. It is beneficial as a whole for increasing global wealth.
4. It allows generating more foreign direct investment

Disadvantages of Trade Deficits : Trade deficits can create substantial problems in the long run. The worst and most obvious problem is that trade deficits can facilitate a sort of economic colonization. If a country continually runs trade deficits, citizens of other countries acquire funds to buy up capital in that nation. That can mean making new investments that increase productivity and create jobs. However, it may also involve merely buying up existing businesses, natural resources, and other assets. If this buying continues, foreign investors will eventually own nearly everything in the country.

Trade deficits are generally much more dangerous with fixed exchange rates. Under a fixed exchange rate regime, devaluation of the currency is impossible, trade deficits are more likely to continue, and unemployment may increase significantly. According to the twin deficits hypothesis, there is also a link between trade deficits and budget deficits. Some economists believe that the European debt crisis was caused in part by some EU members running persistent trade deficits with Germany. Exchange rates can no longer adjust between countries in the Euro zone, making trade deficits a more serious problem.

The disadvantages of the trade deficit are as follows :

1. It is harmful to a developing country as more imports lead to deflation and increase the fiscal deficit.
2. More jobs are outsourced, as domestic industries shrink with less demand when demand for foreign goods increases.
3. In the form of attracting foreign investment due to the trade deficit, the country may end up providing ownership of its resources and assets to the foreign country.
4. A higher trade deficit leads to a decrease in the value of the local currency.

5.3 MEASURING THE ECONOMIC GROWTH OF A NATION, ALONG WITH THE GDP :

Most countries are both importers and exporters. They sell goods that they have in abundance to other countries, while using international markets to buy any products that are in short supply domestically. When the balance between imports and exports becomes skewed, a country can find itself in a trade surplus or trade deficit. A trade deficit occurs when a country imports more than it exports. In other words, when a country buys more than it sells, it has a trade deficit. The word “deficit” can have negative connotations; we use it to mean lacking or to describe shortages. When used in the context of global trade, this often leads to an assumption – that trade deficits are unequivocally negative for economies. Let's address two of the biggest misconceptions.

Trade deficits are bad: They can be – but not exclusively. Notably, trade deficits allow countries to consume more than they produce. This can help increase economic activity and boost living standards.

The World Economic Forum's Global Future Council on Trade (GFCT) takes the view that; "trade deficits are not necessarily bad and are not a measure of whether trade policies or agreements are fair or unfair". The GFCT concludes "there is no straightforward relationship between the state of a nation's trade balance and the state of its economy".

The United States, one of the world's most powerful economies, has run a trade deficit since the 1970s as the chart below illustrates. The US trade deficit has persisted since the mid-1970s. Image: Federal Reserve Bank of St Louis. The Congressional Research Service (CRS), a US government policy research organization, notes that "most economists conclude the trade deficit stems largely from U.S. macroeconomic policies and an imbalance between saving and investment in the economy". It adds that "trade creates both economic benefits and costs, but that the long-run net effect on the economy as a whole is positive".

Trade deficits lead to job losses : When a large trade deficit exists between nations, it is frequently accompanied by assertions that excess imports are destroying jobs in the local manufacturing sector. This claim, however, is often unsupported, according to experts. The United States, for instance, has a significant trade deficit with China, and attempts to reduce the deficit have largely failed to increase US manufacturing jobs.

"Most economists argue that equating a trade deficit, whether on a bilateral basis or overall, with unemployment or job losses is questionable given the macroeconomic origin of the trade deficit and the relatively limited role that trade plays in the overall U.S. economy," the CRS report added.

Analysis from the Center for Strategic International Studies (CSIS) in 2021 also paints a nuanced picture of the relationship between US trade and jobs. "The net effect of trade saw a loss of 3.5 million workers," the CSIS report notes, before adding: "This number is not large when compared to the size of the labor force (over 150 million) or the growth in employment by 40 million jobs from 1991 to 2019".

Hidden causes and hidden effects :: Bilateral trade imbalances- The study concludes that efficiencies in the US manufacturing sector had a much greater impact than trade on the decline of manufacturing jobs as a percentage of the wider US workforce. "The bottom line is that almost the entire decline from 32 percent of the labor force in 1955 to 8 percent in 2019 was not caused by imports but by higher productivity," CSIS states. Today, with economic indicators flashing red, the WTO is urging nations to avoid protectionist trade policies.

"While trade restrictions may be a tempting response to the supply vulnerabilities that have been exposed by the shocks of the past two years, a retrenchment of global supply chains would only deepen inflationary pressures, leading to slower economic growth and reduced living standards over time," WTO Director-General Ngozi Okonjo-Iweala warned in a recent statement. "What we need is a deeper, more diversified and less concentrated base for producing goods and services."

5.4 TYPES OF BALANCE OF TRADE :

As briefly stated above, there are two types of balance of trade – favorable/positive trade balance or trade surplus, and unfavorable/negative trade balance or trade deficit.

a) Favorable/Positive Trade Balance: The balance of trade is positive and favorable when an economy's exports are more than its imports. Most countries work to create policies that encourage a trade surplus in the long term. They consider surplus a favorable trade balance because it makes a country profit. In addition, nations prefer to sell more products when compared to buying products that receive more capital for their residents, which translates into a higher standard of living. It is also beneficial for their companies to gain a competitive advantage in expertise by producing exports. That results in more employment as companies employ more workers and generate more income. But in certain conditions, a trade deficit is a more favorable balance of trade, depending on the stage of the business cycle the country is currently in. Let us take another balance of trade example – Hong Kong, in general, always has a trade deficit. But it is perceived as positive since many of its imports are raw materials which convert into finished goods and finally exports. That gives it a competitive advantage in manufacturing and finance and creates a higher standard of living for its people. Another balance of trade example is Canada, whose small trade deficit results from economic growth. As a result, its residents enjoy a better lifestyle afforded only by diverse imports.

Unfavorable/ Negative Trade Balance :

This is the situation that arises when a country imports more than it exports. Also termed as trade deficits, such situations lead to an unfavorable trade balance for a country. As a criterion, geographies with trade deficits export only raw materials and import many consumer products. Domestic businesses of such countries do not gain experience with the time needed to make value-added products in the long run as they are the main raw material exporter. Thus, the economies of such countries become dependent on global commodity prices.

Some countries are so opposed to trading deficits that they adopt mercantilism to control them. That is considered an extreme form of economic nationalism that removes the trade deficit in every situation. It advocates protectionist measures such as import quotas and tariffs. Although these measures may reduce the deficit in the short run, they raise consumer prices. Along with this, such actions trigger reactionary protectionism from other trade partners.

Formula : The balance of trade formula is as follows:
Balance of Trade = Country's Exports – Country's Imports.

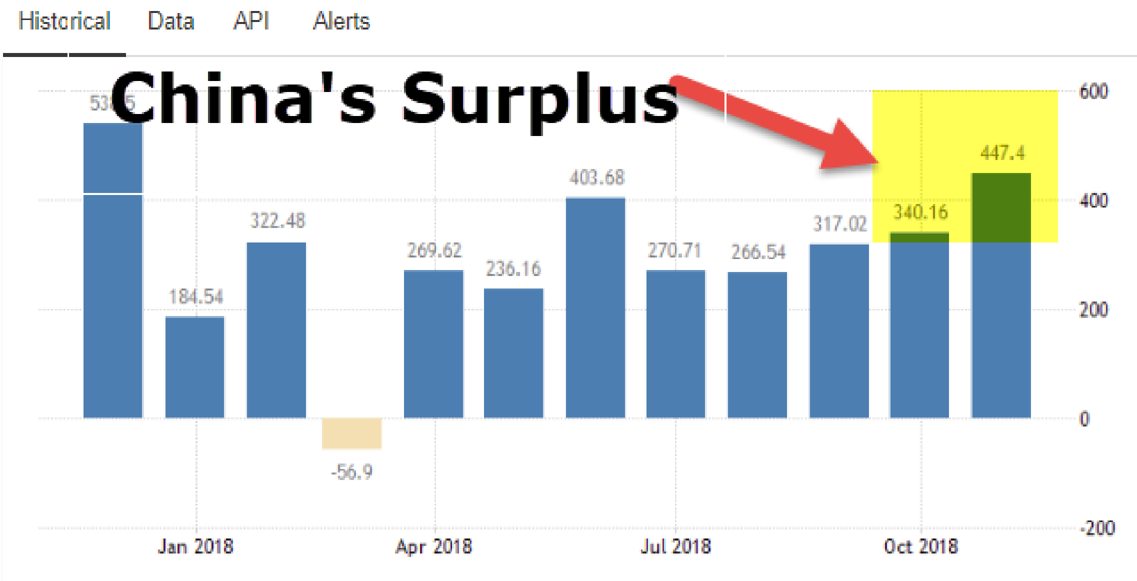
For example, suppose the USA imported $1.8 trillion in 2016 but exported $1.2 trillion to other countries. Then, the USA had a trade balance of -$600 billion, or a $600 billion trade deficit.

$1.8 trillion in imports – $1.2 trillion in exports = $600 billion trade deficit

Examples :

Let us consider the example to see how to calculate the balance of trade figures:
The US has had a trade deficit since 1976, whereas China has had a trade surplus since 1995.

source: tradingeconomics.com



A trade surplus or deficit is not always a final indicator of an economy's health. It must be considered along with the business cycle and other economic indicators. For example, for the balance of trade examples in economic growth, countries prefer to import more to promote price competition, limiting inflation. Conversely, in a recession, governments export more to create economic jobs and demand.

5.5 IMPORTANCE OF BALANCE OF TRADE :

To understand the balance of trade definition more clearly, it is important to know how it enables analysts to learn if an economy is advancing towards growth and progress. Here are a few points to show how it proves to be helpful:

i. The balance of trade and the balance of payment are interrelated as the former helps in calculating the latter. The difference between the balance of trade and the balance of payment is that the first one is the difference between a country's exports and imports figures, while another derives the figure to show how much a country owes to another country and how much is owed to it,
ii. To maintain the balance of trade, countries dive into international trade, which boosts the foreign trade sector, and leads to the development of better trade policies.
iii. It plays a great role in maintaining the Gross Domestic Product (GDP) of a country.
iv. It encourages foreign exchange reserves as international trade gets a significant boost.

Balance of Trade: Favorable Versus Unfavorable : The balance of trade is the value of a country's exports minus its imports. It's the biggest component of the balance of payments that measures all international transactions. It's easy to measure since all goods and many services pass through the customs office. The trade balance is also the biggest part of the current account. It measures a country's net income earned on international assets. It's the trade balance plus any other payments across borders. A positive trade balance (surplus) is when exports exceed imports. A negative trade balance (deficit) is when exports are less than imports. Use the balance of trade to compare a country's economy to its trading partners. A trade surplus is harmful only when the government uses protectionism. A trade deficit can be beneficial to countries that import heavily and simultaneously invest in economic development.

How to Calculate It : A country's trade balance equals the value of its exports minus its imports. The formula is X - M = TB, where: X = Exports, M = Imports, TB = Trade Balance[1.] Exports are goods or services made domestically and sold to a foreigner. That includes a pair of jeans you mail to a friend overseas. It could also be signage a corporate headquarter transfers to its foreign office. If the foreigner pays for it, then it's an export. Imports are goods and services bought by a country's residents but made in a foreign country. It includes souvenirs purchased by tourists traveling abroad. Services provided while traveling, such as transportation, hotels, and meals, are also imports. It doesn't matter whether the company that makes the good or service is a domestic or foreign company. If it was purchased or made in a foreign country, it's an import. When a country's exports are greater than its imports, it has a trade surplus. When exports are less than imports, it has a trade deficit. On the surface, a surplus is preferable to a deficit. However, this is an overly simplistic assumption. A trade deficit is not inherently bad, as it can be indicative of a strong economy. Moreover, when coupled with prudent investment decisions, a deficit can lead to stronger economic growth in the future.

Favorable Trade Balance : Many countries implement trade policies that encourage a trade surplus. These nations prefer to sell more products and receive more capital for their residents, believing this translates into a higher standard of living and a competitive advantage for domestic companies. For some, this holds true, especially over the short term. Unfortunately, to maintain a trade surplus, some nations resort to trade protectionism. They defend domestic industries by levying tariffs, quotas, or subsidies on imports. Soon, other countries react with retaliatory, protectionist measures, and a trade war ensues. Inevitably, this results in higher costs for consumers, reduced international commerce, and diminished economic conditions for all nations.

Unfavorable Trade Balance : Sometimes, a trade deficit can be unfavorable for a nation, especially one whose economy relies heavily on the export of raw materials. Generally, this type of nation imports a lot of consumer products. As a result, its domestic businesses don't gain the experience needed to make value-added products. Rather, its economy becomes increasingly dependent on global commodity prices, which can be highly volatile. Some countries are so opposed to trade deficits that they adopt mercantilism, an extreme form of nationalism that seeks to achieve and maintain a trade surplus at all costs. Mercantilism advocates protectionist measures, such as tariffs and import quotas.[2] While these measures can prove effective in increasing the balance of trade, they typically lead to retaliatory acts of protectionism, which result in higher costs for consumers, reduced international trade, and diminished economic growth.

5.6 DIFFERENCE BETWEEN TRADE BALANCE AND BALANCE OF PAYMENTS :

The balance of trade is the most significant component of the balance of payments. The balance of payments adds international investments plus net income made on those investments to the trade balance. A country can run a but still have a surplus in its balance of payments. A large surplus in investments could offset a trade deficit. That can only occur if the financial account runs a huge surplus. For example, foreigners could invest heavily in a country's assets. They could buy real estate, own oil drilling operations, or invest in local businesses. The capital account records assets that produce future income, such as copyrights. As a result, it would rarely run a surplus large enough to offset a trade deficit.

What is a Trade Deficit? What causes a Trade Deficit? :

- A trade deficit, also known as a trade gap, is a negative commercial trade balance. It occurs when a nation imports more products and services than it exports, more specifically, when the *value* of its imports exceeds those of its exports. If a country exports $100 billion and imports $110 billion, it has a trade deficit of $10 billion. The opposite – when the value of its exports exceeds those of its imports – is a trade surplus.
- Imports are the goods and services people buy from abroad, while exports are those that are sold to foreigners. They are both the major components of international trade.
- This means that a country with a trade deficit has an outflow of domestic currency to foreign markets that is greater than the inflow.
- Even though most of us think that being in a situation where a country is importing more than it exports is not good, economists insist this is not necessarily so.
- Any imbalance in trade should eventually correct itself over time, so several experts believe.
- Do trade balances self-correct?
- Are they right? Recently this belief that a trade balance corrects itself has been subject to a lot of scrutiny and controversy. An example is the United States, which has experienced decades-long and growing deficits.
- Economists express concern at the growing quantity of US dollars being held abroad by nations that can sell them at any time, which would cause the value of the US currency to plummet, thus making imported goods much more expensive, to say nothing of the effect it could have on inflation.

A country can function properly if it runs a trade deficit when other nations provide funds in the form of loans to purchase the excess imports.

The causes of a trade deficit:

i. Domestic companies have located most of their production facilities abroad. This means their goods are imported when sold to the home market.
ii. A country cannot produce enough to meet the needs of its population – the shortfall has to be met by bringing goods in from abroad.

The initial effects of a trade deficit:

i. Initially raises the standard of living as people have more access to a wider variety of goods.
ii. It reduces the threat of inflation – as products are priced competitively.
iii. It is also an indication of a wealthy population, whose purchasing power exceeds domestic production.

The lasting effects of a trade deficit:

i. Companies begin to progressively seek outsourcing opportunities.
ii. Local companies start going bust as domestic demand shifts to foreign-made products.
iii. The country with the trade deficit creates fewer jobs, while more are created in the nations where the imported products come from.

5.7 HOW GOVERNMENTS TRY TO TACKLE A TRADE DEFICIT :

- ❖ Governments are at the forefront of tackling a serious trade deficit problem. This is typically approached by increasing import traffics and enacting laws that encourage trade protectionism.
- ❖ Free-market economists say governments tend to cause more problems in the long run when they implement protectionist policies.
- ❖ In many cases, making it easier for companies to expand at home, and for foreign companies to open up in the country running a trade deficit – by offering tax-breaks and other incentives – is more effective in securing long-term economic stability than putting up trade barriers.
- ❖ One of the major problems with raising import tariffs is the quality of products – without free competition there is not guarantee that the best product wins, and no incentive for domestic producers to improve.
- ❖ For example, if Factory A in America makes inferior TVs to Factory B in Korea, but imported Factory B televisions have a 100% import tariff, Factory A has no incentive to improve its product, because it knows the government has priced Factory B out of the US home market. The government would be encouraging the survival of inferior products, which is bad for consumers and undermines Factory A's long-term ability to compete in world markets.

5.8 SUMMARY :

After studying this chapter, you will be able to Know about the Balance of Trade, to understand various Types of balance of trade and compare Between Trade Balance and Balance of Payments. It is also revealed about Trade Deficit, Measuring the Economic Growth of a Nation, along with the GDP, Importance of Balance of Trade and How governments try to tackle a trade deficit. The biggest drawback associated with domestic trade is a limit to the selection of products available for sale. In a pure domestic trade market, countries that do not have supplies of certain resources will not be able to enjoy those resources. For example, people in northern nations like Canada would be unable to enjoy food grown in tropical regions without the presence of international trade markets.

The same is true for countries that may lack the equipment or technical know-how required to make specific products. A lack of international trade also results in a limited market size for businesses. Once a company has saturated the domestic market for a product, they may have no way to increase sales in the future if international trade is prohibited.

A policy allowing only domestic trade also leads to a lack of globalization, which results in limited knowledge about other people and cultures.

5.9 TECHNICAL TERMS :

- ❖ **Balance of Trade:** The balance of trade is the account that details the value of exported goods and the value of imported goods. To calculate the balance of trade, the national accounts service evaluates imports and exports of goods based on customs statistics on goods.
- ❖ **Trade Deficit:** A trade deficit occurs when a country's imports exceed its exports during a given time period. It is also referred to as a negative balance of trade (BOT). The balance can be calculated on different categories of transactions: goods (a.k.a., "merchandise"), services, goods and services. Balances are also calculated for international transactions—current account, capital account, and financial account.

- **Trade Surplus:** A trade surplus is an economic indicator of a positive trade balance in which the exports of a nation outweigh its imports. Trade balance can be arrived by reducing the total value of imports from the total value of exports. If the value of the trade balance is positive, the trade surplus exists.
- **Economic Growth:** Economic growth is an increase in the production of goods and services in an economy. Increases in capital goods, labor force, technology, and human capital can all contribute to economic growth.
- **GDP:** Gross domestic product is a measurement that seeks to capture a country's economic output. Countries with larger GDPs will have a greater amount of goods and services generated within them, and will generally have a higher standard of living. For this reason, many citizens and political leaders see GDP growth as an important measure of national success, often referring to GDP growth and economic growth interchangeably. Due to various limitations, however, many economists have argued that GDP should not be used as a proxy for overall economic success, much less the success of a society.
- **Balance of Payments:** The balance of payments summarises the economic transactions of an economy with the rest of the world. These transactions include exports and imports of goods, services and financial assets, along with transfer payments (like foreign aid).

5.10 SELF ASSESSMENT QUESTIONS :

1. What is a Trade Deficit?
2. What is Economic Growth ? How it Measuring the Economic Growth of a Nation, along with
3. the GDP?
4. What is balance of trade ? Discuss various Types of balance of trade.
5. Explain the Importance of Balance of Trade.
6. What are the Differences between Trade Balance and Balance of Payments
7. How the governments try to tackle a trade deficit

5.11 SUGGESTED READINGS :

1. Vadilal Dagh: India’s Foreign Trade Jouav Such Foreign Trade and Economic development of under developed countries.
2. Lall G, S. : Financing of Foreign trade and
3. NCAER Export strategy for India
4. Jeevanandam: Foreign Exchange.
5. Jeevanandam: Foreign Exchange arithmetic

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LESSON - 6
BALANCE OF PAYMENT

AIMS AND OBJECTIVES :

After studying this chapter, you will be able:

- To Know about the Balance of Payment
- To understand various Types of balance of payment
- To compare Balance of payments equilibrium

STRUCTURE :

6.1 INTRODUCTION :

As a generic term, trade can refer to any voluntary exchange, from selling baseball cards between collectors to multimillion-dollar contracts between companies. Trade is the voluntary exchange of goods or services between different economic actors. Since the parties are under no obligation to trade, a transaction will only occur if both parties consider it beneficial to their interests. Trade can have more specific meanings in different contexts. In financial markets, trade refers to purchasing and selling securities, commodities, or derivatives. Free trade means international exchanges of products and services without obstruction by tariffs or other trade barriers. In macroeconomics, trade usually refers to international trade, the system of exports and imports that connects the global economy. A product sold to the global market is an export, and a product bought from the global market is an import. Exports can account for a significant source of wealth for well-connected economies.

The theory of comparative advantage helps to explain why protectionism is often counterproductive. While a country can use tariffs and other trade barriers to benefit specific industries or interest groups, these policies also prevent their consumers from enjoying the benefits of cheaper goods from abroad. Eventually, that country would be economically disadvantaged relative to countries that conduct trade. A trade deficit is a situation where a country spends more on aggregate imports from abroad than it earns from its aggregate exports. A trade deficit represents an outflow of domestic currency to foreign markets. This may also be referred to as a negative balance of trade (BOT).$28.5 trillion. The total value of the global trading market, according to the United Nations Conference on Trade and Development. Trade is essential for many reasons, but some of the most commonly cited ones are lowering prices, becoming or remaining competitive, developing relationships, fueling growth, reducing inflation, encouraging investment, and supporting better-paying jobs.

The balance of payment is the statement that files all the transactions between the entities, government anatomies, or individuals of one country to another for a given period of time. All the transaction details are mentioned in the statement, giving the authority a clear vision of the flow of funds. After all, if the items are included in the statement, then the inflow and the outflow of the fund should match. For a country, the balance of payment specifies whether the country has an excess or shortage of funds. It gives an indication of whether the country's export is more than its import or vice versa.

Balance of Payments Definition : The Balance of Payments shows a countries transactions with the rest of the world. It notes inflows and outflows of money and categorises them into different sections. The two sections of the Balance of Payments are: 1. Current Account. – Trade in goods/services/investment incomes/transfers), 2. Financial (Capital) account. – Foreign direct investment, capital flows, portfolio investment

What is the Balance of Payments? The balance of payments (BOP) is the method countries use to monitor all international monetary transactions at a specific period. Usually, the BOP is calculated every quarter and every calendar year. All trades conducted by both the private and public sectors are accounted for in the BOP to determine how much money is going in and out of a country. If a country has received money, this is known as a credit, and if a country has paid or given money, the transaction is counted as a debit. Theoretically, the BOP should be zero, meaning that assets (credits) and liabilities (debits) should balance, but in practice, this is rarely the case. Thus, the BOP can tell the observer if a country has a deficit or a surplus and from which part of the economy the discrepancies are stemming.

The balance of payments (BOP) is the record of all international financial transactions made by the residents of a country. There are three main categories of the BOP: the current account, the capital account, and the financial account. The current account is used to mark the inflow and outflow of goods and services into a country. The capital account is where all international capital transfers are recorded. In the financial account, international monetary flows related to investment in business, real estate, bonds, and stocks are documented. The current account should be balanced versus the combined capital and financial accounts, leaving the BOP at zero, but this rarely occurs.

Meaning of Balance of Payment Account : A Balance of Payment Account is a systematic record of all economic transactions between residents of a country and the rest of the world carried out in a specific period of time. Briefly put, 'Balance of Payment Account is a summary of international transactions of a country for a given period' (i.e., financial year). It records a country's transactions with the rest of the world involving inflow and outflow of foreign exchange. In short BOP Account is a summary statement of transactions in foreign exchange in a year. Simply put, BOP account is a statement of a country's sources and uses of foreign exchange in which main sources are: exports, transfers and remittances from abroad, borrowings from abroad, foreign investments whereas uses of foreign exchange are: imports, transfers to abroad, lending abroad and purchase of assets, etc.

BOP account, like a typical business account, is based on double entry system which contains two sides—Credit side and Debit side. Any transaction which brings in foreign exchange (currency) is recorded on credit side whereas any transaction that causes a country to lose foreign exchange is recorded on debit side. For example, export is credit item as it brings in foreign exchange whereas import is a debit item since it causes outflow of foreign exchange. Similarly, borrowing from rest of the world (ROW) is a credit item while lending to ROW is a debit item. main purpose of BOP Account is to know international economic position of a country and to help the government make appropriate trade and payment policies.

Features of Balance of Payment Account :

i. It is a systematic record of all economic transactions between residents of one country and rest of the world.
ii. It includes all transactions in goods (visible items), services (invisible) and assets (flow of capital) during a period of time.
iii. It is constructed on double entry system of accounting. Thus, every international transaction will result in credit entry and debit entry of equal size.
iv. All economic transactions that are carried out with the rest of world are either credited or debited.
v. In accounting sense total debit will always be equal to total credits, i.e., balance of payments will always be in equilibrium. But in economic sense, if receipts are larger than payments, there is surplus in BOR Similarly, if payments are larger than receipts, there is deficit in BOP.

6.2 BALANCE OF PAYMENT ACCOUNT :

A hypothetical simplified example of a country's Balance of Payment Account is given in the following table. It has two sides—credits (receipts) on the left side and debits (payments made) on the right side.

Credits *(Inflow of foreign exchange)*			**Debits** *(Outflow of foreign exchange)*		
Row(1)	Exports of goods *(Visible items)*	550	**Row(5)**	Imports of goods	800
Row(2)	Exports of services *(Invisibles)*	150	**Row(6)**	Imports of services	50
Row(3)	Unilateral transfers *(gifts, remittances, indemnities, etc. received from foreigners)*	100	**Row(7)**	Unilateral transfers *(gifts, indemnities, etc. paid to foreigners)*	80
Row(4)	Capital receipts *(borrowings from abroad, capital repayments by, or sale of assets to to foreigners)*	200	**Row(8)**	Capital payments *(lending to, capital repayments to, or purchase of assets from foreigners)*	70
	Total Receipts	**1,000**		**Total Payments**	**1,000**

BOP account records a country's all economic transactions with ROW which Involve inflow or outflow of foreign exchange.

Visible and Invisible items : Visible items refer to items relating to trading in goods with other countries. For example export and import of goods (like machinery, tea, etc.) are called visible items because goods are visible items and can be verified by Custom officials. Invisible items refer to items relating to trading of services with other countries and unilateral transfers. Export and import of services are called Invisible items because services are not seen crossing the border. All types of services like services of shipping, banking, tourism, investment services and unilateral transfers are invisible items.

Components of Balance of Payment Account :
The various items which make up country's Balance of Payment Account are listed in a simplified consolidated form in the above table. They are explained as under:

Export and import of goods (Merchandise):

The most straightforward way in which a country can acquire foreign currency is by exporting goods. These are called visible items because goods can be seen, touched and measured. This is shown by Row (1) which indicates that the country has exported goods to a value of Rs 550 crore. In an analogous (similar) way Row (5) shows that the country has imported goods to a value of Rs 800 crore. These two rows describe the country's visible trade. Movement of goods between countries is known as visible trade because the movement is open and can be verified by Customs officials.

Services rendered and received :

(Shipping, banking, insurance, tourism, interest, dividend etc) Under this head, following types of earnings are included.

- **Non-factor income:** Income from shipping, banking, insurance, tourism, software services is called non-factor income. All such payments are listed under Row (2) as export of services or invisible exports.
- **Investment income (Factor income):** Interest and dividends which citizens of a country earn on investment abroad are investment income and treated as factor income. Remember, citizens of the country own land, bonds, shares, etc. in foreign countries for which the foreigners who enjoy the services of this capital will have to pay for them. These payments will be registered under Row (2) as export of services or invisible exports.

In a completely analogous way, Row(6) covers payments which residents of the country m question make to foreigners for similar services, i.e., shipping, banking, insurance payments made by residents as tourists abroad, payments in the form of interest, dividends, profits/or capital services on foreign owned capital.

Unilateral transfers: (Gifts, remittances, indemnities, etc. from foreigners) The items in Row (3) are called unrequited receipts because residents of a country receive 'for free. Nothing has to be paid in return at present or in future for these receipts. These are like transfer payments. Examples of this head are gifts received by residents from foreigners, remittances sent by emigrants to relatives, war indemnities paid by a defeated country, etc. Note: In India unrequited or unilateral transfers are treated as a part of invisible trade.

Capital receipts and Payments: [Borrowings, capital repayments, sale of assets, changes in foreign exchange reserve) :

- It records international transactions which affect assets and liabilities of domestic country with rest of the world. Items (4) and (8) of the table indicate changes in stock magnitudes and refer to capital receipts and payments .Government of a country may borrow (get loan) from another government; a firm may issue stocks abroad or a bank may float a loan in a foreign country.
- In all these instances, the country in question will acquire foreign currency and these transactions will be entered as credit items in Row (4). Similarly foreigners may acquire assets in the country with whose balance of payments they are concerned.
- Assets maybe in the form of land, houses, plants, and shares, etc. Changes m stock of gold or reserves of foreign currency are also included in Row (4). Analogously, if residents of the country in their turn were to acquire similar foreign assets, this would give rise to outflow of foreign currency and come as a capital transfer recorded as a debit item in Row(8).
- Note: First three items of credits and debits shown in the above imaginary table are flow items because they refer to certain value of exports/imports per time period. Since all these payments/receipts are made with reference to current period of time, therefore, they comprise Current Account of Balance of Payment. As against it, the last item of debits and credits, viz. capital receipts/capital payments comprise Capital Account of Balance of Payment as they express changes in stock magnitudes.

6.3 IMPORTANCE OF BALANCE OF PAYMENT :

A balance of payment is an essential document or transaction in the finance department as it gives the status of a country and its economy. A BOP is a crucial document or transaction in the finance department since it reveals a country's and economy's financial position.

The following factors can be used to determine the relevance of BOP:

The importance of the balance of payment can be calculated from the following points:

- It examines the transaction of all the exports and imports of goods and services for a given period.
- It helps the government to analyse the potential of a particular industry export growth and formulate policy to support that growth.
- It gives the government a broad perspective on a different range of import and export tariffs. The government then takes measures to increase and decrease the tax to discourage import and encourage export, respectively, and be self-sufficient.
- If the economy urges support in the mode of import, the government plans according to the BOP, and divert the cash flow and technology to the unfavorable sector of the economy, and seek future growth.
- The balance of payment also indicates the government to detect the state of the economy, and plan expansion. Monetary and fiscal policy are established on the basis of balance of payment status of the country.
- It analyses all of a country's products and service exports and imports during a specific time period.
- It assists the government in determining the potential for a certain industry's export growth and developing policies to encourage such growth.

- ❖ It provides the government with a comprehensive view of a variety of import and export levies. The government then takes steps to raise and lower taxes in order to discourage imports and boost exports, accordingly, and to achieve self-sufficiency.
- ❖ ix. If the economy needs import help, the government will plan according to the BOP, to divert cash flow and technology to the unfavorable sector of the economy in order to achieve future growth.
- ❖ The government may also use the balance of payments to identify the status of the economy and plan expansion. The country's monetary and fiscal policies are based on its balance of payments situation.

The above-mentioned is the concept that is elucidated in detail about ‘Balance of Payment’ for the commerce students. To know more, stay tuned to BYJU’S. The balance of payment (BOP) is a statement that documents all transactions from one nation to another between entities, government agencies, and people during a specific time period. The statement includes all transaction information, giving the authorities a clear picture of the money movement. After all, the fund's intake and outflow should be equal if the items are listed on the statement. The balance of payment for a country reveals whether it has a financial surplus or deficit. It indicates if a country's exports exceed its imports or vice versa.

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

6.4. TYPES/ COMPONENTS OF BALANCE OF PAYMENT :

The balance of payment is divided into three types: Components of Balance of Payment. BOP has the following major components

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

When combined, goods and services together make up a country's balance of trade (BOT). The BOT is typically the biggest bulk of a country's balance of payments as it makes up total imports and exports. If a country has a balance of trade deficit, it imports more than it exports, and if it has a balance of trade surplus, it exports more than it imports. Receipts from income-generating assets such as stocks (in the form of dividends) are also recorded in the current account. The last component of the current account is unilateral transfers. These are credits that are mostly worker's remittances, which are salaries sent back into the home country of a national working abroad, as well as foreign aid that is directly received.

This account tracks all products and services that enter and leave the country. This account is used to cover all payments for raw materials and finished items. Tourism, engineering, stocks, commercial services, transportation, and royalties from licenses and copyrights are among the various deliveries mentioned in this category. All of these factors come together to form a country's BOP. This account scans all the incoming and outgoing of goods and services between countries. All the payments made for raw materials and constructed goods are covered under this account. Few other deliveries that are included in this category are from tourism, engineering, stocks, business services, transportation, and royalties from licenses and copyrights. All these combine together to make a BOP of a country.

Capital Account : This account tracks capital transactions such as the acquisition and selling of non-financial assets such as lands and properties. This account also tracks the flow of taxes, as well as the purchase and sale of fixed assets by immigrants relocating to a new nation. Finance from the capital account controls the current account deficiency or surplus, and vice versa. Capital transactions like purchase and sale of assets (non-financial) like lands and properties are monitored under this account. This account also records the flow of taxes, acquisition, and sale of fixed assets by immigrants moving into the different country. The shortage or excess in the current account is governed by the finance from the capital account and vice versa.

The capital account is where all international capital transfers are recorded. This refers to the acquisition or disposal of non-financial assets (for example, a physical asset such as land) and non-produced assets, which are needed for production but have not been produced, like a mine used for the extraction of diamonds. The capital account is broken down into the monetary flows branching from debt forgiveness, the transfer of goods, and financial assets by migrants leaving or entering a country, the transfer of ownership on fixed assets (assets such as equipment used in the production process to generate income), the transfer of funds received to the sale or acquisition of fixed assets, gift and inheritance taxes, death levies and, finally, uninsured damage to fixed assets.

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

This account records the monies that move to and from other nations through investments such as real estate, foreign direct investments, business companies, and so on. This account estimates the foreign owner of domestic assets and the domestic owner of foreign assets, as well as determining if it is buying or selling additional assets such as stocks, gold, or equity. The funds that flow to and from the other countries through investments like real estate, foreign direct investments, business enterprises, etc., is recorded in this account. This account calculates the foreign proprietor of domestic assets and domestic proprietor of foreign assets, and analyses if it is acquiring or selling more assets like stocks, gold, equity, etc.

The Balancing Act : The current account should be balanced against the combined capital and financial accounts; however, as mentioned above, this rarely happens. We should also note that, with fluctuating exchange rates, the change in the value of money can add to BOP discrepancies. If a country has a fixed asset abroad, this borrowed amount is marked as a capital account outflow. However, the sale of that fixed asset would be considered a current account inflow (earnings from investments). The current account deficit would thus be funded. When a country has a current account deficit that is financed by the capital account, the country is actually foregoing capital assets for more goods and services. If a country is borrowing money to fund its current account deficit, this would appear as an inflow of foreign capital in the BOP.

Liberalizing the Accounts : The rise of global financial transactions and trade in the late-20th century spurred BOP and macroeconomic liberalization in many developing nations. With the advent of the emerging market economic boom, developing countries were urged to lift restrictions on capital- and financial-account transactions to take advantage of these capital inflows. Some economists believe that the liberalization of BOP restrictions eventually lead to financial crises in emerging market nations, such as the Asian financial crisis.3 Many of these countries had restrictive macroeconomic policies, by which regulations prevented foreign ownership of financial and non-financial assets. The regulations also limited the transfer of funds abroad. With capital and financial account liberalization, capital markets began to grow, not only allowing a more transparent and sophisticated market for investors but also giving rise to foreign direct investment (FDI).

For example, investments in the form of a new power station would bring a country greater exposure to new technologies and efficiency, eventually increasing the nation's overall gross domestic product (GDP) by allowing for greater volumes of production. Liberalization can also facilitate less risk by allowing greater diversification in various markets. The balance of payments (BOP) is the method by which countries measure all of the international monetary transactions within a certain period. The BOP consists of three main accounts: the current account, the capital account, and the financial account. The current account is meant to balance against the sum of the financial and capital account but rarely does. Globalization in the late 20th-century led to BOP liberalization in many emerging market economies. These countries lifted restrictions on BOP accounts to take advantage of the cash flows arriving from foreign, developed nations, which in turn boosted their economies.

6.5 BALANCE OF PAYMENTS EQUILIBRIUM :

In a floating exchange rate, the current account will mirror the financial account.
If there is a deficit on importing goods – there will be a surplus on the financial account.
The current account measures:

i. Net export-imports for goods (trade balance) – used to be called trade in visibles.
ii. Net export-imports of services – used to be trade in invisibles. Examples including paying for insurance, tourism.
iii. Investment incomes. For example, a UK firm that invested in Japan, if profit comes back to the UK, this counts as a credit on current account
iv. Transfers. For example, if the UK send money to the EU, this is a debit on the current account

The current account comprises the trade balance (which is trade in goods) and also includes the balance for trade in services.
When people refer to a balance of payments deficit they usually mean a current account deficit
Further reading – Current account balance of payments

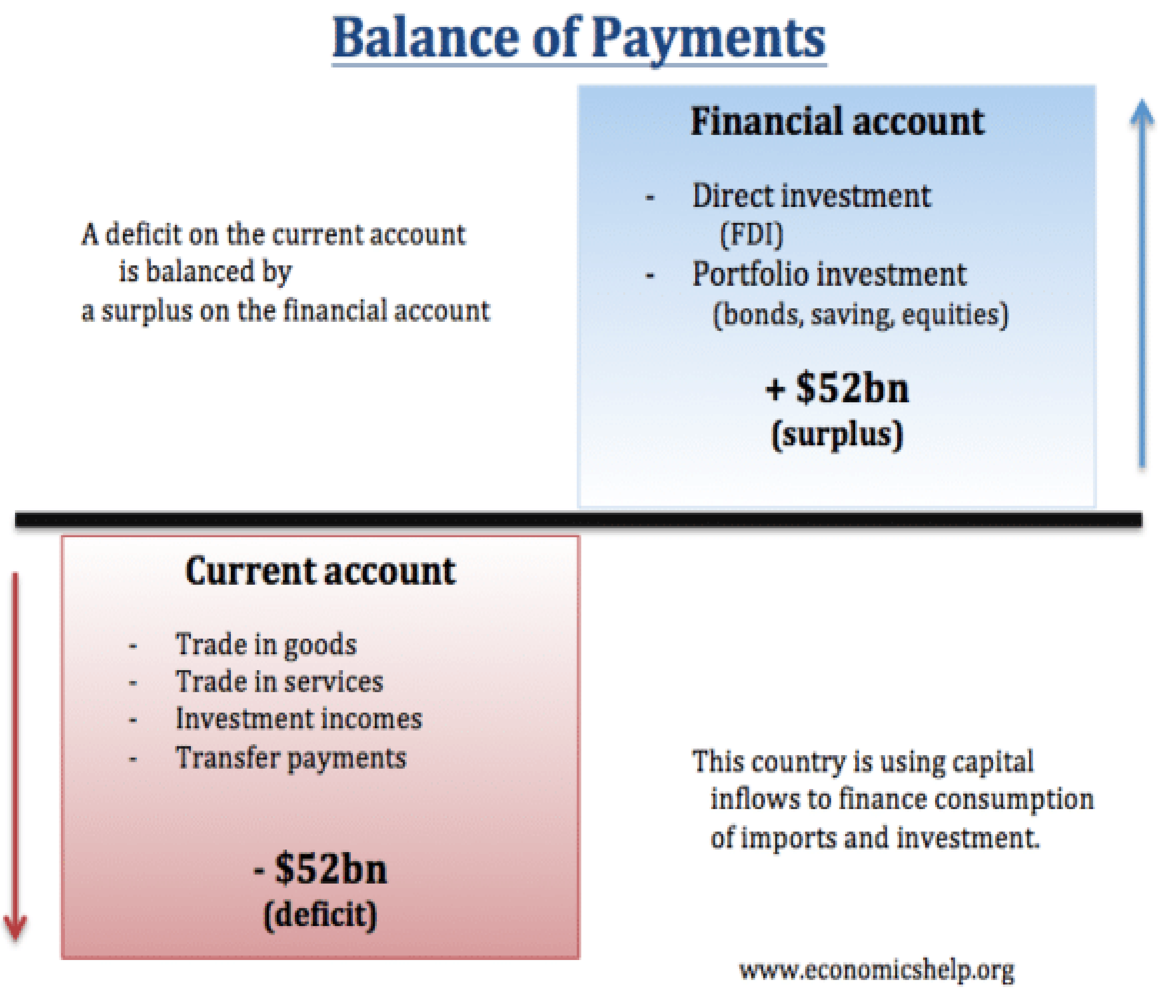
6.6 FINANCIAL ACCOUNT (CAPITAL) BALANCE OF PAYMENTS :

The financial account measures inflows of capital both short term and long term. this includes

1. Foreign direct investment
2. Purchase of securities by investors

Further reading – financial/capital account

Definition of Balancing Item : This is an item used when preparing accounts to cover up imbalances between two figures which should balance. Often when preparing accounts there are slight discrepancies between payments and annual income. The balancing item is used to offset the difference without having to alter the initial calculations. There is a balancing item in the Balance of Payments accounts

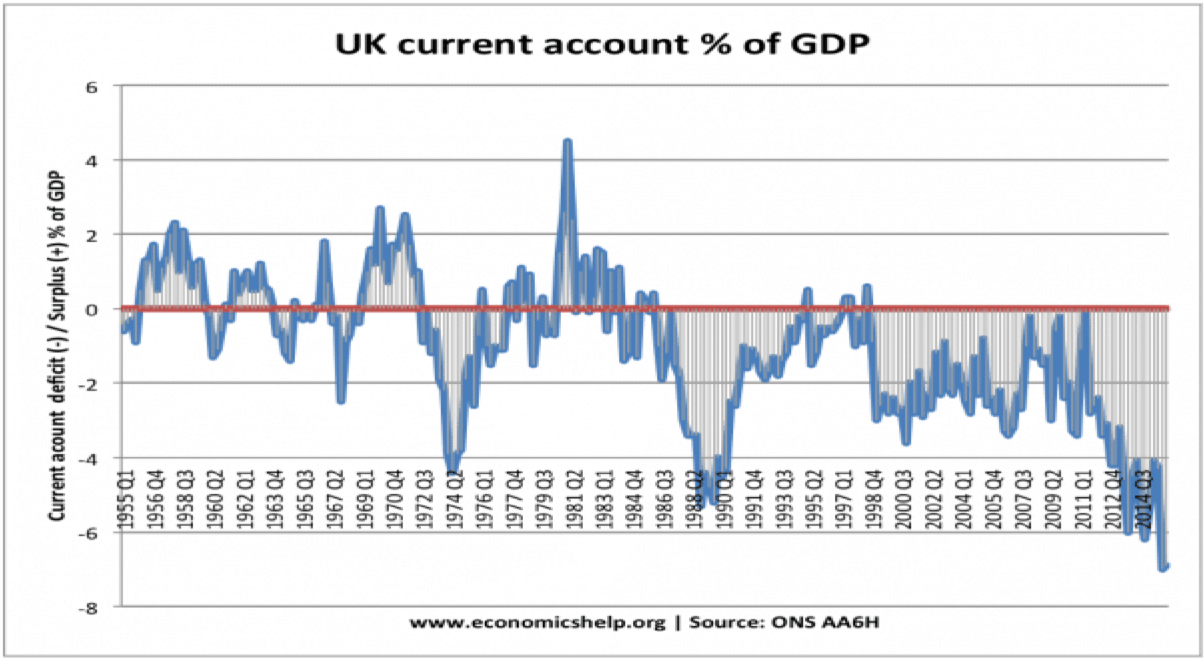


Further reading – equilibrium in balance of payments

Current Account Balance of Payments

Balance of Payments Crisis : This occurs when the current account deficit cannot be maintained. It means there will be a fall in foreign exchange reserves as the country can no longer attract sufficient capital flows to finance the current account deficit. The solution to a balance of payments crisis is usually to devalue the currency and slow down consumer spending on imports, usually by causing a recession. Russia experienced a balance of payments crisis in 1998, leading to devaluation of Rouble.

Lesson summary : The balance of payments: In this lesson summary review and remind yourself of the key terms and calculations related to the balance of payments. Topics include the current account (CA) and the capital and financial account (CFA, sometimes called simply the capital account), and how the movement of goods, services, assets, and remittances appear in the BOP.

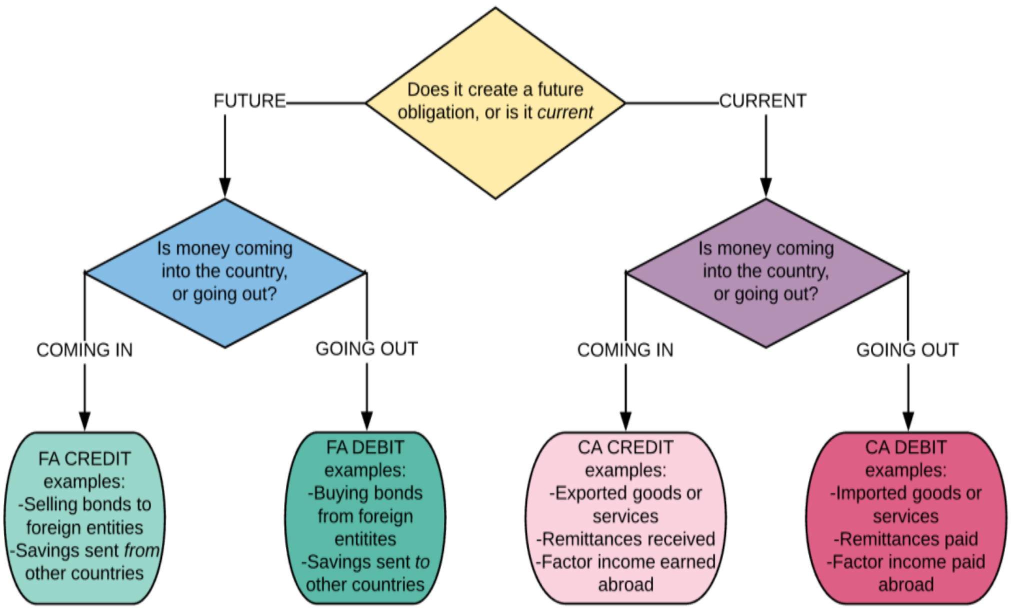


Lesson Summary : The balance of payments tracks international transactions. When funds go into a country, a credit is added to the balance of payments ("BOP"). When funds leave a country, a deduction is made. For example, when a country exports 20 shiny red convertibles to another country, a credit is made in the balance of payments.

6.7 THE CURRENT ACCOUNT (CA) AND CAPITAL AND FINANCIAL ACCOUNT (CFA) RECORDS TRANSFERS AND PURCHASES BETWEEN COUNTRIES :

The balance of payments is a system of recording transactions that happen between countries. Any movement of money into, or out of, a country has to be accounted for. We can use this flowchart to figure out where a transaction should go:

There are two categories in the BOP: the **current account (CA)** and the **capital and financial**



account (CFA). If a transaction creates a liability, like selling a bond to another country, that

gets counted in the capital and financial account. But if a transaction doesn't create a liability (like the fancy red cars), the transaction gets counted in the current account.
Anything that occurs in one account is offset by the opposite happening in the other account. For example, if the current account increases by $100$100dollar sign, 100, the capital and financial account must decrease by $100$100dollar sign, 100. The fact that an entry in the current account is offset by an entry in the capital and financial account creates the mathematical identity:
��=−���CA=−CFAC, A, equals, minus, C, F, A

i. Trade deficits and surpluses in the balance of payments :

A trade surplus exists if a country exports more than it imports. A trade deficit exists if a country exports less than it imports. To see how each of these situations impacts the balance of payments, let's start with a simplified example of Panem's balance sheet.
Amount (in billions) & Category+$200 Exports−$200‾ Imports$0 Current account balance+$ 0 Financial assets received from other countries−$0‾ Financial assets sent to other countries$ 0 Capital and Financial account balance��+��=$0+$0=$0Amount (in billions) +$200−$ 200$0+$0−$0$0CA+FA
& Category Exports Imports Current account balance Financial assets received from other co untries Financial assets sent to other countries Capital and Financial account balance=$0+$0= $0
What happens if Panem starts to run a trade deficit? Suppose Panem's imports increase to $230$230dollar sign, 230:
Amount (in billions) & Category+$200 Exports−$230‾ Imports−$30 CA balanceAmount (in billions) &+$200−$230−$30 Category Exports Imports CA balance
But how will Panem pay for this trade deficit? It will have to borrow money from other countries. Whenever an economy experiences a trade deficit, this will result in foreign *financial assets* entering the country. For example, Panem sells a bond to the nation of Hamsterville for $30$30dollar sign, 30. Panem paid for the trade deficit, but it needs to account for this new obligation in its balance of payments. The $30$30dollar sign, 30 coming into the country is counted in the capital and financial account, and once again ��+���=0CA+CFA=0C, A, plus, C, F, A, equals, 0:
Amount (in billions) & Category+$200 Exports−$230‾ Imports−$30 CA balance+$30 Financ ial inflows$0‾ Financial outflows+$30 CFA balance��+��=−$30+$30=$0Amount (in bil lions) &+$200−$230−$30+$30$0+$30CA+FA
Category Exports Imports CA balance Financial inflows Financial outflows CFA balance=− $30+$30=$0
On the other hand, if Panem runs a trade surplus of $40$40dollar sign, 40, it will be taking in more money from other countries than it sends out, creating a current account surplus. Panem will buy financial assets from other countries with that $40$40dollar sign, 40, which will send funds out of the country:
Amount (in billions) Category+$240 Exports−$200‾ Imports+$40 CA balance+$0 Financial inflows−$40‾ Financial outflows−$40 CFA balance��+��=+$40+−$40=$0Amount (in b illions) +$240−$200+$40+$0−$40−$40CA+FA
Category Exports Imports CA balance Financial inflows Financial outflows CFA balance=+ $40+−$40=$0

ii. Key equation: The balance of payments

The current account (��)(CA)left parenthesis, C, A, right parenthesis and the capital and financial account (���)(CFA)left parenthesis, C, F, A, right parenthesis must sum to zero.
��+���=0CA+CFA=0C, A, plus, C, F, A, equals, 0
Note that this equation can be rearranged to read
��=−���CA=−CFAC, A, equals, minus, C, F, A

Global trade finance involves financing **financial instruments** and products that companies launch or issue to undertake international trade and commerce. The trades carried out by small and medium-sized businesses using trade funds are meant to access **working capital**. Hence, these finances may include serving purposes, like making an investment, paying suppliers, or paying salaries.

When people buy groceries from a physical store, they take the items and pay for them immediately. As a result, there is no time gap between the service delivery, receipt of it, and payment for it. However, there are trade scenarios where payment is not real-time. To assure on-time payment, buyers ask financers to pay for their purchases. This payment is used by sellers/suppliers to produce and sell the ordered goods. If the funds are not offered to suppliers, the production will be affected.

Trade finance makes that payment available to the parties that require it instantly or treated as a payment assurance for further deals. In short, these financing options help fill the transaction gap from the product supply to the receipt of payment involved in the entire trade.

Common misperceptions :

- Students new to the concept of balance of payments sometimes get confused about the "money" that is moving around in the capital and financial account. Changes in the capital and financial account impact the market for loanable funds, not the money market. When a country sends its financial assets to another country, it is really sending its savings. Recall that the supply of loanable funds is the sum of private savings, public savings, and net capital inflows. The capital and financial account tells you how much net capital inflow (or outflow) there is.
- The capital that is being sent to and from countries in the capital and financial account is *financial capital*, not physical capital. Whenever you use the word capital, it's good practice to specify the kind of capital you are talking about. If you are talking about the stock of physical equipment that can lead to economic growth, say "physical capital." If you are talking about the flow of financial assets between countries, say "financial capital."
- Many people assume that a trade deficit is bad. ��CAC, A deficits aren't necessarily bad because a country can consume more goods than they could produce domestically. However, deficits do create a future liability that will eventually need to be paid

6.8 SUMMARY:

After studying this chapter, you will be able: to Know about the Balance of Payment , to understand various Types of balance of Payment and To compare Between Trade Balance and Balance of Payments. Further, it is emphasized on Balance of Payment Account, Importance of Balance of Payment, Types/ Components of Balance of Payment, Balance of payments equilibrium, Financial Account (Capital) Balance of Payments, The current account (CA) and capital and financial account. It is the record of trade in goods and services and transfer payments. It records all the transactions that relate to the actual receipts and payments of the visible items, invisible items, and unilateral transfers during a specific period of time. The balance of payments formula can be expressed as follows: Balance of payments = Balance of current account + Balance of capital account + Balance of financial account + Balancing item. BoP surplus means that exports are more than imports. In contrast, a BoP deficit indicates that imports are more than exports.

6.9 TECHNICAL TERMS :

- ❖ **payments equilibrium :** What is the Formula for Balance of Payments? The formula for calculating the balance of payments is current account + capital account + financial account + balancing item = 0.
- ❖ **Payment Account:** A payment account is a bank account that allows you to make daily payment transactions. These transactions can include depositing funds, making cash withdrawals and card transactions. Accounts that don't allow you to make these types of transactions are known as non-payment accounts.
- ❖ **Financial Account:** Financial Accounting is the process of recording, summarizing and reporting transactions and revenue-expense generations in a time period. For example, investors or sponsors need to verify an account statement before showing interest in associating with the business.
- ❖ **Current account:** Current bank accounts are operated to run a business. It is a non-interest bearing bank account. It needs a higher minimum balance to be maintained as compared to the savings account. Penalty is charged if minimum balance is not maintained in the current account.

6.10 SELF ASSESSMENT QUESTIONS :

1. Explain about Balance of Payment Account.
2. What is the Importance of Balance of Payment
3. Discuss about various Types/ Components of Balance of Payment.
4. What is Balance of payments equilibrium?
5. Explain about Financial Account (Capital) Balance of Payments
6. Discuss about the current account (CA) and capital and financial account

6.11 SUGGESTED READINGS :

1. Vadilal Dagh: India’s Foreign Trade Jouav Such Foreign Trade and Economic development of under developed countries.
2. Lall G, S. : Financing of Foreign trade and
3. NCAER Export strategy for India
4. Jeevanandam: Foreign Exchange.
5. Jeevanandam: Foreign Exchange arithmetic
6. Reviewed by :MICHAEL J BOYLE- Fact checked by: YARILET PEREZ

Dr. KRISHNA BANANA

LESSON - 7
FINANCIAL INSTRUMENTS OF FOREIGN TRADE

AIMS AND OBJECTIVES :

After studying this chapter, you will be able:

- To Know about the Types of Trade, Types of Trade Finance
- To understand Trade finance products , Foreign Trade and the payment procedure
- To analyse Letter of Credit, and Supply Chain Finance

STRUCTURE :

7.1 Introduction
7.2 Trade finance
7.3 Trade finance products
7.4 Types of Trade Finance
7.5 Foreign Trade
7.6 Letter of Credit
7.7 List of documents
7.8 The payment procedure
7.9 Supply Chain Finance
7.10 Summary
7.11 Technical Terms
7.12 Self Assessment Questions
7.13 Suggested Readings

7.1 INTRODUCTION :

Trade seems to be as old as civilization itself—ancient civilizations traded with each other for goods they could not produce for themselves due to climate, natural resources, or other inhibiting factors. The ability of two countries to produce items the other could not and mutually exchange them led to the principle of comparative advantage. This principle, commonly known as the Law of Comparative Advantage, is popularly attributed to English political economist David Ricardo and his book On the Principles of Political Economy and Taxation in 1817. However, Ricardo's mentor James Mill likely originated the analysis. Ricardo famously showed how England and Portugal benefited by specializing and trading according to their comparative advantages. In this case, Portugal was able to make wine at a low cost, while England was able to manufacture cloth cheaply. By focusing on their comparative advantages, both countries could consume more goods through trade than they could in isolation. The first long-distance trade is thought to have occurred 5,000 years ago between Mesopotamia and the Indus Valley.

7.2 TRADE FINANCE :

Trade finance refers to the funds that help fill the payment gap created between the supply of the goods and the receipt of the same by customers. Offering such funds makes sure the movement of goods and services from one end to the other remains smooth and free of financial struggles. It is a process of funding a trade involving the exchange of goods, commodities, and financial instruments between two parties via financial or banking institutions. The financing option helps establish a profound and long-term relationship between a buyer and a seller as it lays the foundation of mutual trust and understanding. In banking, the option involves issuing a Letter of Credit to help exporters and importers involved in trade without any financial interruption, which might cause a gap between supplying items and paying for them. It offers amazing growth prospects with respect to careers. One can either stick to the job and become a specialist or even get an opportunity to switch between different banking roles to find the most suitable one.

Through trade finance, every party involved in the trade process knows it won't have to suffer from financial risks and frauds. From a seller to the buyer and the finance giver, each element in the process remains safe with respect to the trade transactions involved.

- Trade finance is about financing a trade where the exchange of goods, products, commodities, and different financial instruments occurs between sellers/exporters and buyers/importers.
- Trade financing is a mechanism through which the gap between the shipment of a product or commodity from one market to its arrival in another is efficiently bridged.
- It helps mitigate various risks related to products, manufacturing, transport, and currency.
- Letter of Credit, supply chain financing, receivables financing, export contract, etc., are some methods adopted for effective trade financing.

Trade Finance Explained : Trade finance is facilitated and taken care of by multiple providers in the market, be it a banking institution or a financial entity. It is a de-risk strategy applied to tackle the trust issues that might arise between two parties/nations involved in a trade. While many businesses receive supplies on credit, a few suppliers may not trust their clients or customers to an extent where they could allow them to trade on credit, observed most prominently in international trade. Through trade funding, however, this balance in financing remains well-maintained without hampering the flow of goods during imports and exports.

7.3 TRADE FINANCE PRODUCTS :

What Are the Different Types of Trade Finance Products? :

Trade finance products are financial products that facilitate international trade123. These products can be divided into those that affect the exporter's position before shipment and those that affect their position after shipment1. Some common trade finance products include loans, guarantees, insurance, credit extensions, working capital limits, letters of credit, invoice discounting, and export credit123. There are also various documents and products used in trade finance, such as supply chain finance, invoice factoring, and alternative lending for SMEs4

Terry Masters-Last Modified Date: March 27, 2023: There are many different types of financial products that facilitate **international trade**. The most common trade finance products can be broken up into products that affect the exporter's position before the shipment of goods and those that affect his position after shipment. These financial options include loans, guarantees, insurance and credit extensions. Trade finance products play important roles both pre-shipment and while the shipment is in transit.

The two points in the international sales transaction when help from financial intermediaries is particularly important is pre-shipment, when the exporter decides to enter the global market or when an importer first expresses an interest in buying through a **purchase order**, and post-shipment, when the exporter has goods in transit and is waiting for payment upon delivery or upon sale. During pre-shipment, the exporter needs resources to produce the goods and cash flexibility so he can extend to the importer enough credit to be competitive against other exporters without tying up his cash in transit. After the goods ship, the exporter needs payment as quickly as possible so he can reinvest in more product.

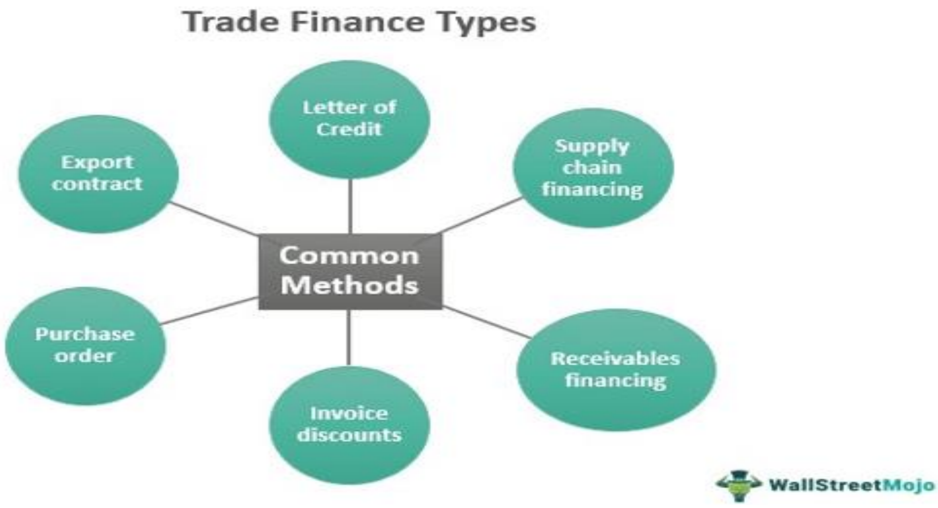
The types of trade finance products that are used during pre-shipment include working capital loans, government guarantees and export credit insurance. Additionally, purchase order financing, factoring and a form of debt discounting called forfaiting are important during this time. Working capital loans and government guarantee programs are often offered as a matter of public policy, to enable businesses to enter the global marketplace by providing resources and working capital. Export credit insurance protects the exporter against nonpayment by the importer so the exporter can extend credit terms. Specialized financial firms use purchase order financing, factoring and forfaiting to take over the collection of an exporter's anticipated receivables for a fee after an evaluation of the creditworthiness of the importer.

Post-shipment trade finance products include various types of **letters of credit** and documentary collections. Letters of credit are bank guarantees that a party will meet his obligations under an international sales transaction. The bank serves as a type of escrow agent to exchange the documents that will allow the goods to be picked up for the importer's payment. Letters of credit can be guaranteed or non-guaranteed, and can support multiple sales or open sales terms. Documentary collections work very much like letters of credit in that banks on both sides of the transaction handle the exchange of money for delivery documents.

7.4. TYPES OF TRADE FINANCE :

Letter of Credit: There are several methods to achieve trade financing. However, the most common is the **Letter of Credit**, a document banks offer to protect global trading activities. This **international trade finance** option is available in different forms, given the purpose for which the fund is required, whether personal or commercial.

Supply chain financing (SCF) is the method that keeps the supply chain efficient. Some exporters do not agree to offer goods on credit to importers, which might delay the meeting of customer demands in the market. Through SCF, the export-import process remains uninterrupted as the trade finance providers pay exporters on importers' behalf. In addition to the supply chain funding method, export-import efficiency can also be controlled using the export contract, which a bank provides as proof of **loan** offered to exporters.



Then, there comes the purchase order financing, a pre-shipment funding alternative. Through **purchase order**, the lender pays an upfront amount, a certain percentage of the total cost of supplies. The finance is received by suppliers directly. The next on the list is invoice discounting, which is one of the most popular forms of trade finance, especially in the United States. Under this option, the invoice ownership is transferred to sellers, who make **debtors** liable to the financing company directly. In short, the funding and repayment occur between the buyers and the lenders. The sellers are present nowhere in the process. Last but not least is receivables financing which is a claim for repayment. It signifies the company's right to receive the amount another party owes. It is a legally enforceable document that businesses hold for products and services sold.

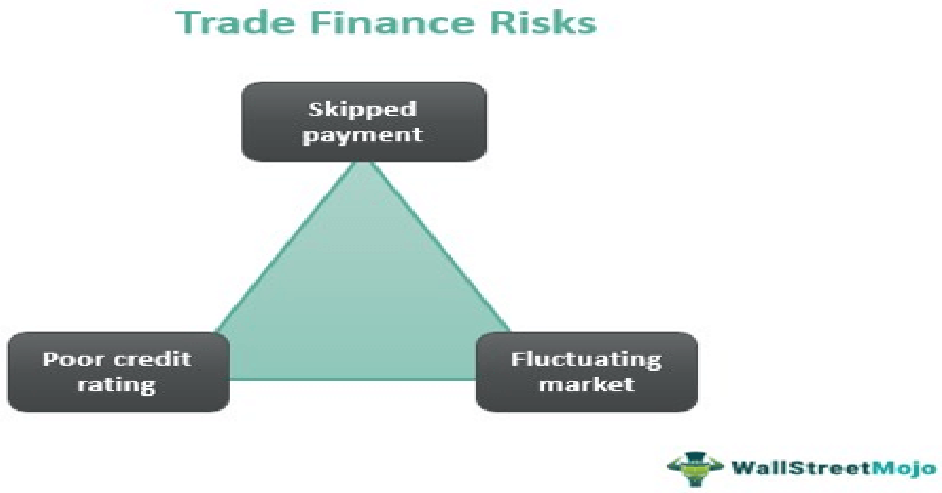
Participants: Multiple providers help in the risk-mitigating process, and numerous borrowers are awaiting fund disbursal when needed. In addition, some providers and users participate in making trade finance an effective finance solution for global trade and commerce.

While banking institutions, syndicates, and trade finance houses are the finance providers, manufacturers, exporters, and importers use the funds offered to maintain efficiency in facilitating smoother trade and commerce.

Examples: Customer demand for Brand A's sugar was significantly increasing in the market. As a result, the company ordered supplies from Supplier B. The supplier, however, was recently cheated by a buyer who did not pay for the supplies. Thus, it developed some trust issues with other bands.

Thus, the supplier doesn't agree to deliver the items until the amount is paid. Due to the bulk order, Brand A could not pay the supplier. As a result, it connects with XYZ Bank and asks to pay the supplier on its behalf. The bank pays Supplier B, and the brand gets its supplies as promised.
With the sale of the product, the buyer repays the lender. This is how trade finance works.

Risk Reduction : Trade finance saves buyers from delayed receipt of supplies that might hamper the demand for their products in the market. In addition, the same helps in reducing risks in the international trade market. As the participants involved in the trade are unfamiliar with each other, it is difficult and doubtful to say if the exporters/sellers are supplying goods and importers/buyers are receiving those items in return.



In the event of delivery issues, the repayment might become doubtful. Plus, the poor credit rating of the borrower might be another major factor. Above all, the fluctuating market conditions, which affect the currency exchange rates, are always a matter of concern.

Trade finance enables trading parties to reduce such risks. Therefore, the ones interested in trade finance jobs must know of the risks associated while dealing with exporters and importers. This, in turn, will help them assist the market players in the best possible way.

7.5 FOREIGN TRADE :

Foreign trade is the exchange of capital, goods, and services across international borders or territories. In most countries, it represents a significant share of gross domestic product (GDP). Industrialization, advanced transportation, globalization, multinational corporations, and outsourcing are all having a major impact on the international trade system. Increasing international trade is crucial to the continuance of globalization. International trade is a major source of economic revenue for any nation that is considered a world power.

Without international trade, nations would be limited to the goods and services produced within their borders.

What is Foreign Trade? : Foreign trade is the exchange of goods across national boundaries. Prof. J.L. Hanson said, "An exchange of various specialized commodities and services rendered among the corresponding countries is known as foreign trade." Foreign trade is, in principle, not different from domestic trade as the motivation and the behavior of parties involved in a trade does not change fundamentally depending on whether a trade is across a border or not. The main difference is that international trade is typically more costly than domestic trade. The reason is that a border typically imposes additional costs such as tariffs, time costs due to border delays, and costs associated with country differences such as language, the legal system, or a different culture. Foreign trade is all about imports and exports. The backbone of any foreign trade between nations is those products and services which are being traded to some other location outside a particular country's borders. Some nations are adept at producing certain products at a cost-effective price. Perhaps it is because they have the labor supply or abundant natural resources which make up the raw materials needed. No matter what the reason, the ability of some nations to produce what other nations want is what makes foreign trade work.

Types of Foreign Trade :

1. **Import:** Importing is the purchasing of goods or services made in another country. For example, importing edible oil from Chinese producers to sell in Africa.
2. **Export:** Exporting is selling domestic-made goods in another country. For example, Hameem Garments exports Readymade Garments (RMG) products to Western Countries.
3. **Re-export:** When goods are imported from a foreign country and are re-exported to buyers in some other foreign countries, it is called re-export.

For example, Firm/ Readymade Garments located at EPZs imports raw materials (cotton) from Korea and produces Readymade Garments products by Thai cotton and then those products to Canada.

Reasons / Need / Importance / Advantages of Foreign Trade :

The following points explain the need and importance of foreign trade to a nation.
Division of Labor and Specialization: Foreign trade leads to the division of labor and specialization at the world level. Some countries have abundant natural resources.
They should export raw materials and import finished goods from countries which are advanced in skilled manpower. This gives benefits to all the countries and thereby leading to the division of labor and specialization.

- **Optimum Allocation and Utilization of Resources:** Due to specialization, unproductive lines can be eliminated, and wastage of resources avoided. In other words, resources are canalized for the production of only those goods, which would give the highest returns.
- Thus there is rational allocation and utilization of resources at the international level due to foreign trade.
- **Equality of Prices:** Prices can be stabilized by foreign trade. It helps to keep the demand and supply position stable, which in turn stabilizes the prices, making allowances for transport and other marketing expenses.
- **Availability of Multiple Choices:** Foreign trade helps in providing a better choice to the consumers. It helps in making available new varieties to consumers all over the world.
- **Ensures Quality and Standard Goods:** Foreign trade is highly competitive. To maintain and increase the demand for goods, the exporting countries have to keep up the quality of goods.
- Thus quality and standardized goods are produced.
- **Raises Standard of Living of the People:** Imports can facilitate the standard of living of the people. This is because people can have a choice of new and better varieties of goods and services. By consuming new and better varieties of goods, people can improve their standard of living.
- **Generate Employment Opportunities:** Foreign trade helps in generating employment opportunities by increasing the mobility of labor and resources. It generates direct employment in the import sector and indirect employment in other sectors of the economy.
- Such as Industry, Service Sector (insurance, banking, transport, communication), etc.
- **Facilitate Economic Development:** Imports facilitate the economic development of a nation. This is because, with the import of capital goods and technology, a country can generate growth in all sectors of the economy, agriculture, industry, and service sector.
- **Assistance During Natural Calamities:** During natural calamities such as earthquakes, floods, famines, etc., the affected countries face the problem of shortage of essential goods. Foreign trade enables a country to import food grains and medicines from other countries to help the affected people.
- **Maintains Balance of Payment Position:** Every country has to maintain its balance of payment position. Since every country has to import, which results in an outflow of foreign exchange, it also deals in export for the inflow of foreign exchange.
- **Brings Reputation and Helps Earning Goodwill:** A country which is involved in exports earns goodwill in the international market. For example, Japan has earned a lot of goodwill in foreign markets due to its exports of quality electronic goods.

- **Promotes World Peace:** Foreign trade brings countries closer. It facilitates the transfer of technology and other assistance from developed countries to developing countries. It brings different countries closer due to economic relations arising out of trade agreements.

Thus, foreign trade creates a friendly atmosphere for avoiding wars and conflicts. It promotes world peace as such countries try to maintain friendly relations among themselves.

7.6 LETTER OF CREDIT :

What is Letter of Credit : A letter of credit is a bank undertaking of payment separate from the sales or other contracts on which it is based. It is a way of reducing the payment risks associated with the movement of goods. Expressed more fully, it is a written undertaking by a bank (issuing bank) given to the seller (beneficiary) at the request, and following the buyer's (applicant) instructions to effect payment — that is by making a payment, or by accepting or negotiating bills of exchange (drafts) — up to a stated amount, against stipulated documents and within a prescribed time limit.

Characteristics of Letter of Credit : Among the instrument used in international business, L/C has been distinguished by the following characteristics;

- **Negotiability :** Letters of credit are usually negotiable. The issuing bank is obligated to pay not only the beneficiary but also any bank nominated by the beneficiary. Negotiable instruments are passed freely from one party to another almost in the same way as money. To be negotiable, the letter of credit must include an unconditional promise to pay on demand or at a definite time. The nominated bank becomes a holder in due course. As a holder in due course, the holder takes the letter of credit for value; in good faith; and without notice of any claims against it. A holder in due course is treated favorably under the Uniform.
- **Commercial Code:** The transaction is considered a straight negotiation if the issuing bank's payment obligation extends only to the beneficiary of the credit.
- If a letter of credit is a straight negotiation it is referenced on its face by "we engage with you" or "available with ourselves". Under these conditions, the promise does not pass to a purchaser of the draft as a holder in due course.
- **Revocability:** Letters of credit may be either revocable or irrevocable. Whether revocable or irrevocable, it will state on the face of the document what type of credit is being presented. A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. A revocable letter of credit cannot be confirmed. If a correspondent bank is engaged in a transaction that involves a revocable letter of credit, it serves only as of the advising bank. Once the documents have been presented and meet the terms and conditions in the letter of credit, and the draft is honored, the letter of credit cannot be revoked. The revocable letter of credit is not commonly used. It is generally used to provide guidelines for shipment. The most commonly used irrevocable letter of credit may not be revoked or amended without the agreement of the issuing bank; the confirming bank; and the seller (beneficiary). An irrevocable letter of credit from the issuing bank insures the seller that if the required documents are presented and the terms and conditions are complied with, payment will be made.
- **Transfer and Assignment**: The seller has the right to transfer or assign the right to draw, under a letter of credit only when the letter of credit states that it is transferable or assignable. Letters of credit governed by the Uniform Commercial Code (Domestic) may be transferred an unlimited number of times. Under the Uniform

Customs. Practice for Documentary Credits (International) the credit may be transferred only once. However, even if the credit specifies that it is nontransferable or non-assignable, the seller may transfer their rights before a performance.

- **Sight and Time Drafts:** All letters of credit require the seller to present a draft and specified documents to receive payment. A draft is a written order by which the party creating it, orders another party to pay money to a third party. A draft is sometimes referred to as a bill of exchange. The two types of drafts used in letters of credit are sight and time. A sight draft is payable as soon as it is presented for payment although the issuing bank is allowed a reasonable time to review the documents before making payment. A time draft is not payable until the lapse of a particular period stated on the draft (often 90 days). The issuing bank is required to accept the draft as soon as the documents comply with the letter of credit terms. The issuing bank is then obligated to pay the draft at maturity.

Types of Letters of Credit :

Basic Types of Letters of Credit : There are three basic features of letters of credit, each of which has two options. These are described below. Each letter of credit has a combination of each of the three features.

- ***Sight or Term/ Usance***: Letters of credit can permit the beneficiary to be paid immediately upon presentation of specified documents (sight letter of credit), or at a future date as established in the sales contract (term/usance letter of credit).
- ***Revocable or Irrevocable***: Letters of credit can be revocable. This means that they can be canceled or amended at any time by the issuing bank without notice to the beneficiary.
- However, drawings negotiated before notice of cancellation or amendment must be honored by the issuing bank. An irrevocable letter of credit cannot be canceled without the consent of the beneficiary.
- ***Unconfirmed or Confirmed***: An unconfirmed letter of credit carries the obligation of the issuing bank to honor all drawings, provided that the terms and conditions of the letter of credit have been complied with. A confirmed letter of credit also carries the obligation of another bank which is normally located in the beneficiary's country, thereby giving the beneficiary the comfort of dealing with a bank known to him.

Special Types of Letters of Credit : So far a description has been provided of the basic types of letters of credit used to cover the shipment of goods. In addition to these basic types, various specialized formats meet particular sets of circumstances.

- ***Red Clause Letter of Credit:*** A red clause letter of credit incorporates a clause, traditionally written in red, which authorizes the bank acting as the negotiating or paying bank to pay the beneficiary in advance of shipment. This enables the purchase and accumulation of goods from several different suppliers, and the arrangement of shipment under the letter of credit terms. Such advances will be deducted from the amount due to be paid when the documents called for are presented under the letter of credit. If the beneficiary fails to ship the goods or cannot do so before the expiry of the Letter of credit, the issuing bank is bound to reimburse the negotiating or paying bank, recovering its payment from the applicant. Variations of such credits may also require that any advances be secured by temporary warehouse receipts until shipment is effected. Beneficiaries of red clause letters of credit are invariably brokers/agents of buyers in a particular field.
- ***Transferable Letter of Credit:*** A transferable letter of credit allows the beneficiary to act as a middleman and transfer his rights under a letter of credit to another party or

parties who may be suppliers of the goods. Depending on whether the letter of credit permits partial shipments, fractional amounts may be transferred to more than one beneficiary. The letter of credit, however, can be transferred only once: the secondary beneficiaries cannot transfer their rights to a third party. Transfer of a letter of credit can be made on specific application by the original beneficiary to the authorized transferring bank.To be transferable, a letter of credit must be so marked by the issuing bank which can only do so on the applicant's specific instructions. The applicant should be aware that any second beneficiary, the probable supplier, is usually a party not likely known to the applicant. The terms and conditions of the transferred letter of credit must be identical to those of the original letter of credit with the following exceptions:

- ***Back-to-Back Letter of Credit:*** Although not recorded on a letter of credit, "back-to-back" is a term used in transactions involving two irrevocable letters of credit. Such transactions originate when a seller receives a letter of credit covering goods which must be obtained from a third party that in turn requires a letter of credit. The "second" issuing bank looks to the first issuing bank for reimbursement after paying under the second letter of credit. The difference between back-to-back letters of credit and transferable letters of credit is such that in a transferable letter of credit, the rights under the existing letter of credit are transferred. In a back-to-back transaction, different letters of credit are issued. Because technical problems can arise in back-to-back transactions, banks tend to discourage their use.
- ***Deferred Payment Letter of Credit:*** Under a deferred payment letter of credit, the applicant does not pay until a future date determined under the terms of the letter of credit. No drafts are called for, which avoids "stamp duties" charged by some countries on bills of exchange (drafts). One reason an exporter might extend credit terms to an importer could be the competitiveness of the market and the need for the exporter to finance the importer if the exporter is to make the sale.

Other Types of Letters of Credit ; The letters of credit described thus far cover the movement of goods from one destination to another. There are other types of letters of credit that are not specifically related to the movement of goods.

- ***Standby Letters of Credit***: Standby letters of credit may apply in general to transactions that are based on the concept of default by the applicant in the performance of a contract or obligation. In the event of default, the beneficiary is permitted to draw under the letter of credit. Standby letters of credit may be used as a substitute for performance guarantees or issued to guarantee loans granted by one firm to another, thereby securing payment to the creditor in the event the other party fails to repay its obligation on the due date. Even if the applicant claims to have performed, the bank issuing the letter of credit is obliged to make payment provided the beneficiary produces complying documents, usually a sight draft, and a written demand for payment.
- ***Uniform Customs and Practice for Documentary Credits (UCP):*** The Uniform Customs and Practice for Documentary Credits is an internationally agreed-upon set of rules for all parties involved in all types, of letters of credit transactions. The rules, which were adopted by the International Chamber of Commerce in Vienna in 1933, have been revised several times and are used by banks in practically all countries. The Uniform Customs and Practice for Documentary Credits, currently applicable, is a set of rules which, when not in contravention of local laws, are binding on the parties who have adopted them. The authority of UCP lies in its universal acceptance which is acknowledged by a statement on the letter of credit itself. All Scotia banks'

Documentary Letters of Credit are issued subject to UCP. Copies of the Uniform Customs and Practice for Documentary Credits are available upon request from your nearest Scotia bank office.

Importance and Need for Letter of Credit (L/C): The need for a letter of credit is a consideration in the course of negotiations between the buyer and seller when the important matter of method of payment is being discussed. Payment can be made in several different ways:

i. by the buyer remitting cash with his order
ii. by open account whereby the buyer remits payment at an agreed time after receiving the goods;
iii. by documentary collection through a bank in which case the buyer pays the collecting bank for account of the seller in exchange for shipping documents which would include, in most cases, the document of title to the goods.

Benefits of a Letter of Credit: a) Benefits of a Letter of Credit To The Exporter/Seller

- Letters of credit open doors to international trade by providing a secure mechanism for payment upon fulfillment of contractual obligations. A bank is substituted for the buyer as the source of payment for goods or services exported.
- The issuing bank undertakes to make the payment, provided all the terms and conditions stipulated in the letter of credit are complied with.
- Financing opportunities, such as pre-shipment finance secured by a letter of credit and/or discounting of accepted drafts drawn under letters of credit, are available in many countries.
- Bank expertise is made available to help complete trade transactions successfully.

Payment for the goods shipped can be remitted to your bank or a bank of your choice.

Benefits of a Letter of Credit To the Importer/Buyer

- Payment will only be made to the seller when the terms and conditions of the letter of credit are complied with.
- The importer can control the shipping dates for the goods being purchased. Cash resources are not tied up. Parties involved in a Letter of Credit Transaction
- To help the reader understand the steps taken in a letter of credit transaction, the following is a brief description of the parties most commonly involved in letters of credit. parties in a letter of credit transaction

- ***Accepting Bank :*** The bank named in a letter of credit on whom term drafts are drawn and who indicates acceptance of the draft by dating and signing across its face, thereby incurring a legal obligation to pay the amount of the draft at maturity.
- ***Advising Bank:*** A branch or correspondent bank at or near the domicile of the beneficiary, to which the issuing bank either sends the letter of credit or a notification that a letter of credit has been issued, with instructions to notify the beneficiary. The advising bank advises the beneficiary of the letter of credit without engagement.
- ***Applicant:*** The buyer or the party who requests the letter of credit to be issued. Beneficiary The seller or the party to whom the letter of credit is addressed.
- ***Confirming Bank:*** A bank usually in the country of the beneficiary which, at the request of the issuing bank, joins that bank in undertaking to honor drawings made by the beneficiary, provided the terms and conditions of the letter of credit have been complied with.
- Discounting Bank: A bank that discounts a draft for the beneficiary after it has been accepted by an accepting bank.
- ***Drawer Bank:*** The bank named in the letter of credit on which drafts aro to be drawn.

- Drawer: The beneficiary of the letter of credit who will draw the draft under the terms of the letter of credit.
- ***Issuing Bank:*** The bank opens a letter of credit on behalf of the applicant and forwards it to the advising bank for delivery to the beneficiary.
- ***Negotiating Bank:*** Usually, the beneficiary's bank which, after satisfying itself that the documents conform with the letter of credit, agrees to purchase the draft (pay the beneficiary).
- ***Paying Bank:*** The bank named in the letter of credit where drafts are to be paid. It is not necessarily the issuing bank, but often a branch of the issuing bank or its correspondent. Once drafts have been paid or accepted by the paying/ drawer bank, there is no recourse to the drawers.
- ***Reimbursing Bank:*** The bank authorized by the issuing bank to reimburse the drawer bank or other banks submitting claims under the letter of credit.

Steps in Letter of Credit Transaction: Steps in an Import Letter of Credit Transaction :

Step 1. The Sales Contract: The sales contract is the formal agreement between the buyer and seller specifying the terms of sale that both parties have agreed upon. The contract should include a description of the goods; the amount; the unit price; the terms of delivery; the time allowed for shipment and presentation of documents; the currency; and the method of payment.

Step 2. Application & Agreement: The bank's letter of the credit application and agreement forms, when executed, constitute a payment and reimbursement contract between the issuing bank and its customer. It is also the customer's instruction to the issuing bank. The letter of credit must be issued exactly under the customer's instructions; therefore, the application must be completed fully and accurately, to avoid the inconvenience of having to have the letter of credit amended. The agreement constitutes an undertaking by the customer to reimburse the issuing bank for drawings paid following the terms of the letter of credit, and normally takes the form of an authorization to debit the customer's account.

Step 3. Issuance of the Letter of Credit: The issuing bank prepares the letter of credit as specified in the application and forwards it by transmission or airmail to the advising bank, (a branch or correspondent of the issuing bank). The issuing bank instructs the advising bank as to whether or not to add its confirmation, as per their customer's instructions.

Step 4. Advising: The advising bank forwards the letter of credit to the beneficiary (seller) stating that no commitment is conveyed on its part. However, if the advising bank has been asked to confirm the letter of credit and agrees to do so, it will incorporate a clause undertaking to honor the beneficiary's drafts, provided the documents evidence that all terms and conditions of the letter of credit have been complied with.

Steps in an Export Letter of Credit Transaction :

Step 1. Shipment of Goods: Upon receiving the letter of credit, the beneficiary should examine it carefully and be satisfied that all the terms and conditions can be complied with. If this is not possible, the beneficiary should request the applicant to arrange an amendment to the letter of credit. Once completely satisfied, the beneficiary will then be in a position to assemble and ship the goods.

Step 2. Presentation of Documents by Beneficiary: The beneficiary prepares an invoice in the number of copies required, with the description of goods shown exactly as stipulated in the letter of credit. The beneficiary obtains the bill of lading and/or other transport documents from the carrier and prepares and/or obtains all other documents required by the letter of credit. These are attached to the draft, drawn on the bank indicated and at the term stipulated in the letter of credit, and are presented to the advising/ confirming/ negotiating bank.

Step 3. Sending Documents to the Issuing Bank: The advising/confirming/negotiating bank checks the documents presented by the seller against the letter of credit. If the documents meet the requirements of the letter of credit, that bank will send them to the issuing bank, claiming reimbursement and paying the seller.

Step 4. Delivering Documents to the Applicant: The issuing bank will also check the documents for compliance and then deliver them to the applicant either against payment or as an undertaking to pay on the maturity of the drawing under the letter of credit.

Documents Usually Required Under a Letter of Credit

7.7 LIST OF DOCUMENTS :

There is no limit to the number and variety of documents that letters of credit may stipulate. The following is a list of documents most commonly seen in a letter of the credit transaction. Each document is described in brief with a check-list for preparing the document. As already stated, the beneficiary should, on first being advised of the letter of credit, examine it carefully and be satisfied that all the documentary requirements can be complied with. Unless the documentary requirements can be strictly complied with, the beneficiary may not receive payment from the issuing bank. If any requirements cannot be complied with, the beneficiary should immediately request the applicant to arrange for an appropriate amendment to the letter of credit. documents usually required under a letter of credit

- **Draft:** A draft is a bill of exchange and a legally enforceable instrument which may be regarded as the formal evidence of debt under a letter of credit. Drafts drawn at sight are payable by the drawee on presentation. Term (usance) drafts, after acceptance by the drawee, are payable on their indicated due date.
- **Commercial Invoice:** The commercial invoice is an itemized account issued by the beneficiary and addressed to the applicant, and must be supplied in the number of copies specified in the letter of credit.
- **Consular or Customs Invoice:** A consular or customs invoice is prepared by the beneficiary on forms either supplied by the buyer or local consulate offices; Consular invoices must be visaed (officially stamped) and signed by a consular officer of the importing country and be supplied in the official form and number of copies as stipulated in the letter of credit. All headings of the forms must be completed. The value of goods required must agree with that shown on the commercial invoice.
- **Bill of Lading:** A bill of lading is a receipt issued by a carrier for goods to be transported to a named destination, which details the terms and conditions of transit. In the case of goods shipped by sea, it is the document of title which controls the physical custody of the goods.
- **Air Waybill:** An air waybill is a receipt issued by an air carrier indicating receipt of goods to be transported by air and slowing goods consigned to a named party. Being a non-negotiable receipt it is not a document of title.
- **Insurance Policy or Certificate:** Under the terms of a CIF contract, the beneficiary is obliged to arrange insurance and furnish the buyer with the appropriate insurance policy or certificate. The extent of coverage and risks should be agreed upon between the buyer and seller in their initial negotiations and be set out in the sales contract.
- Since the topic of marine insurance is extremely specialized and with conditions varying from country to country, the services of a competent marine insurance broker are useful and well-advised.

- **Packing List:** A packing list is usually requested by the buyer to assist in identifying the contents of each package or container. It must show the shipping marks and the number of each package. It is not usually required to be signed.
- **Certificate of Origin:** As the name suggests, a certificate of origin certifies as to the country of origin of the goods described and should comply with any stipulations in the letter of credit as to originating country and by whom the certificate is to be issued. The certificate should be consistent with and identified with the other shipping documents by shipping marks and numbers and must be signed.
- **Inspection Certificate**: When a letter of credit calls for an inspection certificate it will usually specify by whom the certificate is to be issued; otherwise, the same general comments as in the case of the certificate of origin apply. As a preventative measure against fraud or as a means of protecting the buyer against the possibility of receiving substandard or unwanted goods, survey or inspection certificates issued by a reputable third party may be deemed prudent. Such certificates indicate that the goods have been examined and found to be as ordered.

Payment Procedure L/C

7.8 THE PAYMENT PROCEDURE :

- **Payment:** On presentation of the documents called for under the letter of credit, provided they comply with its terms, the advising/negotiating bank, in the case of an unconfirmed letter of credit, may pay/negotiate the draft. In the case of a confirmed letter of credit, the confirming bank is obliged to honor the drawing without recourse to the beneficiary.
- **Reimbursement:** The advising/confirming/negotiating bank will claim reimbursement from the issuing bank.
- **Settlement:** On receipt of conforming documents, the issuing bank will also be responsible for checking documents and will charge the applicant’s account under the terms of the letter of the credit application and agreement forms, effecting reimbursement to the negotiating bank.

What to Do if Documents are Dishonored? :

When documents are presented by the beneficiary and are found not to be under the terms of the letter of credit, the following courses of action are available:

- ***Alternative 1:*** The documents may be corrected if possible. However, this option is only applicable if the discrepancies are such that the beneficiary, shipping company or whoever is concerned can correct the discrepancies before the expiry of the letter of credit and within the period allowed for presentation of the documents.
- ***Alternative 2:*** If the discrepancies cannot be corrected, the beneficiary’s bank may request authority from the issuing bank to negotiate the draft, despite the discrepancies.
- ***Alternative 3:*** If in the case of a sight draft, the beneficiary wishes to receive the proceeds of the drawing immediately, then an indemnity may be the expedient method. Under the indemnity, the beneficiary agrees to indemnify the negotiating bank for payment of principal, interest and any other loss resulting from the refusal of the issuing bank to honor the drawing due to non-conformity of the documents. If the discrepancies are considered minor, the beneficiary’s bank may be prepared to negotiate the draft “under reserve”; it is understood the beneficiary’s bank will have recourse to the beneficiary if the discrepancies are unacceptable to the issuing bank.

- ***Alternative 4:*** As a last resort, documents may be sent to the issuing bank on an “approval” basis; the documents to be delivered to the buyer only against the buyer’s authority to pay or accept.

Common Problems with Letters of Credit : Most problems result from the seller’s inability to fulfill the obligations stated in the letter of credit. The seller may find these terms difficult or impossible to fulfill and, either try to fulfill them and fails or asks the buyer to amend to the letter of credit. As most letters of credit are irrevocable, amendments may at times be difficult since both the buyer and the seller must agree.

Sellers may have one or more of the following problems:

i. The shipment schedule cannot be met;
ii. The stipulations concerning freight costs are unacceptable;
iii. The price becomes too low due to exchange rates fluctuations;
iv. The quantity of product ordered is not the expected amount;
v. The description of the product is either insufficient or too detailed; and,
vi. The stipulated documents are difficult or impossible to obtain.

7.9 SUPPLY CHAIN FINANCE :

Supply chain finance (SCF) or reverse factoring is an arrangement between the buyer, the supplier, and a financier or factor by which the payment for the receivables by the supplier is received in advance, thereby benefiting both the buyer and the supplier. Supply chain finance involves an arrangement between a buyer, a supplier, and a third-party financier that benefits both parties. It is not a loan but rather an extension of credit that helps both parties achieve their objectives. It is initiated by the buyer, making it different from factoring initiated by the supplier. It also differs from trade finance, which involves banks financing trade between importers and exporters. It works by the supplier raising invoices, which the third-party financier then funds.

Digital supply chain finance is a form that uses digital technologies to automate and streamline the financing process. It typically involves using online platforms and tools to connect suppliers, buyers, and financiers, making it faster, more efficient, and more transparent than traditional supply chain financing methods. There are three main types of supply chain finance: supplier finance, buyer finance, and inventory finance. Supplier finance provides funding to a supplier based on their invoices, buyer finance provides funding to a buyer to pay their suppliers early, and inventory finance provides funding to a company to purchase inventory at a lower interest rate than traditional financing options. There are three main types of supply chain finance: supplier finance, buyer finance, and inventory finance. Supplier finance provides funding to a supplier based on their invoices, buyer finance provides funding to a buyer to pay their suppliers early, and inventory finance provides funding to a company to purchase inventory at a lower interest rate than traditional financing options.

Features: Let us look at some features of the **supply chain finance platform.**

i. Supply chain finance involves the participation of a third party or supply chain financier who assists in completing the model. The financer makes the payment to the seller on time and extends the payable time for the buyer.

ii. It is not a loan. It is just the extension of credit for mutual assistance of both the buyer and the supplier. The buyer has control over their cash outflow and the sellers receivable time is reduced.
iii. Unlike factoring, which the supplier initiates, this is initiated by the buyer. Hence, sometimes it is also referred to as reverse factoring. So, unlike factoring, which is directed just towards the seller's objectives, the SCF fulfills the objectives of both the buyer and the seller.
iv. Since the SCF works based on the invoices raised by the seller on the buyer, it comes into consideration after due diligence of the buyer's creditworthiness. If the buyer does not have good credibility, the financier may refuse to fund the supplier in advance.

Benefits: Some benefits of the **supply chain finance process flow** is explained below.

i. It works to the mutual advantage of both the supplier and the buyer, extending the credit line and getting the funds available to the supplier.
ii. It improves the relationship between the buyers and sellers and paves the way for future trades.
iii. Improves the creditworthiness of the buyer and gives the liquidity advantage to the seller.
iv. Unlike the involvement of the banks who charge a higher rate, the financing cost in the case of supply chain finance is relatively small.

Limitations: The **supply chain finance process flow** has some limitations too.

i. Since a financier is not a bank, there is a risk in dealing with a third party. The may not pay the seller on time or may not honour the contract as per the terms.
ii. It is used as a tool to cover payments for dubious goods. There are great supply chain finance risks where the seller or the buyer takes advantage of the time gap in payment to transact goods which are illegal.
iii. It can only be used to finance finished goods which has a readily available market value. If the goods are not ready for sale it is not possible to get a financer to make payment. The financer will not enter into contract for payment of goods that is not ready to be sold.

7.10 SUMMARY :

After studying this chapter, the student will be able: To Know about the Types of Trade, Types of Trade Finance, To understand Trade finance products, Foreign Trade and the payment procedure, To analyses the Letter of Credit, and Supply Chain Finance. Further, it is covered that One of the key difficulties with trade across international borders is the time it takes from when an importer places a sales order with an exporter and the actual receipt of goods. The shipping delay means that one party or the other has to absorb a heightened risk of non-performance: either of paying upfront under the risk that the order may never be delivered or sending product out on credit under the risk that payment may never be made. Trade finance products exist to ameliorate that risk and ensure exporters have enough working capital to be effective sellers in the international marketplace.

To help with this issue, the buyer and supplier get into a mutual agreement with an external financier who uses the invoices raised and grants the supplier credit on that basis. When the invoice payments become due, it gets the payment from the buyer. Through this, the supplier got early access to his receivables, and the buyer also did not have to

compromise his payment window. This way, supply chain finance enables both parties to fulfill their objectives without proving disadvantageous to the other.

7.11 TECHNICAL TERMS :

- **Trade:** Trade is the voluntary exchange of goods or services between different economic actors. Since the parties are under no obligation to trade, a transaction will only occur if both parties consider it beneficial to their interests.
- **Foreign Trade:** Foreign Trade is the exchange of goods and services between two countries in the international market. It helps in the availability of raw material/finished product in a country that either does not have it or has it in scarcity.
- Trade finance: Trade finance is the term used to describe the tools, techniques, and instruments that facilitate trade and protect both buyers and sellers from trade-related risks. The purpose of trade finance is to make it easier for businesses to transact with each other.
- **Letter of Credit:** Consider an exporter in an unstable economic climate, where credit may be more difficult to obtain. A bank could offer a buyer a letter of credit, available within two business days, in which the purchase would be guaranteed by the bank's branch. Because the bank and the exporter have an existing relationship, the bank is knowledgeable of the buyer's creditworthiness, assets, and financial status.
- **Supply Chain Finance:** Supply chain finance, also known as supplier finance or reverse factoring, is a financing solution in which suppliers can receive early payment on their invoices. Supply chain finance reduces the risk of supply chain disruption and enables both buyers and suppliers to optimize their working capital.

7.12 SELF ASSESSMENT QUESTIONS :

1. What is trade finance? Explain about different types of trade finance.
2. What is trade finance in banking?
3. Is trade finance a good career?
4. What is digital supply chain finance?
5. What are the different types of supply chain finance?
6. What are some of the risks associated with supply chain finance?
7. Who are participants Trade Finance?

7.13 SUGGESTED READINGS :

1. Vadilal Dagh: India’s Foreign Trade Jouav Such Foreign Trade and Economic development of under developed countries.
2. Lall G, S. : Financing of Foreign trade and
3. NCAER Export strategy for India
4. Jeevanandam: Foreign Exchange.
5. Jeevanandam: Foreign Exchange arithmetic
6. Reviewed by :MICHAEL J BOYLE & YARILET PEREZ
7. Abhijeet Sharma, Reviewed by Dheeraj Vaidya, CFA, FRM

Dr. KRISHNA BANANA

LESSON - 8
RBI & BANKS ROLE IN FOREIGN TRADE

AIMS AND OBJECTIVES :

After studying this chapter, the student will be able:

- To Know about the Role of Commercial Banks in Foreign Trade
- To understand Role of Reserve Bank of India (RBI) in Foreign Trade
- To awareness about Directorate General of Foreign Trade (DGFT)
- An Analysis the Indian Foreign Trade Policy 2023 –

STRUCTURE :

8.1. INTRODUCTION :

Banking : Banking is directly or indirectly connected with the trade of a country and the life of each individual. It is an industry that manages credit, cash, and other financial transactions. In banking, the commercial bank is the most influential institution for any country's economy or for providing any credit to its customers. In India, a banking company is responsible for transacting all the business transactions including withdrawal of cheques, payments, investments, etc. In other words, the bank is involved in the deposit and withdrawal of money, repayable on demand, savings, and earning a decent amount of profits by lending money. Banks also help to mobilise the savings of an individual, making funds accessible to businesses and help them to start a new venture. However, unlike commercial banks, private sector banks are owned, operated, and regulated by private investors and have the right to operate according to the market forces.

Structure of Banking in India : Structure of Banking in India of the present times has taken its form over several decades. The structure of banking in India aims to serve the credit and banking services needs of the Indian economy. Every banking and finance aspirant must have a clear understanding of the existing banking structure of the country not only to prepare for the exams but also for practical knowledge. In the today's banking structure of India, there are several layers that cater to the specific and diverse needs of different borrowers and customers. The structure of the banking system in the country plays a key role in the mobilization of savings and promoting economic growth. After the financial sector reforms of 1991, the strength and the performance of the banking structure improved by leaps and bounds. The financial soundness of the commercial banking system in India compares favorably with most of the developed countries. Let's understand more about the structure of banking in India as far as all its related concepts are concerned. The following article explores the meaning, concepts, structure, examples, and more about the existing banking system of the country.

Types of Banking : Banks are further segregated into four types.

- **Commercial banks:** These banks are regulated by Banking Regulation Act, 1949. They accept the public deposit from the public for lending or investment.
- **Cooperative banks:** Cooperative banks are undertaken by the State Cooperative Societies Act and give cheap credit to their members. The rural population is dependent on the cooperative banks for its financial backup.
- **Specialised banks:** These banks provide financial help to special industries, foreign trade, etc. Few examples of specialised banks are foreign exchange banks, export and import banks, development banks, etc.
- **Central banks:** These banks manage, check, and monitor all the activities of the commercial banks of a country.

Functions of Commercial Banks :

(1) Acceptance of deposits :

i. Banks provide the loans only based on the amount deposited by the public.
ii. They lend money and get interested in them.
iii. They get funds for lending through deposits in current and savings accounts.
iv. They pay interest on deposits according to the rates decided by RBI.

(2) Lending of funds :

i. Providing loans to the public is an important function of banks.
ii. Advances can be made in the form of overdrafts, cash credits, term loans, etc.

(3) Cheque facilities :

i. Banks provide cheque facilities to the owners of savings and current accounts to withdraw their money.
ii. It is the most developed form of credit instrument.
iii. Banks also encash the cheques drawn on another bank.
iv. There are two types of cheques.
   - Bearer cheques that are cashable immediately
   - Crossed cheques that are to be credited to the payee's account

(4) Remittance of funds :

i. Banks also provide the function of money transfer.
ii. It provides money transfer facilities through drafts, pays orders, net banking, NEFT/RTGS, etc., on nominal commission charges.
iii. A payee can present the cheques in the drawer bank to collect the funds.

Types of Commercial Banks :

(1) Public sector banks

i. Public sector banks are those banks in which the major holding is of the government.
ii. Examples: SBI, PNB, OBC, etc.

(2) Private sector banks

i. Private sector banks are those banks that are owned, controlled, and managed by private promoters.
ii. They operate according to the market forces.
iii. Examples: HDFC, ICICI, Kotak Mahindra, etc.

vi. What is e-banking? What are its benefits?

E-banking	● It is the method by which the customer conducts transactions electronically via the internet. ● Some of the examples of e-banking are managing deposit account, online fund transfer, ATM, electronic data interchange, etc.
Benefits	● It provides 24 hours and 365 days of banking services. ● The load on branches can be reduced by having a centralised database for faster processing. ● Customers can make a transaction from anywhere like the home office market, etc. ● It includes recording of every transaction. ● It provides greater customer satisfaction, higher security in terms of money.

8.2 ROLE OF COMMERCIAL BANKS IN FOREIGN TRADE :

Commercial banks are crucial to international trade. When trading partners are on the other side of the world or in a country where business contracts are difficult to enforce, banks lessen the risks of doing business overseas with financial products like letters of credit.

Bank Issued Letters of credit : Bank Issued Letters of credit are the most common financial service that commercial banks provide for international businesses according to the New York Federal Reserve. Vox says they are typically used for exporting goods to countries where there can be difficulty enforcing contracts or when trading with countries that present a considerable risk. Very few U.S. firms use letters of credit when shipping to Canada, Mexico or most members of the European Union. Letters of credit are most often used when trading with riskier destinations, such as Pakistan, Turkey, India or China. Approximately 30 percent of U.S. exports to China are facilitated with letters of credit from commercial banks.

How a Letters of credit works : Once the buyer and the seller have entered into a contract for the sale of goods, the buyer will ask the bank for a letter of credit. The seller's bank must authenticate the letter of credit before any goods can be shipped, says Investopedia. Once the seller ships the goods, it forwards the export documents to their bank. The seller's bank matches up the export documents with the letter of credit to make sure that what was contracted to be shipped is what was actually shipped. If all the documents agree, the buyer's bank sends its payment to the seller's bank.

Funding a Letters of credit: In most cases a letter of credit is a negotiable instrument, like a bank check, that the issuing bank will pay to the seller. A transferable letter of credit permits the seller to transfer the payment to a third party, such as a corporate parent company. The same way a consumer who writes a personal check for payment of goods must have enough money in the bank to cover his or her purchase, Shipping Solutions says that banks require buyers requesting letters of credit to provide collateral, such as cash or securities, in exchange for issuing a letter of credit.

In addition, banks may levy a service charge that is a percentage of the amount of the letter of credit requested. The service charge often reflects the amount of risk the bank assumes. The riskier the destination, the higher the fees are likely to be. To eliminate risk in some instances, banks will accept only cash paid in advance before shipping.

Is a Bill of Lading the Same as a Letter of Credit? :

A bill of lading and a letter of credit are completely different documents that serve unique purposes. These two documents are linked in that they are both commonly found in international trade transactions. Knowing the difference between a bill of lading and a letter of credit can help you to understand the import/export industry and the international trade process.

Bill of Lading : Bill of lading is a document listing and detailing all of the goods in a shipment of any kind, whether by land, sea or air. Sellers of goods print a bill of lading that details the product types, quantities, prices, weights and any other factors important to the distributor and the buyer. The seller then signs the bill of lading and attaches it to the shipment as it is passed off to the distributor, assuming the seller uses a third-party distributor.

The shipping company can use the bill of lading to double check that all goods are accounted for. Although shippers generally cannot check the contents of containers, like boxes or pallets, they can check the number and type of containers present in the shipment.

When the buyer receives the shipment, an employee can use the bill of lading to ensure that all items on the bill are present in the shipment and to compare the list of shipped goods against the buyer's purchase records to ensure all purchased goods are included in the bill. The buyer can then use the bill of lading as an official receipt for the transaction.

Letter of Credit : A letter of credit is essentially a promise made by one bank to another that the first bank's customer can be relied upon to pay for goods after they have been received. In practice, a buyer from one country asks his bank to send a letter of credit to the seller's bank in another country. This assures the seller that he can ship the goods to the buyer with a measure of financial security, since the letter of credit requires the buyer's bank to cover the payment if the buyer defaults. This is a form of private industry regulation. Since there is no international authority with the power to enforce trade rules across countries, the banking industry relies on letters of credit to provide protection to international businesses.

Correlation : Letters of credit and bills of lading represent two distinct steps in a single process. After making a deal for an international transaction involving a physical shipment, the buyer initiates a letter of credit. Once the seller's bank accepts the letter, the seller can draft a bill of lading and ship the goods.

Process : Companies create bills of lading themselves, either by creating them from scratch or using a template packaged with an office productivity software package. Bills of lading can take a wide range of forms, as long as all relevant information is included.
Letters of credit are drafted and sent by the buyer's bank. The purchaser in the transaction must simply contact the bank, request a letter of credit be initiated and provide information about the transaction, the seller and the seller's bank.

Letter of Credit : Pros & Cons Before credit cards and traveler's checks came into common use, many merchants and individuals used letters of credit as financial backing for their sales and service transactions when dealing with unknown customers or merchants. Letters of credit are still in use, and provide a number of advantages. However, letters of credit also have drawbacks, some of which are significant.

Definition : A bank issues a letter of credit to guarantee payment made on the behalf of a named beneficiary, often a business or merchant customer of the bank. When used for commercial transactions, letters of credit serve a similar function as a line of credit or an account with a specified payment date, such as net -15--payment within 15 days--or net -30--payment within 30 days. Banks may also issue letters of credit to prominent citizens whom they trust to make good on their financial obligations. Letters of credit allow individuals to travel without carrying large sums of cash.

Types : Letters of credit take several forms, which differ in some functions depending on the specific type. A letter of credit may be primary--that is, it serves as the main method of payment--or secondary, which means that the letter of credit serves as a backup in case the beneficiary fails to pay. A confirmed letter of credit is issued by a foreign bank and guaranteed as valid by a domestic bank. A commercial letter of credit guarantees payment for goods to a seller delivered to the bearer of the letter upon presentation of satisfactory documentation by the seller. An irrevocable letter of credit guarantees payment by the issuing bank as long as the beneficiary meets the terms specified in the document, as opposed to a revocable letter of credit, for which a bank may modify or cancel payment.

Special Letters of Credit: Letters of credit also cover special circumstances. Transferable letters of credit allow the original beneficiary to transfer the letter of credit and its guarantee of payment to a third party, who then becomes the beneficiary. Deferred payment letters of credit specify payment after a specific time has passed. A back-to-back letter of credit uses the first letter of credit as collateral for a second letter of credit, which the beneficiary issues to the actual supplier of merchandise or service. A red-clause letter of credit advances cash to the seller in advance of actual delivery of merchandise or services. A revolving line of credit allows the beneficiary to draw on the specified amount of credit for a specified number of times; the issuing bank restores the credit to the original amount after each transaction.

Advantages and Disadvantages: The main advantage of a letter of credit is that it eliminates the need for up-front cash payments. However, sellers may encounter problems with letters of credit, such as impossible delivery schedules or unacceptable costs. Attempts to modify the terms of a letter of credit may also cause disruptions in the transaction. Discrepancies in the documents presented by the seller may also cause the issuing bank to void the letter of credit, according to the Credit Research Foundation. Commercial banks are crucial to international trade. When trading partners are on the other side of the world or in a country where business contracts are difficult to enforce, banks lessen the risks of doing business overseas with financial products like letters of credit.

8.3. FORMS OF FINANCIAL ASSISTANCE PROVIDED BY EXIM BANK TO INDIAN EXPORTERS :

EXIM Bank extends Lines of Credit (LOCs) to overseas governments, financial institutions, regional banks and other overseas entities, to finance India's exports to those countries. EXIM Bank's LOC is a risk-free, non-recourse export financing option available to Indian exporters for promoting their exports. Under this arrangement, overseas importers are required to pay advance payment to Indian exporters, which is usually 10% of the contract value. EXIM Bank pays the balance amount, which is normally 90% of the contract value, to Indian exporters through negotiating banks in India, upon shipment of goods. EXIM Bank also operates LOCs, announced by the Government of India, to the country's trading partners.

***Delayed Payment Exports* -** Term loans are provided to those exporters who deal with exporting of goods and services and this enables them to offer delayed credit to the foreign buyers. This system of deferred credit covers Indian consultancies, technology and other services. Commercial banks take part in this program either directly or under risk syndication arrangements.

Pre-shipment credit - Indian companies which are highly involved in the execution of export activities beyond the cycle time of six months are funded by EXIM Bank. The construction or turnkey project exporters enjoy the provision of rupee mobilization.
Term loans for export production - EXIM Bank offers term loans to the 100 percent export oriented units, units involved in free trade zones, and exporters of various soft ware's in India. EXIM bank also works in association with International Finance Corporation, Washington, to provide financial assistance to the small scale and medium industrial units in terms of ameliorating the export production capacity of these units in India. EXIM Bank also provides funded and non- funded facilities to deemed exports from India.
Foreign Investment Finance - EXIM bank provides financial assistance for equity contribution to the Indian companies who form Joint Venture with the foreign companies.
Financing export marketing - It helps the exporters carry out their export market development plan in Indian market.

8.4 EXPORT CREDIT INSURANCE-EXPORT FINANCE :

- ❖ **Eligibility :** Any bank authorized to deal in foreign exchange can obtain the Export Finance Cover in respect of its exporter-client who has been classified as a standard asset and whose CR is acceptable to ECGC.
- ❖ **Period Of Cover :** 12 months
- ❖ **Eligible Advances :** Advances against incentives such as cash assistance, duty drawback, etc., receivable at post-shipment stage.
- ❖ **Protection Offered :** Against losses that may be incurred in extending post-shipment advances against incentives due to protracted default or insolvency of the exporter-client.
- ❖ **Percentage of Cover :** 75%
- ❖ **Premium :** 6 paise per Rs.100 p.m. on the highest amount outstanding on any day during the month.
- ❖ **Maximum Liability :** 75% of the post-shipment limit sanctioned to the account.
- ❖ **Important Obligations Of The Bank :** Monthly declaration of advances granted and payment of premium before 10th of succeeding month. Approval of the Corporation for extension of due date beyond 360 days from due date to be obtained. Default to be reported within 4 months from due date or extended due date of advances, if not recovered, filing of claim within 6 months of the Report of Default. Recovery action after payment of claim and the subsequent sharing of recovery.
- ❖ **Highlights :** Banks can take the cover selectively. Banks having ECIB-WTPS are eligible for concessionary premium rate and higher percentage of cover as applicable.

8.5 ROLE OF RESERVE BANK OF INDIA (RBI) IN FOREIGN TRADE :

RBI framework for invoicing and payments for international trade in Indian Rupee- Posted On: 06 FEB 2023 6:42PM by PIB Delhi- The Reserve Bank of India (RBI) has allowed invoicing and payments for international trade in Indian Rupee vide A.P (DIR Series) Circular No. 10 RBI/2022-2023/90 dated 11.07.2022 on "International Trade Settlement in Indian Rupees (INR)". This was stated by the Union Minister of State for Finance, Dr Bhagwat Kisanrao Karad, in a written reply to a question in Lok Sabha today.

Giving more information, thr Minister stated that the Circular lays down that all exports and imports under the arrangement may be denominated and invoiced in Rupee (INR) and the settlement of trade transactions under the arrangement shall take place in INR. RBI has put in place the arrangement to promote growth of global trade with emphasis on exports from India and to support the increasing interest of global trading community in INR. The framework put in place by RBI is applicable for any partner country seeking to undertake trade with India in INR in terms of RBI's Circular dated 11.07.2022, the Minister added.

Further, the Minister stated, the Directorate General of Foreign Trade (DGFT) has introduced a provision in the Foreign Trade Policy vide Notification No. 33/2015-20 dated 16.09.2022, to allow for International Trade Settlement in INR i.e., invoicing, payment, and settlement of exports / imports in Indian Rupees in sync with RBI's Circular dated 11.07.2022. Further changes have been introduced in the Foreign Trade Policy vide DGFT's Notification 43/2015-20 dated 09.11.2022 and Public Notice 35/2015-20 dated 09.11.2022 for grant of exports benefits and fulfilment of Export Obligation for export realisations in INR as per RBI guidelines, the Minister stated.

Reserve Bank of India (RBI) Objectives :

- To establish a good image for the country at the international level thus helping in attracting foreign trade.
- To ensure that the RBI has backup funds if the rupee rapidly devalues or becomes altogether insolvent,
- To check the rupee depreciation by selling the dollar in the Indian money market,
- To support our imports since all international transactions are settled in US dollars.
- To limit any vulnerability because of a sudden disruption in foreign capital flows, which could happen during a crisis

8.6 INDIA: FOREIGN TRADE POLICY 2023 – AN ANALYSIS :

The Government of India announced the much-anticipated Foreign Trade Policy 2023 earlier this month. The previous Foreign Trade Policy 2015-20 was extended till 31st March 2023, in light of the COVID-19 pandemic and the volatile geo-political situation. The new policy is dynamic with long term focus around four pillars: Incentive to Remission, Export Promotion through Collaboration, Ease of Doing Business, and Emerging Area.

The Ministry of Commerce and Industry, on 31st March 2023 announced the new Foreign Trade Policy 2023, which will be effective from 1st April 2023. Unlike the previous policy, the new policy will not be applicable for only a period of five years. As per the Ministry, the policy will be dynamic, updated as and when required, with no end date. This move has been made to accommodate the emerging needs of the time by allowing various sectors to give valuable feedback to the Ministry. A consultation mechanism will also be put in place to address the concerns of various stakeholders. Further, the Central Government has set a sector-specific target of achieving $1 trillion merchandise exports and 1$ trillion service exports by the end of 2030. One of the key highlights of the policy is internationalisation of the Indian currency by encouraging trade settlement in INR. This is a fundamental step in increasing the acceptance of INR in the global market and add to its resilience to external shocks. The key features of the policy are discussed in detail below.

Revisions in export incentive schemes : The policy focuses on ease of doing business for traders through paperless and automated approval system and reduced transaction cost. It has reduced the processing time for issuance of licenses under Advance Authorization scheme and Export Promotion Capital Goods scheme, revalidation of authorisations and extension of export obligation period from upto 31 days to 1 day. All applications for redemption of advance authorisation licence shall become paperless making the entire lifecycle of the authorization paperless. The policy has also reduced the application fee for MSMEs under advance authorisation and EPCG schemes. Even e-Certificate of Origin has been revamped with self-certification of CoOs and automatic approval.

The policy has also aimed at export promotion by rationalising the export performance threshold to enable more exporters to achieve higher status. For instance, the qualifying criterion for a five-star exporter has been reduced from $2 billion to $800 million. Further, merchanting trade which involves shipment of goods from one foreign country to another involving an Indian intermediary, without touching the Indian ports has also been allowed. However, it is subject to regulations set by the RBI in July 2022 and is not allowed for goods/items in the CITES and SCOMET lists.

Regional export promotion schemes : Four new Towns of Export Excellence (TEE), namely Faridabad, Mirzapur, Moradabad, and Varanasi, have been declared for apparel, handicraft, handmade carpets and handloom and handicrafts respectively. This will be in addition to 39 towns that are already approved. TEEs are industrial clusters that are recognized based on their export performance. Such recognition helps such industrial clusters in expanding to new markets, compete at a global level, receive financial assistance under Market Access Initiative Scheme, and eligibility for EPCG authorisation, among other benefits.

The policy has also taken efforts to take forward the Districts as Export Hubs Initiative by allowing collaboration between exporters as well as States and Districts, allowing for a wider participation by States and Districts in promoting exports. The regional Authorities of DGFT will also work with States and UTs to prepare District Export Action Plans and identify products / services in all districts. Further, the policy allows for creation of institutional mechanisms at State and District level to strategize exports. It will address infrastructure and logistic bottlenecks and help districts build export oriented eco-systems.

Amnesty scheme : Another important feature of the policy is the introduction of the Amnesty Scheme. The Scheme allows for one-time settlement of default in export obligation in case of EPCG and Advance Authorizations schemes. All pending cases for default in Export Obligation (EO) of authorizations can be settled by the authorization holder on payment of all customs duties exempted in proportion to unfulfilled Export Obligation. The maximum interest is capped at 100% of such duties exempted. However, no interest is payable on Additional Customs Duty and Special Additional Customs Duty payable. The scheme will only be applicable till 30th September 2023.

Focus on e-commerce sector : Another notable feature of the policy is the increased focus on the e-commerce sector. The policy outlines the roadmap for establishing e-commerce export hubs and offers a range of facilities to give the e-commerce sector a major boost. All the benefits of the policy will be extended to e-commerce with necessary enablement of IT systems in various government departments. Consultation with various ministries will be held to formulate guidelines to facilitate further exports under e-Commerce. The policy provides for designated hubs to be notified with warehousing facilities to help e-Commerce.

Other notable changes : The Central Government has recently shown a keen interest in green energy products such as the EV sector. Accordingly, under the new policy, Battery Electric Vehicles for all types will be eligible for a reduced Export Obligation requirement under the ECPG Scheme.

Steps have also been taken to give aid to the manufacturing sector. On March 17th, 2023, the Government of India had announced the setting up of 7 Prime Minister Mega Integrated Textile Region and Apparel (PM MITRA) Parks for the textile industry. These sites are a major step towards achieving India's vision of making India the global hub for textile manufacturing. Under the new policy, the PM MITRA parks will be eligible to claim benefits under Common Service Provider Scheme and EPCG Scheme. Further, in order to promote the dairy sector, it has been exempted from maintaining Average Export Obligation. Special Advance Authorisation Scheme has been extended to export of Apparel and Clothing sector. Moreover, self-Ratification Scheme for fixation of Input-Output Norms has been extended to 2 star and above status holders.

Lastly, the policy has streamlined the Special Chemicals, Organisms, Materials, Equipment and Technologies (SCOMET) licencing procedure through measures such as consolidation of policy for export of dual use items (SCOMET items) at one place and general authorizations for export of certain SCOMET items. Overall, the Foreign Trade Policy 2023 brings a new opportunity for growth with several new facilities that allows **ease of doing business** and increased relaxation to the traders. It is already in contrast with the previous policies by removing the sunset clause with a mechanism for continuous improvement. The policy focuses on long term growth of the manufacturing and export sector, including the e-commerce sector. However, in order for the new policy to succeed, it is imperative, that the intended schemes are effectively implemented and proper assistance is offered to the businesses to adopt these changes.

Businesses planning to set up a trading company, or start importing or exporting from India, must understand the stages and stakeholders involved in the process, as well as the regulatory framework and documentation required. The Indian government on 31st March, 2023 announced the new Foreign Trade Policy (FTP) 2023 proving to be a boost to exports amid slowing global trade. The FTP 2015-20 was extended...The Circuitous Rules And Regulations Surrounding ODI Through FDI Transactions- PSA. Overseas Direct Investment ("ODI") through Foreign Direct Investment ("FDI") transactions (often referred as "round-tripping") has had a checkered past on account of suspicion...Foreign Trade Policy 2023- Khaitan & Co LLP. The Foreign Trade Policy 2015-20 had multiple extensions till 31 March 2023, owing to the COVID-19 pandemic and the unstable geo-political situation. Targeted Dumping And The Use Of Zeroing-TPM Consultants- Targeted dumping is said to exist when the export price to certain producers or regions or during certain time periods is significantly different from others.

8.7 MASTER DIRECTION – IMPORT OF GOODS AND SERVICES :

- ❖ Import of Goods and Services into India is being allowed in terms of Section 5 of the Foreign Exchange Management Act 1999 (42 of 1999), read with Notification No. G.S.R. 381(E) dated May 3, 2000 viz. Foreign Exchange Management (Current Account Transaction) Rules, 2000. These Regulations are amended from time to time to incorporate the changes in the regulatory framework and published through amendment notifications.
- ❖ Within the contours of the Regulations, Reserve Bank of India also issues directions to Authorised Persons under Section 11 of the Foreign Exchange Management Act (FEMA), 1999. These directions lay down the modalities as to how the foreign exchange business has to be conducted by the Authorised Persons with their customers/constituents with a view to implementing the regulations framed.
- ❖ Instructions issued on import of goods and services into India have been compiled in this Master Direction. The list of underlying circulars/ notifications which form the basis of this Master Direction is furnished in the Appendix. Reporting instructions can

be found in Master Direction on reporting (Master Direction No. 18 dated January 01, 2016).

- ❖ It may be noted that, whenever necessary, Reserve Bank shall issue directions to Authorised Persons through A.P. (DIR Series) Circulars in regard to any change in the Regulations or the manner in which relative transactions are to be conducted by the Authorised Persons with their customers/ constituents. The Master Direction issued herewith shall be amended suitably simultaneously.

8.8 DIRECTORATE GENERAL OF FOREIGN TRADE (DGFT) :

Import trade is regulated by the Directorate General of Foreign Trade (DGFT) under the Ministry of Commerce & Industry, Department of Commerce, Government of India. Authorised Dealer Category – I (AD Category – I) banks should ensure that the imports into India are in conformity with the Foreign Trade Policy in force and Foreign Exchange Management (Current Account Transactions) Rules, 2000 framed by the Government of India vide Notification No. G.S.R.381 (E) dated May 3, 2000 and the Directions issued by Reserve Bank under Foreign Exchange Management Act, 1999 from time to time.

- ❖ AD Category – I banks should follow normal banking procedures and adhere to the provisions of Uniform Customs and Practices for Documentary Credits (UCPDC), etc. while opening letters of credit for import into India on behalf of their constituents.
- ❖ Compliance with the provisions of Research & Development Cess Act, 1986 may be ensured for import of drawings and designs.
- ❖ AD Category – I banks may also advise importers to ensure compliance with the provisions of Income Tax Act, wherever applicable.

Any reference to the Reserve Bank should first be made to the Regional Office of the Foreign Exchange Department situated in the jurisdiction where the applicant person resides, or the firm / company functions, unless otherwise indicated. If, for any particular reason, they desire to deal with a different office of the Foreign Exchange Department, they may approach the Regional Office of its jurisdiction for necessary approval.

8.9 GENERAL GUIDELINES FOR IMPORTS :

- ❖ ***Rules and regulations to be followed by the AD Category*** – I banks from the foreign exchange angle while undertaking import payment transactions on behalf of their clients are set out in the following paragraphs. Where specific regulations do not exist, AD Category – I banks may be governed by normal trade practices. AD Category – I banks may particularly note to adhere to "Know Your Customer" (KYC) guidelines issued by Reserve Bank (Department of Banking Regulation) in all their dealings.
- ❖ ***Remittances for Import Payments:*** AD Category I Banks may allow remittance for making payments for imports into India, after ensuring that all the requisite details are made available by the importer and the remittance is for bona fide trade transactions as per applicable laws in force.
- ❖ ***Import Licences:*** Except for goods included in the negative list which require licence under the Foreign Trade Policy in force, AD Category - I banks may freely open letters of credit and allow remittances for import. While opening letters of credit, the ‘For Exchange Control purposes’ copy of the licence should be called for and adherence to special conditions, if any, attached to such licences should be ensured. After effecting remittances under the licence, AD Category - I banks may preserve the copies of utilised licence /s till they are verified by the internal auditors or inspectors.

- ***Obligation of Purchaser of Foreign Exchange***: In terms of Section 10(6) of the Foreign Exchange Management Act, 1999 (FEMA), any person acquiring foreign exchange is permitted to use it either for the purpose mentioned in the declaration made by him to an Authorised Dealer Category – I bank under Section 10(5) of the Act or for any other purpose for which acquisition of foreign exchange is permissible under the said Act or Rules or Regulations framed there under.

8.10 SUMMARY :

After studying this chapter, the student will be able: To Know about the Role of Commercial Banks in Foreign Trade, To understand Role of Reserve Bank of India (RBI) in Foreign Trade, To awareness about Directorate General of Foreign Trade (DGFT) and An Analysis the Indian Foreign Trade Policy 2023. In addition to that the student should be able to learn about Forms of Financial Assistance Provided by EXIM Bank to Indian Exporters, Export Credit Insurance-Export Finance, and General Guidelines for Import.

8.11 TECHNICAL TERMS :

- **Foreign Trade:** Foreign Trade is the exchange of goods and services between two countries in the international market. It helps in the availability of raw material/finished product in a country that either does not have it or has it in scarcity.
- **EXIM Bank:** Exim Bank was established by the Government of India, under the Export-Import Bank of India Act, 1981 as a purveyor of export credit, mirroring global Export Credit Agencies. Exim Bank serves as a growth engine for industries and SMEs through a wide range of products and services.
- **DGFT:** This Directorate, with headquarters at New Delhi, is responsible for formulating and implementing the Foreign Trade Policy with the main objective of promoting India's exports. The DGFT also issues scrips/authorization to exporters and monitors their corresponding obligations through a network of 24 regional offices.
- **Export Finance:** Export Finance is to finance the purchase of capital goods through a loan agreement granted to the importer, secured by sovereign guarantors, among other : Export Credit Agency (ECA) from the exporter's country, Multilateral / Bilateral institution, Sovereign / Sub-sovereign obligor.

8.12 SELF ASSESSMENT QUESTIONS :

1. What is Foreign Trade? Discuss about the Role of Commercial Banks in Foreign Trade
2. Explain different Forms of Financial Assistance Provided by EXIM Bank to Indian Exporters
3. Briefly discuss about Export Credit Insurance-Export Finance
4. Explain the Role of Reserve Bank of India (RBI) in Foreign Trade
5. Write about Foreign Trade Policy 2023 – An Analysis
6. Do you know about Directorate General of Foreign Trade (DGFT)
7. What are the General Guidelines imposed by the RBI for Import/

8.13 SUGGESTED READINGS :

1. Aastha Gupta and Nishtha Gupta,TPM Consultants, 28 April 2023
2. Aastha Gupta,& Nishtha Gupta TPM Consultants, Your LinkedIn Connections
3. Frances Katz, Published on 21 Nov 2018
4. Chris Blank, Published on 26 Sep 2017
5. David Ingram, Published on 26 Sep 2017

Dr. KRISHNA BANANA

LESSON - 9

INTERNATIONAL SETTLEMENTS

OBJECTIVES:

1. Understand the meaning & scope of international trade.
2. Understand the meaning of International settlement.
3. Aware about the methods of international settlements.

STRUCTURE:

9.1. Introduction
9.2. Scope of International Trade.
9.3. Features of International Trade.
9.4. Methods of entering into foreign trade.
9.5. Advantages of Foreign Trade.
9.6. Dis advantages of Foreign Trade.
9.7. Importance of Export Business in India.
9.8. Methods of Payment in International Trade.
9.9. Risk management & Settlement.
9.10. Recent Developments in International Settlement.
9.11. Summary
9.12. Technical Terms
9.13. Self Assessment Questions
9.14. Suggested Readings

9.1 INTRODUCTION :

- International business involves transactions across the national boundaries. It includes the transfer of goods, services, technology, managerial knowledge and capital to other countries. International business has gained greater visibility and importance in recent years because of the large multinational corporations. International trade is a part of total marketing process.
- It refers to the marketing activities carried on by a marketer in more than one nation. “Trade carried on across national boundaries”.
- “The Performance of business activities that directs the flow of goods and services to consumers or users in more than one nation” – Hess &Cateor

9.2 SCOPE OF INTERNATIONAL TRADE :

- **Exports And Imports:** It includes merchandise (tangible or having physical existence) of Goods. Export merchandise means sending goods to other nations. Import merchandise means receiving goods from other nations. It does include the trade of services.
- **Service Trade:** It is also known as invisible trade. It includes the trade of services (intangible or no physical existence). There is both export and import of services. Services like tourism, hotel, transportation, training, research etc.,
- **Licensing & Franchising:** Under this permission is given to the organization of other countries. To sell the product of a particular company. Under its trademark, patents in return of some fees. Example– Pepsi and Coca Cola are produced and sold through

different 2 sellers abroad. Franchising is similar to licensing but associated with services. Example Dominos, burger king, etc.,

- **Foreign Investment:** It includes the investment of available funds in foreign companies to get returns. It can be of 2 types :(1) Direct investment means investing funds in plant and machinery for marketing and production, also known as a foreign direct investment (FDI). Sometimes these investments are done jointly known as joint ventures. (2) Portfolio investment means one company invests in another company by way of investing in its securities and earn income in the form of interest and dividends.
- **Consultancy Services :** The exporting company offers consultancy service by undertaking Turnkey projects in foreign countries. For this purpose, it sends its consultants and experts to foreign countries who guide and direct the manufacturing activities of the spot.
- **Exchange Of Technical And Managerial Knowhow:** The Technicians and Managerial personnel of the exporting company guide and train the technicians and the manager of the importing company.

9.3 FEATURES OF INTERNATIONAL TRADE :

The following are the distinguishing features of international trade:

- **Immobility Of Factors:** The degree of immobility of factors like labour and capital is generally greater between countries than within a country. Immigration laws, citizenship, qualifications, etc. often restrict the international mobility of labour.
- **Heterogeneous Markets:** In the international economy, world markets lack homogeneity on account of differences in climate, language, preferences, habit, customs, weights and measures, etc. The behaviour of international buyers in each case would, therefore, be different.
- **Different National Groups:** International trade takes place between differently cohered groups. The socio-economic environment differs greatly among different nations.
- **Different Political Units/Legal Systems:** International trade is a phenomenon which occurs amongst different political units.
- **Different National Policies And Government Intervention :** Economic and political policies differ from one country to another. Policies pertaining to trade, commerce, export and import, taxation, etc., also differ widely among countries though they are more or less uniform within the country. Tariff policy, import quota system, subsidies and other controls adopted by governments interfere with the course of normal trade between one country and another.
- **Different Currencies:** Another notable feature of international trade is that it involves the use of different types of currencies. So, each country has its own policy in regard to exchange rates and foreign exchange.

PROCEDURES AND DOCUMENTATIONS : The different laws and customs of trade in each country demand different procedures and documentary requirements for the import and export of the goods and services.

9.4 METHODS OF ENTERING FOREIGN TRADE :

- **Exporting :** Exporting is the direct sale of goods and / or services in another country. It is possibly the best-known method of entering a foreign market, as well as the lowest risk. It may also be cost-effective as you will not need to invest in production facilities in your chosen country – all goods are still produced in your home country then sent to foreign countries for sale. However, rising transportation costs are likely to increase the cost of exporting in the near future. The majority of costs involved with exporting come from marketing expenses. Usually, you will need the involvement of four parties: your business, an importer, a transport provider and the government of the country of which you wish to export to.

- **Licensing:** Licensing allows another company in your target country to use your property. The property in question is normally intangible – for example, trademarks, production techniques or patents. The licensee will pay a fee in order to be allowed the right to use the property. Licensing requires very little investment and can provide a high return on investment. The licensee will also take care of any manufacturing and marketing costs in the foreign market.
- **Franchising:** Franchising is somewhat similar to licensing in that intellectual property rights are sold to a franchisee. However, the rules for how the franchisee carries out business are usually very strict – for example, any processes must be followed, or specific components must be used in manufacturing.
- **Joint Venture:** A joint venture consists of two companies establishing a jointly-owned business. One of the owners will be a local business (local to the foreign market). The two companies would then provide the new business with a management team and share control of the joint venture. There are several benefits to this type of venture. It allows you the benefit of local knowledge of a foreign market and allows you to share costs. However, there are some issues – there can be problems with deciding who invests what and how to split profits.
- **Foreign Direct Investment:** Foreign direct investment (FDI) is when you directly invest in facilities in a foreign market. It requires a lot of capital to cover costs such as premises, technology and staff. FDI can be done either by establishing a new venture or acquiring an existing company.
- **Wholly Owned Subsidiary:** A wholly owned subsidiary (WOS) is somewhat similar to foreign direct investment in that money goes into a foreign company but instead of money being invested into another company, with a WOS the foreign business is bought outright. It is then up to the owners whether it continues to run as before or they take more control of the WOS.
- **Piggybacking**: Piggybacking involves two non-competing companies working together to cross-sell the other's products or services in their home country. Although it is a low-risk method involving little capital, some companies may not be comfortable with this method as it involves a high degree of trust as well as allowing the partner company to take a large degree of control over how your product is marketed abroad.

9 .5 ADVANTAGES OF FOREIGN TRADE :

The following are the major gains claimed to be emerging from international trade:

- **Optimum Allocation:** International specialization and geographical division of labour leads to the optimum allocation of world's resources, making it possible to make the most efficient use of them.
- **Gains Of Specialization:** Each trading country gains when the total output increases as a result of division of labour and specialization. These gains are in the form of more aggregate production, larger number of varieties and greater diversity of qualities of goods that become available for consumption in each country as a result of international trade.
- **Enhanced Wealth:** Increase in the exchangeable value of possessions, means of enjoyment and wealth of each trading country.

- **Larger Output:** Enlargement of world's aggregate output.
- **Welfare Contour:** Increase in the world's prosperity and economic welfare of each trading nation.
- **Cultural Values:** Cultural exchange and ties among different countries develop when they enter into mutual trading.
- **Better International Politics:** International trade relations help in harmonizing international political relations.
- **Dealing With Scarcity:** A country can easily solve its problem of scarcity of raw materials or food through imports.
- **Advantageous Competition:** Competition from foreign goods in the domestic market tends to induce home producers to become more efficient to improve and maintain the quality of their products.
- **Larger Size Of Market:** Because of foreign trade, when a country's size of market expands, domestic producers can operate on a larger scale of production which results in further economies of scale and thus can promote development. Synchronized application of investment to many industries simultaneously become possible. This helps industrialization of the country along with balanced growth.

9.6 DISADVANTAGES OF FOREIGN TRADE :

When a country places undue reliance on foreign trade, there is a likelihood of the following disadvantages:

- **Exhaustion of Resources**: When a country has larger and continuous exports, her essential raw materials and minerals may get exhausted, unless new resources are tapped or developed (e.g., the near-exhausting oil resources of the oil-producing countries).
- **Blow to Infant Industry**: Foreign competition may adversely affect new and developing infant industries at home.
- **Dumping**: Dumping tactics resorted to by advanced countries may harm the development of poor countries.
- **Diversification of Savings:** A high propensity to import may cause reduction in the domestic savings of a country. This may adversely affect her rate of capital formation and the process of growth.
- **Declining Domestic Employment:** Under foreign trade, when a country tends to specialize in a few products, job opportunities available to people are curtailed.
- **Over Interdependence**: Foreign trade discourages self-sufficiency and self-reliance in an economy. When countries tend to be interdependent, their economic independence is jeopardized.

For instance, for these reasons, there is no free trade in the world. Each country puts some restrictions on its foreign trade under its commercial and political policies.

9.7 IMPORTANCE OF EXPORT BUSINESS IN INDIA

- **Meeting imports of industrial needs** – Imports of capital equipment, raw materials of critical nature, technical know-how for building the industrial base in the country for rapid industrialization and developing the necessary infrastructure.
- **Debt Servicing** – India has been receiving external aid over the years for its industrial development resulting in the need for debt servicing. Therefore, it is essential to concentrate on export earnings to cover both imports and debt servicing.
- **Fast Economic Growth** – The countries that would like it grow economically should create exportable surpluses i.e., surpluses after meeting domestic demands. 4. Optimum Use of Natural Resources – Foreign exchange can be utilized in establishing

industrial unit based on different natural resources availability in the country by making the necessary imports of plant and machinery for the purpose.

- **Meeting Competitions** – To improve the exports, the government announces several concessions and incentives. By utilizing these concessions domestic producers concentrates his mind towards the improvement of quality of goods produced and reduces the cost of production so as to face the acute competitive situation in the foreign markets by making intensive use of latest technology.
- **Increasing Employment Opportunities** – The problem of employment and underemployment can be solved to some extent by increasing the level of export.
- **Increasing National Income** – A country's national income increases to a sizable extent through organized export marketing.
- **Increasing the standard of Living in the following ways**

  a. Import of necessary items.
  b. Purchasing power increases.
  c. Widespread industrialization.
  d. Competitive quality

- **Develops International Collaboration** – To settle international issues some countries from group or a common platform to discuss various issues concerning their international trade and take decision. OPEC & EEC are such groups.
- **Develops Cultural Relations** – Local representatives and other related persons come into contact with foreign representatives and know their habits and customs.
- **Brings Political Peace** – Various countries with different political ideologies import or export their product, which enhances the chances of peace.

9.8 METHODS OF PAYMENT IN INTERNATIONAL TRADE :

To succeed in today's global marketplace and win sales against foreign competitors, exporters must offer their customers attractive sales terms supported by the appropriate payment methods. Because getting paid in full and on time is the ultimate goal for each export sale, an appropriate payment method must be chosen carefully to minimize the payment risk while also accommodating the needs of the buyer. During or before contract negotiations, you should consider which method in the figure is mutually desirable for you and your customer.

Key Points :

International trade presents a spectrum of risk, which causes uncertainty over the timing of payments between the exporter (seller) and importer (foreign buyer).
For exporters, any sale is a gift until payment is received.
Therefore, exporters want to receive payment as soon as possible, preferably as soon as an order is placed or before the goods are sent to the importer.
For importers, any payment is a donation until the goods are received.
Therefore, importers want to receive the goods as soon as possible but to delay payment as long as possible, preferably until after the goods are resold to generate enough income to pay the exporter.

Cash-In-Advance :

With cash-in-advance payment terms, an exporter can avoid credit risk because payment is received before the ownership of the goods is transferred. For international sales, wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters. With the advancement of the Internet, escrow services are becoming another cash-in-advance option for small export transactions. However, requiring payment in advance is the least attractive option for the buyer, because it creates unfavourable cash flow. Foreign buyers are also concerned that the goods may not be sent if payment is made in advance. Thus, exporters who insist on this payment method as their sole manner of doing business may lose to competitors who offer more attractive payment terms.

Letters of Credit: Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents. The buyer establishes credit and pays his or her bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. An LC also protects the buyer since no payment obligation arises until the goods have been shipped as promised.

Documentary Collections: A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents that its buyer needs to the importer's bank (collecting bank), with instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. D/Cs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance). The collection letter gives instructions that specify the documents required for the transfer of title to the goods. Although banks do act as facilitators for their clients, D/Cs offer no verification process and limited recourse in the event of non-payment. D/Cs are generally less expensive than L

Open Account : An open account transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60 or 90 days. Obviously, this is one of the most advantageous options to the importer in terms of cash flow and cost, but it is consequently one of the highest risk options for an exporter. Because of intense competition in export markets, foreign buyers often press exporters for open account terms since the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may lose a sale to their competitors. Exporters can offer competitive open account terms while substantially mitigating the risk of non-payment by using one or more of the appropriate trade finance techniques covered later in this Guide. When offering open account terms, the exporter can seek extra protection using export credit insurance.

Consignment : Consignment in international trade is a variation of open account in which payment is sent to the exporter only after the goods have been sold by the foreign distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold. Clearly, exporting on consignment is very risky as the exporter is not guaranteed any payment and its goods are in a foreign country in the hands of an independent distributor or agent. Consignment helps exporters become more competitive on the basis of better availability and faster delivery of goods. Selling on consignment can also help exporters reduce the direct costs of storing and managing inventory. The key to success in exporting on consignment is to partner with a reputable and trustworthy foreign distributor or a third-party logistics provider. Appropriate insurance should be in place to cover consigned goods in transit or in possession of a foreign distributor as well as to mitigate the risk of non-payment.

9.9 RISK MANAGEMENT AND SETTLEMENT :

The foreign exchange market is characterised by constant changes and rapid innovations in trading methods and products. While the innovative products and ways of trading create new possibilities for profit, they also pose various kinds of risks to the market. Central banks all over the world, therefore, have become increasingly concerned of the scale of foreign exchange settlement risk and the importance of risk mitigation measures. Behind this growing awareness are several events in the past in which foreign exchange settlement risk might have resulted in systemic risk in global financial markets, including the failure of Bankhaus Herstatt in 1974 and the closure of BCCI SA in 1991.

The foreign exchange settlement risk arises because the delivery of the two currencies involved in a trade usually occurs in two different countries, which, in many cases are located in different time zones.

This risk is of particular concern to the central banks given the large values involved in settling foreign exchange transactions and the resulting potential for systemic risk. Most of the banks in the EMEs use some form of methodology for measuring the foreign exchange settlement exposure. Many of these banks use the single day method, in which the exposure is measured as being equal to all foreign exchange receipts that are due on the day.

Some institutions use a multiple day approach for measuring risk. Most of the banks in EMEs use some form of individual counterparty limit to manage their exposures. These limits are often applied to the global operations of the institution. These limits are sometimes monitored by banks on a regular basis.

In certain cases, there are separate limits for foreign exchange settlement exposures, while in other cases, limits for aggregate settlement exposures are created through a range of instruments. Bilateral obligation netting, in jurisdictions where it is legally certain, is an important way for trade counterparties to mitigate the foreign exchange settlement risk. This process allows trade counterparties to offset their gross settlement obligations to each other in the currencies they have traded and settle these obligations with the payment of a single net amount in each currency.

Several emerging markets in recent years have implemented domestic real time gross settlement (RTGS) systems for the settlement of highvalue and time critical payments to settle the domestic leg of foreign exchange transactions. Apart from risk reduction, these initiatives enable participants to actively manage the time at which they irrevocably pay away when selling the domestic currency, and reconcile final receipt when purchasing the domestic currency. Participants, therefore, are able to reduce the duration of the foreign exchange settlement risk.

Recognising the systemic impact of foreign exchange settlement risk, an important element in the infrastructure for the efficient functioning of the Indian foreign exchange market has been the clearing and settlement of inter-bank USD-INR transactions. In pursuance of the recommendations of the Sodhani Committee, the Reserve Bank had set up the Clearing Corporation of India Ltd. (CCIL) in 2001 to mitigate risks in the Indian financial markets. The CCIL commenced settlement of foreign exchange operations for inter-bank USD-INR spot and forward trades from November 8, 2002 and for inter-bank USD-INR cash and tom trades from February 5, 2004. The CCIL undertakes settlement of foreign exchange trades on a multilateral net basis through a process of novation and all spot, cash and tom transactions are guaranteed for settlement from the trade date.

Apart from managing the foreign exchange settlement risk, participants also need to manage market risk, liquidity risk, credit risk and operational risk efficiently to avoid future losses. The open position is generally measured separately for each foreign currency consisting of the net spot position, the net forward position, and the net options position. Various limits for exposure, viz., overnight, daylight, stop loss, gap limit, credit limit, value at risk (VaR), etc., for foreign exchange transactions by banks are fixed. Within the contour of these limits, front office of the treasury of ADs transacts in the foreign exchange market for customers and own proprietary requirements.

9.10 RECENT DEVELOPMENTS IN INTERNATIONAL SETTLEMENT :

International Trade Settlement in Indian Rupees : In order to promote growth of global trade with emphasis on exports from India and to support the increasing interest of global trading community in INR, it has been decided to put in place an additional arrangement for invoicing, payment, and settlement of exports / imports in INR. Before putting in place this mechanism, AD banks shall require prior approval from the Foreign Exchange Department of Reserve Bank of India, Central Office at Mumbai.

The broad framework for cross border trade transactions in INR under Foreign Exchange Management Act, 1999 (FEMA) is as delineated below:

a. **Invoicing:** All exports and imports under this arrangement may be denominated and invoiced in Rupee (INR).
b. **Exchange Rate:** Exchange rate between the currencies of the two trading partner countries may be market determined.
c. **Settlement:** The settlement of trade transactions under this arrangement shall take place in INR in accordance with the procedure laid down in Para 3 of this circular.

In terms of Regulation 7(1) of Foreign Exchange Management (Deposit) Regulations, 2016, AD banks in India have been permitted to open Rupee Vostro Accounts. Accordingly, for settlement of trade transactions with any country, AD bank in India may open Special Rupee Vostro Accounts of correspondent bank/s of the partner trading country. In order to allow settlement of international trade transactions through this arrangement, it has been decided that:

a. Indian importers undertaking imports through this mechanism shall make payment in INR which shall be credited into the Special Vostro account of the correspondent bank of the partner country, against the invoices for the supply of goods or services from the overseas seller /supplier.
b. Indian exporters, undertaking exports of goods and services through this mechanism, shall be paid the export proceeds in INR from the balances in the designated Special Vostro account of the correspondent bank of the partner country.

Documentation: The export / import undertaken and settled in this manner shall be subject to usual documentation and reporting requirements. Letter of Credit (LC) and other trade related documentation may be decided mutually between banks of the partner trading countries under the overall framework of Uniform Customs and Practice for Documentary Credits (UCPDC) and incoterms. Exchange of messages in safe, secure, and efficient way may be agreed mutually between the banks of partner countries.

Advance against exports : Indian exporters may receive advance payment against exports from overseas importers in Indian rupees through the above Rupee Payment Mechanism. Before allowing any such receipt of advance payment against exports, Indian Banks shall ensure that available funds in these accounts are first used towards payment obligations arising out of already executed export orders / export payments in the pipeline. The said permission would be in accordance with the conditions mentioned in para-C.2 on Receipt of advance against exports under Master Direction on Export of Goods and Services 2016 (as amended from time to time). In order to ensure that the advance is released only as per the instructions of the overseas importer, the Indian bank maintaining the Special Vostro account of its correspondent bank shall, apart from usual due diligence measures, verify the claim of the exporter with the advice received from the correspondent bank before releasing the advance.

Setting-off of export receivables: 'Set-off' of export receivables against import payables in respect of the same overseas buyer and supplier with facility to make/receive payment of the balance of export receivables/import payables, if any, through the Rupee Payment Mechanism may be allowed, subject to the conditions mentioned in para C.26 on Set-off of export receivables against import payables under Master Direction on Export of Goods and Services 2016 (as amended from time to time).

Bank Guarantee: Issue of Bank Guarantee for trade transactions, undertaken through this arrangement, is permitted subject to adherence to provisions of FEMA Notification No. 8, as amended from time to time and the provisions of Master Direction on Guarantees & Co-acceptances.

Use of Surplus Balance: The Rupee surplus balance held may be used for permissible capital and current account transactions in accordance with mutual agreement. The balance in Special Vostro Accounts can be used for:

a. Payments for projects and investments.
b. Export/Import advance flow management
c. Investment in Government Treasury Bills, Government securities, etc. in terms of extant guidelines and prescribed limits, subject to FEMA and similar statutory provision.

Reporting Requirements : Reporting of cross- border transactions need to be done in terms of the extant guidelines under FEMA 1999.

Approval Process: The bank of a partner country may approach an AD bank in India for opening of Special INR VOSTRO account. The AD bank will seek approval from the Reserve Bank with details of the arrangement. AD bank maintaining the special Vostro Account shall ensure that the correspondent bank is not from a country or jurisdiction in the updated FATF Public Statement on High Risk &Non-Co-operative Jurisdictions on which FATF has called for counter measures.

9.11 SUMMARY :

International business involves transactions across the national boundaries. It includes the transfer of goods, services, technology, managerial knowledge and capital to other countries. International business has gained greater visibility and importance in recent years because of the large multinational corporations. International trade is a part of total marketing process. It creates lot of benefit to the nations in form employment, improvement in GDP, enhancement of foreign reserves etc., Settlement may be done through cash in advance, letter of credit, consignment, open account and documentary evidence. There are many tools are available to manage and control the risk. To sum up, the foreign exchange market structure in India has undergone substantial transformation from the early 1990s. The market participants

have become diversified and there are several instruments available to manage their risks. Sources of supply and demand in the foreign exchange market have also changed in line with the shifts in the relative importance in balance of payments from current to capital account.

9.12 TECHNICAL TERMS :

- **Transactions across:** Transactions that span over multiple physical systems or computers over the network, are simply termed Distributed Transactions. In the world of micro services a transaction is now distributed to multiple services that are called in a sequence to complete the entire transaction.
- **National boundaries:** Rivers, mountain ranges, oceans, and deserts can all serve as physical boundaries. Many times, political boundaries between countries or states form along physical boundaries. For example, the boundary between France and Spain follows the peaks of the Pyrenees Mountains, while the Alps separate France from Italy.
- **Transfer of goods:** The property in the goods is said, to be transferred from the seller to the buyer when the latter acquires the proprietary rights over the goods and the obligations linked thereto.
- **Managerial knowledge:** Knowledge management tools are technology that helps teams gather, organize, and share information across a business and for its customers. Examples of knowledge management tools include knowledge bases, community forums, and self-service portals.
- **Foreign reserves:** Foreign exchange reserves are assets denominated in a foreign currency that are held by a nation's central bank. These may include foreign currencies, bonds, treasury bills, and other government securities.
- **Transformation:** A transformation is a dramatic change in form or appearance. An important event like getting your driver's license, going to college, or getting married can cause a transformation in your life. A transformation is an extreme, radical change.

9.13 SELF ASSESSMENT QUESTIONS :

1. Explain the Scope of International Trade.
2. What are Features of International Trade. Explain it.
3. What is foreign trade ? Discuss about Methods of entering into foreign trade.
4. What are the Advantages of Foreign Trade?
5. What are the Disadvantages of Foreign Trade?
6. Discuss about the Importance of Export Business in India.
7. Explain about different Methods of Payment in International Trade.
8. Explain the Risk management & Settlement in foreign trade
9. Discuss the Recent Developments in International Settlement.

9.14 SUGGESTED READINGS :

1. Lall G.S, Financing of Foreign Trade & Exchange
2. NCAER, Export strategy for India
3. Rene. M. Stulz, ―Risk Management & Derivatives, 2003, Thomson South western.
4. Jayanth Rama Varma, ―Derivatives and Risk Management, TMH.

Dr. CH . V. R. KRISHNARAO

LESSON - 10

EXCHANGE RISK - ECGC

OBJECTIVES :

After studying this lesson, you will be able to…

- Understand the meaning and types of risk.
- Apply the derivatives to manage risk in foreign trade.
- Know the role and responsibilities of ECGC in foreign trade.

STRUCTURE :

10.1 Introduction
10.2 Nature of Risk.
10.3 Sources of Risk
10.4 Major types of Risk
10.5 Risk management frame work.
10.6 Financial Derivatives
10.7 Types of Derivatives
10.8 Foreign Exchange Derivative instruments in India
10.9 ECGC Ltd.
10.10 Need for Export Credit insurance
10.11 History
10.12 Objectives of ECGC Ltd.
10.13 Summary
10.14 Technical Terms
10.15 Self-Assessment Questions
10.16 Suggested readings

10.1 INTRODUCTION :

Risk: Every living being is exposed to the risk of extinction from the movement they are created, and human beings are no exception to this rule. Therefore, risk is associated with fear of loss. The loss can be physical or financial. A person buying a car fear that his car may meet with an accident, and hence takes insurance cover. We take life insurance policies to protect our dependants from loss of life and income. The dictionary meaning of risk is the possibility of loss or injury and the degree or probability of such loss. Risk is defined as variability in return or volatility in return. Risk is the chance of the actual return being less than the expected return. Thus, risk means any deviation from expected returns.

According to the Basel Committee, risk is “the probability of the unexpected or planned outcome in a negative way.” In finance, the risk involved in the investment is the probability that the actual return from the investment will be different from the expected level. To put it in a nutshell, risk is the uncertainty associated with the changes in asset prices.

Characteristics Of Risk :

Risk is related to loss or value

1. Risk can be financial or non-financial
2. Risk is common to all, but certain types of risks are specific to certain groups or people.
3. Risk cannot be completely eliminated, but can only be transferred.
4. Risk reduces the return; hence, there is a strong relationship between risk and return.
5. Risk carries a value which is known as premium.
6. Risk can be anticipated, and hence protective measures can be taken.
7. Risk can be identified and measured. Mathematical formulae available to measure risk
8. Risk can be monitored and controlled through risk audit.

10.2 NATURE OF RISK :

All organizations deal with risks, through that nature and magnitude may differ for each type of organization. This is especially true for banks/financial instructions, as they deal with money. They act has financial intermediaries in any economic system. They help in mobilizing household/corporate savings and making them available to deficit unit. Since they help in credit creation by means of loans and advances, they face many risks. In fact, taking risk is the core of the most of the products and services offered by banks/financial institutions.

- **Funds Mobilization :** Funds are mobilized by accepting term deposits by issuing securities such as bonds, debentures, credit notes, commercial papers etc., As well as by allowing customers to operate their checking accounts by leaving balances in them.
- **Funds Deployment : T**he funds that are mobilized are fist subject to regulatory investment requirements-i.e. banks have to invest a specified proposition of their funds in certain instruments, often government securities. The surplus funds are available as loan for various segments of corporate and retail borrowers.
- **Fund Transfer :** Banks and financial institutions are key vehicles for moving funds on behalf of their customers. The core competence of banks is to act as agents of corporations in supporting their liquidity needs across various geographical locations. Banks also act as settlement agents for their corporate clients in the realization and payment of their funds. With growth in size, geographic expansion and increase in complexity of corporations, the banks have had to change payment systems to ensure a rapid turnaround of money.
- **Risk Transfer :** The bank customers manufacturing and other concerns are exposed to various risks and some of the risks are very crucial to their business. They relate to product, business model, distribution channel etc., These have to be mainly handled by the companies themselves. However, for risks that arise from financial markets, corporate take expertise of their banks to take them over since it is the core competence to handle them. Along with their own risks, banks also have to handle the risks passed on by their customers.
- **Transaction Services :** Banks assist their customer in carrying out various trade transactions, both domestic and international. International transactions involve dealing with multiple currencies. The global network of the banking system and its relationship constitute the backbone of such trade.

- **Credit Enhancement Services :** In the course of business, it is quite possible that the concerned parties may not be familiar with each other. Therefore, suppliers of goods often expect the bank's help in evaluating or enhancing the credit worthiness of a customer. The entire bunch of services offered through letter of credit or guarantee falls under credit enhancement facility.

All these roles involve dealing with risk of some type. Inadequate risk management may adversely affect the earnings of the bank/financial institution in the short run and its survival in the long run.

10.3 SOURCES OF RISK :

Risks arise from a variety of sources, and affect the value of the assets held by any corporation. Risk arises to the possibility that the actual outcome could be different from the expected outcome. The probability of an outcome is governed by the availability of certain information. Some of the factors that can expose any economic entity to various are risks are discussed below.

a. Economic policies of governments and resultant budget deficits or surpluses; changes in money supply, level of inflation and interest rates as well as capital formation that takes place in the economy. All these in turn influence the movement of capital in and out the country; have an impact on the relative value of currencies and the value of various debt instruments.
b. Consumption and savings pattern and the preferences of individual consumers, which result in certain patters of international trade. In the process, they create trade surpluses in some economics and deficits in others.
c. Political, social, racial, and ethnic issues that impact the availability of or demand for a particular commodity and thus result in disturbances in various commodity markets.
d. Technological factors that bring in new products and thus having an effect on the fortunes of the corporations manufacturing and marketing them.
e. Governance of corporations and their financial performance as well as the financial structures opted for by the individual organization.

In addition to the factors present in the environment, human nature adds to the possibilities in the dynamic situation. An individual may be placed in a situation where her self-interest via-a-vis her professional responsibility are in conflict. The temptation to opt for self-interest can potentially threaten the interest of corporation that the individual works for and can create difficulties for it.

10 .4 MAJOR TYPES OF RISKS :

Liquidity Risks **:** defined as the particular risk from conducting transactions in markets with low liquidity as evidenced in low trading volume and large bid-ask spreads. Under such conditions, the attempt to sell assets may push prices lower, and assets may have to be sold at prices below their fundamental values or within a time frame longer than expected.

Market Risk is defined as the risk to a financial portfolio from movements in market prices such as equity prices, foreign exchange rates, interest rates, and commodity prices. While financial firms take on a lot of market risk and thus reap the profits (and losses), they typically try to choose the type of risk to which they want to be exposed.

There are four major types of market risk:

i. Interest Rate Risk
ii. Equity Price Risk
iii. Foreign Exchange Risk
iv. Commodity Price Risk

i. **Interest Rate Risk:** Interest rate risk is the risk that the value of a security will fall as a result of increase in interest rates. However, in complex portfolios, many different types of exposures can arise.

ii. **Equity Price Risk:** Equity price risk refers to the risk arising from the volatility in the stock prices. While talking about equity risk, it is important to differentiate between systematic risk and unsystematic risk. Systematic risk refers to the risk due to general market factors and affects the entire industry. It cannot be diversified away. Unsystematic risk is the risk specific to a company that arises due to the company specific characteristics. According to portfolio theory, this risk can be eliminated through diversification.

iii. **Foreign Exchange Risk:** Foreign exchange risk arises because of the fluctuations in the currency exchange rates. Companies may be exposed to the foreign exchange risk in their normal course of business because of the un hedged positions or because on imperfect hedges.

Types of Foreign Exchange Risk

Transaction risk: A firm has transaction risk whenever it has contractual cash flows (receivables and payables) whose values are subject to unanticipated changes in exchange rates due to a contract being denominated in a foreign currency. To realize the domestic value of its foreign-denominated cash flows, the firm must exchange foreign currency for domestic currency. As firms negotiate contracts with set prices and delivery dates in the face of a volatile foreign exchange market with exchange rates constantly fluctuating, the firms face a risk of changes in the exchange rate between the foreign and domestic currency. It refers to the risk associated with the change in the exchange rate between the time an enterprise initiates a transaction and settles it.

Economic risk : A firm has economic risk (also known as forecast risk) to the degree that its market value is influenced by unexpected exchange rate fluctuations. Such exchange rate adjustments can severely affect the firm's market share position with regards to its competitors, the firm's future cash flows, and ultimately the firm's value. Economic risk can affect the present value of future cash flows.

Translation risk : A firm's translation risk is the extent to which its financial reporting is affected by exchange rate movements. As all firms generally must prepare consolidated financial statements for reporting purposes, the consolidation process for multinationals entails translating foreign assets and liabilities or the financial statements of foreign subsidiaries from foreign to domestic currency. While translation risk may not affect a firm's cash flows, it could have a significant impact on a firm's reported earnings and therefore its stock price.

Contingent risk : A firm has contingent risk when bidding for foreign projects or negotiating other contracts or foreign direct investments. Such a arises from the potential of a firm to suddenly face a transnational or economic foreign exchange risk, contingent on the outcome of some contract or negotiation. For example, a firm could be waiting for a project bid to be accepted by a foreign business or government that if accepted would result in an immediate receivable. While waiting, the firm faces a contingent risk from the uncertainty as to whether or not that receivable will happen.

iv. Commodity Price Risk: Commodity Price Risk refers to the risk of unexpected changes in a commodity price, such as the price of oil. These commodities may be grains, metals, gas, electricity etc. Commodity risk affects various sections of people:

- Producers (Farmers, plantation companies, and mining companies)
- Buyers (Cooperatives, commercial traders, etc)
- Exporters
- Governments

Operational Risk : Operational risk can be defined as the risk of loss due to inadequate or failed internal processes, people, systems or external events. Some operational risks directly affect the financial performance of the organization. Others do so by interacting with credit and market and other risks. The nature of operational risk is somewhat different from that of market or credit risk. Banks make a conscious decision to take a certain amount of credit and market risk. Operational risk, by contrast, is a necessary part of doing business. More often than not, operational risks are “inherent not chosen”. The only way to avoid operational risk is by exiting the business!

It is much more difficult to identify, quantify and manage operational risk than credit or market risk. Data on operational risk is not exhaustive. Most banks are still in the process of collecting data. Developing statistical models for operational risk is thus challenging.

10.5 RISK MANAGEMENT FRAME WORK :

All companies face risk; without risk there is no reward. The flip side of this is that too much risk can lead to business failure. Risk management allows a balance to be struck between taking risks and reducing them. Effective risk management can add value to any organization. In particular, companies operating in the investment industry rely heavily on risk management as the foundation that allows them to withstand market crashes. An effective risk management framework seeks to protect an organization's capital base and earnings without hindering growth. Furthermore, investors are more willing to invest in companies with good risk management practices. This generally results in lower borrowing costs, easier access to capital for the firm and improved long-term performance.

There are six crucial components that must be considered when creating a risk management framework;

they are:

- risk identification

- risk measurement
- risk mitigation
- risk reporting & monitoring
- risk governance

10.6 FINANCIAL DERIVATIVES :

Financial derivatives like futures, forwards options and swaps are important tools to manage assets, portfolios and financial risks. Thus, it is essential to know the terminology and conceptual framework of all these financial derivatives in order to analyze and manage the financial risks. The prices of these financial derivatives contracts depend upon the spot prices of the underlying assets, costs of carrying assets into the future and relationship with spot prices.

The term “Derivative” indicates that it has no independent value, i.e., its value is entirely derived from the value of the underlying asset. The underlying asset can be securities, commodities, bullion, currency, livestock or anything else.

In other words, derivative means forward, futures, option or any other hybrid contract of predetermined fixed duration, linked for the purpose of contract fulfillment to the value of a specified real or financial asset or to an index of securities.

The Securities Contracts (Regulation) Act 1956 defines “derivative” as under :

“Derivative” includes

1. Security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.
2. A contract which derives its value from the prices, or index of prices of underlying securities.

The above definition conveys that

1. The derivatives are financial products.
2. Derivative is derived from another financial instrument/contract called the underlying. In the case of Nifty futures, Nifty index is the underlying. A derivative derives its value from the underlying assets.
   Accounting Standard SFAS133 defines a derivative as, ‘a derivative instrument is a financial derivative or other contract with all three of the following characteristics:
   (i) It has (1) one or more underlings, and (2) one or more notional amount or payments provisions or both. Those terms determine the amount of the settlement or settlements.
   (ii) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
   (iii) Its terms require or permit net settlement. It can be readily settled net by a means outside the contract or it provides for delivery of an asset that puts the recipients in a position not substantially different from net settlement.

Functions of Derivatives:

1. Derivatives shift the risk from the buyer of the derivative product to the seller and as such are very effective risk management tools.

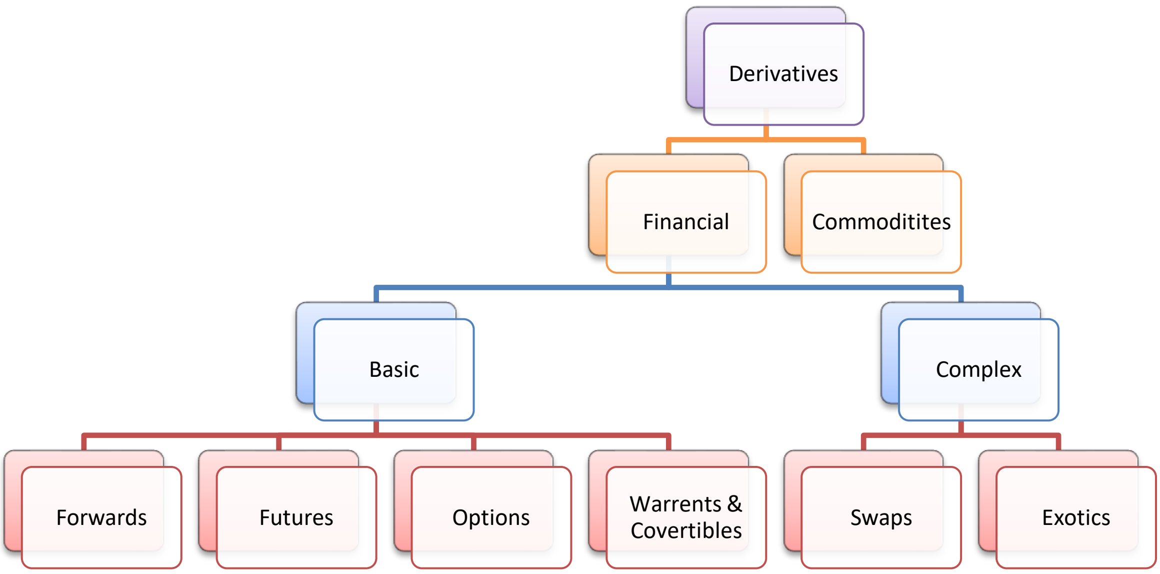
2. Derivatives improve the liquidity of the underlying asset.

10.7 TYPES OF DERIVATIVES :

One form of classification of derivative instruments is between commodity derivatives and financial derivatives. The basic difference between these is the nature of the underlying instrument or asset. In a commodity derivative, the underlying instrument is a commodity which may be wheat, cotton, pepper, sugar, jute, turmeric, corn, soya beans, crude oil, natural gas, gold, silver, copper and so on.

In a financial derivative, the underlying instrument may be treasury bills, stocks, bonds, foreign exchange, stock index, gilt-edged securities, cost of living index, etc. It is to be noted that financial derivative is fairly standard and there are no quality issues whereas in commodity derivative, the quality may be the underlying matters. However, the distinction between these two from structure and functioning point of view, both are almost similar in nature.

Due to complexity in nature, it is very difficult to classify the financial derivatives, so in the present context, the basic financial derivatives which are popular in the market have been classified into the following.



Another way of classifying the financial derivatives is into basic and complex derivatives. In this, forward contracts, futures contracts and option contracts have been included in the basic derivatives whereas swaps and other complex derivatives are taken into complex category because they are built up from either forwards/futures or options contracts, or both. In fact, such derivatives are effectively derivatives of derivatives.

10.8 FOREIGN EXCHANGE DERIVATIVE INSTRUMENTS IN INDIA :

Foreign Exchange Forwards : Authorised Dealers (ADs) (Category-I) are permitted to issue forward contracts to persons resident in India with crystallised foreign currency/foreign interest rate exposure and based on past performance/actual import-export turnover, as permitted by the Reserve Bank and to persons resident outside India with genuine currency exposure to the rupee, as permitted by the Reserve Bank. The residents in India generally hedge crystallised foreign currency/ foreign interest rate exposure or transform exposure from one currency to another permitted currency. Residents outside India enter into such contracts to hedge or transform permitted foreign currency exposure to the rupee, as permitted by the Reserve Bank.

Foreign Currency Rupee Swap : A person resident in India who has a long-term foreign currency or rupee liability is permitted to enter into such a swap transaction with ADs (Category-I) to hedge or transform exposure in foreign currency/foreign interest rate to rupee/rupee interest rate.

Foreign Currency Rupee Options : ADs (Category-I) approved by the Reserve Bank and ADs (Category-I) who are not market makers are allowed to Box VI.4 Foreign Exchange Derivative Instruments in India sell foreign currency rupee options to their customers on a back-to-back basis, provided they have a capital to risk weighted assets ratio (CRAR) of 9 per cent or above. These options are used by customers who have genuine foreign currency exposures, as permitted by the Reserve Bank and by ADs (Category-I) for the purpose of hedging trading books and balance sheet exposures.

Cross-Currency Options : ADs (Category-I) are permitted to issue cross-currency options to a person resident in India with crystallised foreign currency exposure, as permitted by the Reserve Bank. The clients use this instrument to hedge or transform foreign currency exposure arising out of current account transactions. ADs use this instrument to cover the risks arising out of market-making in foreign currency rupee options as well as cross currency options, as permitted by the Reserve Bank.

Cross-Currency Swaps : Entities with borrowings in foreign currency under external commercial borrowing (ECB) are permitted to use cross currency swaps for transformation of and/or hedging foreign currency and interest rate risks. Use of this product in a structured product not conforming to the specific purposes is not permitted.

10.9 ECGC Ltd :

The ECGC Ltd. (formerly known as Export Credit Guarantee Corporation of India Ltd.) wholly owned by government of India, was set up in 1957 with the objective of promoting exports from the country by providing credit risk insurance and related services for exports. Over the years it has designed different export credit risk insurance products to suit the requirements of Indian exporters. ECGC is essentially an export promotion organisation, seeking to improve the competitiveness of the Indian exports by providing them with credit insurance covers. ECGC Ltd. also administers the National Export Insurance Account (NEIA) Trust which caters to project exports of strategic and national importance.

The Corporation has introduced various export credit insurance schemes to meet the requirements of commercial banks extending export credit. The insurance covers enable the banks to extend timely and adequate export credit facilities to the exporters. ECGC keeps its premium rates at the optimal level.

ECGC provides :

(i) a range of insurance covers to Indian exporters against the risk of non-realization of export proceeds due to commercial or political risks

(ii) different types of credit insurance covers to banks and other financial institutions to enable them to extend credit facilities to exporters and

(iii) Export Factoring facility for MSME sector which is a package of financial products consisting of working capital financing, credit risk protection, maintenance of sales ledger and collection of export receivables from the buyer located in overseas country.

ECGC Ltd. (Formerly Export Credit Guarantee Corporation of India Ltd.), wholly owned by Government of India, was set up in 1957 with the objective of promoting exports from the country by providing Credit Risk Insurance and related services for exports. It functions under the administrative control of Ministry of Commerce & Industry, and is managed by a Board of Directors comprising representatives of the Government, Reserve Bank of India, banking, and insurance and exporting community. Over the years it has designed different export credit risk insurance products to suit the requirements of Indian exporters and commercial banks extending export credit.

ECGC is essentially an export promotion organization, seeking to improve the competitiveness of the Indian exporters by providing them with credit insurance covers. ECGC keeps its premium rates at the optimal level.3

What does ECGC do? :

- Provides a range of credit risk insurance covers to exporters against loss in export of goods and services
- Offers Export Credit Insurance covers to banks and financial institutions to enable exporters to obtain better facilities from them
- Provides Overseas Investment Insurance to Indian companies investing in joint ventures abroad in the form of equity or loan

How does ECGC help exporters? :

ECGC Offers insurance protection to exporters against payment risks.

- Provides guidance in export-related activities.
- Makes available information on different countries with its own credit ratings.
- Makes it easy to obtain export finance from banks/financial institutions.
- Assists exporters in recovering bad debts.
- Provides information on credit-worthiness of overseas buyers.

10.10 NEED FOR EXPORT CREDIT INSURANCE :

Payments for exports are open to risks even at the best of times. The risks have assumed large proportions today due to the far-reaching political and economic changes that are sweeping the world. An outbreak of war or civil war may block or delay payment for goods exported. A coup or an insurrection may also bring about the same result. Economic difficulties or balance of payment problems may lead a country to impose restrictions on either import of certain goods or on transfer of payments for goods imported. In addition, the exporters have to face commercial risks of insolvency or protracted default of buyers. The commercial risks of a foreign buyer going bankrupt or losing his capacity to pay are aggravated due to the political and economic uncertainties. Export credit insurance is designed to protect exporters from the consequences of the payment risks, both political and commercial, and to enable them to expand their overseas business without fear of loss.

10.11 HISTORY :

The need for export promotion had started immediately after Independence in 1947.

In 1953, a proposal for initiation of an export credit guarantee scheme was put forward at a meeting of the Export Advisory Council. Ministry of Commerce & Industry analyzed in depth the pros and cons of the Export Credit Insurance Scheme and a revised draft proposal on the scheme was presented to the Export Advisory Council in 1955.

Shri T TKrishnamachari, Finance Minister in Pandit Nehru's cabinet appointed a special committee under the Chairmanship of Shri T.C.Kapur to examine the feasibility of setting up an effective organization to provide insurance against export credit risks. The Government accepted the recommendations of Kapur Committee and thus the Export Risk Insurance Corporation (ERIC) was registered on 30th July 1957 in Mumbai as a Private Ltd. Company, entirely state owned, under the Companies Act with an authorized capital of Rs.5 crores and paid-up capital of Rs.25 lakhs. Shri Ratilal M Gandhi was the First Chairman and Shri T C Kapur was the First Managing Director of the Corporation. Shri Morarji Desai, Union Commerce Minister inaugurated ERIC and the first Policy was issued on 14th October 1957.

After introduction of insurance covers to banks during the period 1962-64, ERIC's name was changed to Export Credit & Guarantee Corporation Ltd in 1964.

The above name was changed to Export Credit Guarantee Corporation of India Ltd. in the year 1983. Subsequently in August 2014, it was renamed as ECGC Ltd.

10.12 OBJECTIVES OF ECGC Ltd. :

1. To encourage and facilitate globalization of India's trade.
2. To assist Indian exporters in managing their credit risks by providing timely information on worthiness of the buyers, bankers and the countries.
3. To protect the Indian exporters against unforeseen losses, which may arise due to failure of the buyer, bank or problems faced by the country of the buyer by providing cost effective credit insurance covers in the form of Policy, Factoring and Investment Insurance Services comparable to similar covers available to exporters in other countries.
4. To facilitate availability of adequate bank finance to the Indian exporters by providing surety insurance covers for bankers at competitive rates.
5. To achieve improved performance in terms of profitability, financial and operational efficiency indicators and achieve optimum return on investment.
6. To develop world class expertise in credit insurance among employees and ensure continuous innovation and achieve the highest customer satisfaction by delivering top quality service.
7. To educate the customers by continuous publicity and effective marketing.

10.13 SUMMARY :

Risk is “the probability of the unexpected or planned outcome in a negative way.” In finance, the risk involved in the investment is the probability that the actual return from the investment will be different from the expected level.In business we come across different types of risks like liquidity risk, product risk, commodity risk, operational risk and foreign exchange risk. The process of risk management includes risk identification, risk measurement, risk mitigation, risk reporting & monitoring and risk governance. To manage the risk derivative is one of the options. Different variants of derivatives are available like forwards, futures, swaps and options. To manage the risk in foreign trade ECGC Ltd. offers multiple services.

10.14 TECHNICAL TERMS :

Risk, Derivatives, foreign exchange risk, systematic risk, forwards, futures, options, swaps, Credit guarantee, and ECGC

10.15 SELF-ASSESSMENT QUESTIONS :

1. What is risk? Explain the nature of risk?
2. What is foreign exchange risk? Discuss different types of foreign exchange risk?
3. How do you mitigate the risk with derivatives? Explain/
4. What is a derivative contract? Explain the features of derivative contract?
5. Discuss different types of derivatives?
6. Explain the role of ECGE in foreign trade?

10.16 SUGGESTED READINGS :

1. Lall G.S, Financing of Foreign Trade & Exchange
2. NCAER, Export strategy for India
3. Rene. M. Stulz, ―Risk Management & Derivatives‖, 2003, Thomson South western.
4. Jayanth Rama Varma, ―Derivatives and Risk Management, TMH.

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LESSON - 11

INTRODUCTION TO EXCHANGE RATE

AIMS AND OBJECTIVES :

- ❖ Know the meaning of foreign exchange market
- ❖ Various types of exchange transaction quotations.
- ❖ Describe the functions of the foreign exchange markets.

STRUCTURE :

11.1 INTRODUCTION :

The trade takes place between the residents of two countries; the two countries being a sovereign state have their own set of regulations and currency. Due to the different currency the problem arises in the conduct of international trade and settlement of the transactions. While the exporter would like to get the payment in the currency of his country, the importer can pay only in the currency of the importers country. This creates a need for the conversion of the currency of importer‘s into that of the exporter‘s country. Foreign exchange is the mechanism by which the currency of one country is converted into the currency of another country. The conversion is done by the banks who deal in foreign exchange.

11.2 MEANING :

A market for the purchase and sale of foreign currencies is called a ‘foreign exchange market’. Foreign exchange market is the market in which foreign currencies are bought and sold. The buyers and sellers include individuals, firms, foreign exchange brokers, commercial banks and the central bank. Like any other market, foreign exchange market is a system in which the transactions are not confined to only one or few foreign currencies. There are a large number of foreign currencies which are traded, converted and exchanged in the foreign exchange market. The foreign exchange market assists international trade and investment by enabling currency conversion. The foreign exchange market is a form of exchange for the global decentralized trading of international currencies.

Foreign exchange in short form is called forex. The foreign exchange market or forex market is the market where one currency is exchanged or traded for another currency. Forex markets are also called foreign currency or just currency markets. There are domestic and international foreign currency markets. Domestic foreign currency markets serve the foreign currency buying, selling, borrowing and lending needs of residents where as international markets serve non-residents also. Currencies are also traded in other forms as "derivative contracts" such as currency swaps, options and futures. These are more sophisticated instruments for trading in foreign currencies.

11.3 EXCHANGE RATES DEFINITION :

An exchange rate is a price: The relative price of two currencies.
Example: The price of a Euro (EUR) in terms of USD is USD 1.115 per EUR ;

St = USD/EUR.

11.4 EXCHANGE RATE QUOTATIONS :

A foreign exchange rate is the price of a foreign currency. A foreign exchange quotation or quote is a statement of willingness to buy or sell at an announced rate. Interbank quotations are given as “bid” and “ask”. A bid is the exchange rate in one currency at which a dealer will buy another currency. An ask is the Exchange rate at which a dealer will sell the other currency. Dealers buy at the bid price and sell at the Ask price, profiting from the spread between the bid and ask prices: bid<ask. Bid ask quotations are complicated by the fact that the bid for one currency is the ask for another currency.

The exchange rates include two numbers: the bid and the offer. The bid (or buy) is the price at which a Bank or financial services firm is willing to buy a specific currency. The ask (or offer or sell) willing to sell that currency. Typically, the bid or the buy is always cheaper than the sell; banks make a profit on the transactions from that difference.

11.5 DETERMINANTS OF EXCHANGE RATES :

1) Demand for and supply of foreign exchange: the foreign exchange rate is determined by demand for and supply of foreign exchange. The rate established at a point where demand and supply is equal is called equilibrium rate of exchange.
2) Inflation: inflation is one of the most important factors that affect the exchange rate. Theoretically a low inflation rate scenario will show arising currency rate, as the purchasing power of the currency will increase as compared to other currency.
3) Interest rates: inflation and interest rates are very much correlated. Higher inflation usually means higher interest rates in an economy. The central bank check on any major currency fluctuation.
4) Current account deficits: the current account is the balance of trade between two countries. It reflects all payments and receipts between the two countries for goods, services, interest and dividends.

11.6 FACTORS INFLUENCING EXCHANGE RATES :

Foreign Exchange rate (Forex rate) is one of the most important means through which a countries relative level of economic health is determined. A country's foreign exchange rate provides a window to its economic stability, which is why it is constantly watched and analyzed. While sending or receiving money from overseas, there is a need to keep a keen eye on the currency exchange rates.3

The exchange rate is defined as "the rate at which one country's currency may be converted into another."It may fluctuate daily with the changing market forces of supply and demand of currencies from one country to another. For these reasons; when sending or receiving money internationally, it is important to understand what determine exchange rates.

- ❖ **Inflation Rates :** Changes in market inflation cause changes in currency exchange rates. A country with a lower inflation rate than another‘s will see an appreciation in the value of its currency. The prices of goods and services increase at a slower rate where the inflation is low. A country with a consistently lower inflation rate exhibits a rising currency value while a country with higher inflation typically sees depreciation in its currency and is usually accompanied by higher interest rates
- ❖ **Interest Rates :** Changes in interest rate affect currency value and dollar exchange rate. Forex rates, interest rates, and inflation are all correlated. Increases in interest rates cause a country's currency to appreciate because higher interest rates provide higher rates to lenders, there by attracting more foreign capital, which causes arise in exchange rates.
- ❖ **Country’s Current Account/Balance of Payments :** A country‘s current account reflects balance of trade and earnings on foreign investment. It consists of total number of transactions including its exports, imports, debt, etc. A deficit in current account due to spending more of its currency on importing products than it is earning through sale of exports causes depreciation. Balance of payments fluctuates exchange rate of its domestic currency.
- ❖ **Government Debt :** Government debt is public debt or national debt owned by the central government. A country with government debt is less likely to acquire foreign capital, leading to inflation. Foreign investors will sell their bonds in the open market if the market predicts government debt within a certain country. As a result, a decrease in the value of its exchange rate.
- ❖ **Terms of Trade :** Related to current accounts and balance of payments, the terms of trade are the ratio of export prices to import prices. A country's terms of trade improves if its exports prices raise at a greater rate than its imports prices. This results in higher revenue, which causes a higher demand for the country's currency and an increase in its currency's value. This results in an appreciation of exchange rate.
- ❖ **Political Stability & Performance :** A country's political state and economic performance can affect its currency strength. A country with less risk for political turmoil is more attractive to foreign investors, as a result, drawing investment away from other countries with more political and economic stability. Increase in foreign capital, in turn, leads to an appreciation in the value of its domestic currency. A country with sound financial and trade policy does not give any room for uncertainty in value of its currency. But, a country prone to political confusions may see depreciation in exchange rates.
- ❖ **Recession :** When a country experiences a recession, its interest rates are likely to fall, decreasing its chances to acquire foreign capital. As a result, its currency weakens in comparison to that of other countries, therefore lowering the exchange rate.

- **Speculation :** If a country's currency value is expected to rise, investors will demand more of that currency in order to make a profit in the near future. As a result, the value of the currency will rise due to the increase in demand. With this increase in currency value comes arise in the exchange rate as well. All of these factors determine the foreign exchange rate fluctuations. If you send or receive money frequently, being up-to-date on these factors will help you better evaluate the optimal time for international money transfer. To avoid any potential falls in currency exchange rates, opt for a locked-in exchange rate service, which will guarantee that your currency is exchanged at the same rate despite any factors that influence an unfavorable fluctuation.

11.7 FOREX MARKET :

Foreign exchange market is the most largest and liquid financial market in the world. It is referred to foreign currency market, where a party of a country purchases some quantity of a currency in exchange of paying some quantity of another currency. Basically large banks, Speculator of currency, central banks, government and other financial institutes are involved in trading in foreign exchange market.

11.8 NEED OF FOREIGN EXCHANGE MARKET :

The foreign exchange market is a crucial international market and is the world’s most respected financial institution. On a daily basis, the forex exchange trades with approximately two trillion dollars foreign exchange transaction are central to global commerce.

1. **Protection of currency :** To accumulate the reserve governments protects the currency trade by the help of foreign exchange market. It affects by value of the currency. And it is easy to do payments. If economy changes then central bank can ensures the reserves are enough to face the situation.
2. **Job opportunities :** with the increased use of the internet, online forex exchange has become a Prominent features in the foreign exchange market. Many people trading currencies online on a daily basis which in turn increasing the job opportunities.
3. **Hedging facilitator :** Forex is a hedging facilitator. Here hedging means protecting the business from risk. It provides business owners with mechanism with mechanism that guard them against incurring losses in the event that values of the currencies they trade in fluctuate.
4. **Facilities international trade :** the need for acquiring currency to trade arises when the business deal with other country investors. Transfer of purchasing is facilitated by foreign exchange among the countries. By acquiring capital purchasing power can be enhanced.
5. **Currency liquidity :** the foreign exchange market provides liquidity for currencies. Liquidity is the ease with which it can convert a foreign currency into a domestic currency.
6. **Credit provision :** it has a facility of credit provision. It helps to enhance the growth of foreign trade. Most investors dealing with international trade depend on the credit facilities that are advanced to them by forex markets.

11.9 CHARACTERISTICS/FEATURES OF FOREIGN EXCHANGE MARKET :

Some of the important features of a foreign exchange market are as follows–

1. **Electronic Market:** Foreign Exchange market is described as OTC (Over the Counter) market as there is no physical place where the participants meet to execute the deals. It means, foreign exchange market does not have a physical place. It is a market where by trading in foreign currencies takes place through the electronically linked network of banks, foreign exchange brokers and dealers whose function is to bring to get her buyers and sellers of foreign exchange.
2. **Geographical spreading:** A feature of the foreign exchange market is that it is not to be found in one place. The market is vastly dispersed throughout the leading financial center of the world such as London, New York, Amsterdam, Tokyo, Hong Kong Toronto and other cities.
3. **Superior liquidity:** In a forex market, traders are free to buy and sell currencies of their own co hosing. The superior liquidity of the forex market enables traders to easily exchange currencies without affecting the price of the curreremcies being traded.
4. **Transfer of purchasing power:** The basic function of the foreign exchange market is to facilitate the conversion of one currency into another. It aims at permitting the transfer of purchasing power denominated in one currency to another where by one currency is traded for another currency, i.e, to accomplish transfers of purchasing power between two countries. This transfer of purchasing power is affected through a variety of credit instruments, such as telegraphic transfers, bank draft and foreign bills. In performing the transfer function, the foreign exchange market carries out payments internationally by clearing debts in both directions simultaneously; analogous to domestic clearings It is the foreign exchange market, which facilitates such a settlement between countries in their respective currency units.
5. **Intermediary:** Foreign exchange markets provide a convenient way of converting the currencies earned into currencies wanted of their respective countries. For this purpose, the market acts as an intermediary between buyers and sellers of foreign exchange.
6. **Volume:** A special feature of the foreign exchange market is that out of the trading transactions that take place in the foreign exchange market, around 95% takes the firm of cross-border purchase and sale of assets, that is, international capital flows. Only around5%relatestotheexportandimportactivities.
7. **Provision of credit:** A foreign exchange market provides credit through specialized instruments such as bankers' acceptance and letters of credit. The credit thus provided is of much help to the traders and business men in the international market.
8. **Minimizing risks:** The foreign exchange market helps the importer and exporter in the foreign trade to minimize their risks of trade. This is being done through the provision of 'Hedging' facilities. This enables traders to transact business in the international market with a view to earning a normal business profit without exposure to an expected change in anticipated profit. This is because exchange rates suddenly change.
9. **24 Hours Market:** The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus, at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day.
10. **Currencies Traded:** In most markets, US dollar is the vehicle currency i.e. this

currency is used to denominate international transactions.

11. **Strong market trends:** Forex trader make money by getting accurate market data and then analyzing the direction the market stakes.
12. **Credit Function:** It provides credit for foreign trade. Bills of exchange, with maturity period of three months, are generally used for international payments. Credit is required for this period in order to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.
13. **Hedging Function:** A third function of the foreign exchange market is to hedge foreign exchange risks. Hedging means the avoidance of a foreign exchange risk. In a free exchange market when exchange rate, i. e., the price of one currency in terms of another currency, change, there may be a gain or loss to the party concerned. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilities which are to be met in foreign money. Exchange risk as such should be avoided or reduced. For this the exchange market provides facilities for hedging anticipated or actual claims or liabilities through forward contracts in exchange.

11.10 NATURE OF FOREX MANAGEMENT :

Forex management may be defined as the science of management of generation, use and storage of foreign currencies in the process of exchange of one currency into other called foreign exchange.
The Forex management has the following essential elements:

It is part of management science :

Forex management is part of the broader management science. It is a scientific discipline requiring scientific and analytic orientation. The techniques of management are applied to the broad spectrum of foreign currencies. This broad spectrum refers to all the currencies of the world excluding the domestic currency. These techniques include planning for forex, organization of forex and control of forex. We use the terms forex and foreign exchange interchangeably. The planning part includes budgeting for forex, organization refers to utilization of forex and control part focuses on creation of forex reserves.

The tools of forex management are akin to domestic currency management but the level of analytical skills required for it is slightly higher because of the existence of spot, forwards and futures markets unlike the domestic currency area. Operations in the forex market require quicker response time because of the greater volatility in exchange rates.

It refers to generation of Forex :

Forex is generated from international trade transactions. When a country exports goods or services, it earns forex. When goods or services are imported by a country, forex is consumed. If the exports of a country are more than the imports, the forex would be accumulated in reserves of the country. If the imports are more than the exports, the result would be a forex deficit which has to be met by international borrowings. Either way, the forex needs to be generated. Generation of forex is a more difficult proposition because of variation in international trade practices and extent of competition.

It pertains to use of forex :

Forex management is concerned with use of forex in meeting the requirements of the user group. The tools of cash management come handy in using forex. The process of use of forex involves identification of suppliers of goods and services, negotiation of terms and conditions of the transaction and culmination of transaction with the exchange of goods and services with forex. Because of relative uncertainty about availability of forex and volatility in its rates, advance tie-up of forex is made through forward purchase contracts. In this entire process, close track of exchange rates needs to be maintained.

It covers storage of forex :

Forex management involving firm level forex storage could be done through forward purchase contracts or through deposits in foreign currency bank accounts. At the national level, forex storage is done through forex reserves which are held in the form of Gold, Special Drawing Right (SDRs) of IMF and foreign currencies. While some amount of foreign exchange reserves need to be maintained to meet unforeseen contingencies, excessive accretion to reserves involve a cost which is sometimes justified on other economic consideration at the firm's level. Forex is stored for meeting future import liabilities, whether certain or contingent. While storing forex, it is important to bear in mind the actual cost of storage and the opportunity cost of not using the forex elsewhere. Depending upon availability of forex, if the opportunity cost is more than the cost of storage, then it is better not to store it.

11.11 SCOPE OF FOREX MANAGEMENT :

Forex management has quite a wide scope of operation. We can cover in its ambit all those transactions which involve use of forex. Let us consider the following illustrations:

- **a.** A citizen of India travels abroad on a business visit and purchases foreign currency from an authorized dealer.
- **b.** An Indian citizen goes to USA for a period of three years under an employment contract. He periodically remits US Dollars to his bank account in India.
- **c.** An Indian student subscribes to a British scientific magazine and pays for it through an international credit card held by him.
- **d.** An Indian industrialist imports raw material from Malaysia for his plant under a Letter of Credit arrangement provided by his bank.
- **e.** A sports goods manufacturer of India exports his consignment to Europe and gets paid for it in foreign currency received through banking channels.
- **f.** Indian subsidiary of a Multinational corporation imports white goods in completely knocked down (CKD)from the Chinese affiliate. After reassembling these goods, the same are exported to Europe.
- **g.** The World Bank disburses aid to an Indian State under an infrastructure development project.

Forex management being involved in all the trade and non-trade transactions involving forex, it is essential to have a broad idea of international banking and trading practices. Since the transactions are taking place among counter parties from different countries, a standardized format of documentation is used to minimize errors. Apart from the transaction value, forex management finds scope as a mode of investment. Because of the frequent and often miniscule fluctuations in forex values, enough arbitrage and speculative opportunities crop up in the forex market for astute investors. There are many expert forex dealers specializing in trading of forex.

11.12 SIGNIFICANCE OF FOREX MANAGEMENT :

Business operations in countries across the globe have been in existence for centuries, but an unprecedented growth in worldwide production and distribution of a large number of capital, intermediate and consumer goods has been witnessed in the past fifty years. At present most of the countries are economically related to each other through a complex network of trade, foreign investment and international loans.

The emergence of WTO and the process of global integration have reinforced the importance of International trade, cross border financial flows and consequently foreign currency transactions. Each country has its own currency and each currency has different value in relation to a globally accepted standard. The significance of forex management lies in the study and maintenance of the exchange levels. Every good or service reaching us from abroad involves forex. Knowledge of the forex management can help avoid harmful effects of international events and perhaps even profit from these events. With the advent of globalization and liberalization the scope for international trade and international financing has increased tremendously. International trade has grown more quickly than trade in general. This has put up both benefits and challenges.

The principal benefit for international trade has been in the form of the gain in standard of living it has permitted. The gain has come from exploiting relative efficiencies of production in different countries. The challenges of international trade are the introduction of exchange rate risk and country risk. Various methods and markets have evolved that allow firms to avoid or reduce these risks. The after effect of development of international trade has been swift movement of funds from one finance Centre to the other. There has been investment by multinationals in the third world countries in the form of capital outlays. All this has necessitated the need for a better understanding of the mechanism of forex flows.

Forex management has become a more important subject because of an increased globalization of financial markets. The benefits of the increased flow of capital between nations include a better international allocation of capital and greater opportunities to diversify risk. However, globalisation of investment has meant new risks from exchange rates, political actions and increased interdependence of financial conditions in different countries.

11.13 FUNCTIONS OF FOREIGN EXCHANGE MARKETS :

1. **Transfer of purchasing power:** Forex allows transferring the purchasing power or conservation of one currency to another currency in the market to complete the business between two countries.
2. **Provision of credit**: To promote foreign trade between the countries, foreign exchange market provides credit to the trade both national and international. It helps the trader to trade easily.
3. **Minimizing foreign exchange risk:** foreign exchange market minimizing the risk of trade. Foreign transaction are done minimizes the risk of trade. Foreign transactions are done through the payment and receipts of foreign currency exchange.

11.14 STRUCTURE OF THE FOREIGN EXCHANGE MARKET :

The foreign exchange market is merely a part of the money market in the financial centers. It is a place where foreign moneys are bought and sold. The buyers and sellers of claim on foreign money and the intermediaries together constitute a foreign exchange market. It is not restricted to any given country or a geographical area. Thus, the foreign exchange market is the market for a national currency (foreign money) anywhere in the world, as the financial centers of the world are united in a single market. There is a wide variety of dealers in the foreign exchange market. The most important among them are the banks. Banks dealing in foreign exchange have branches with substantial balances in different countries. Through their branches and correspondents, the services of such banks, usually called Exchange Banks, are available all over the world. The following figure is going to disclose the structure of foreign Exchange Market.

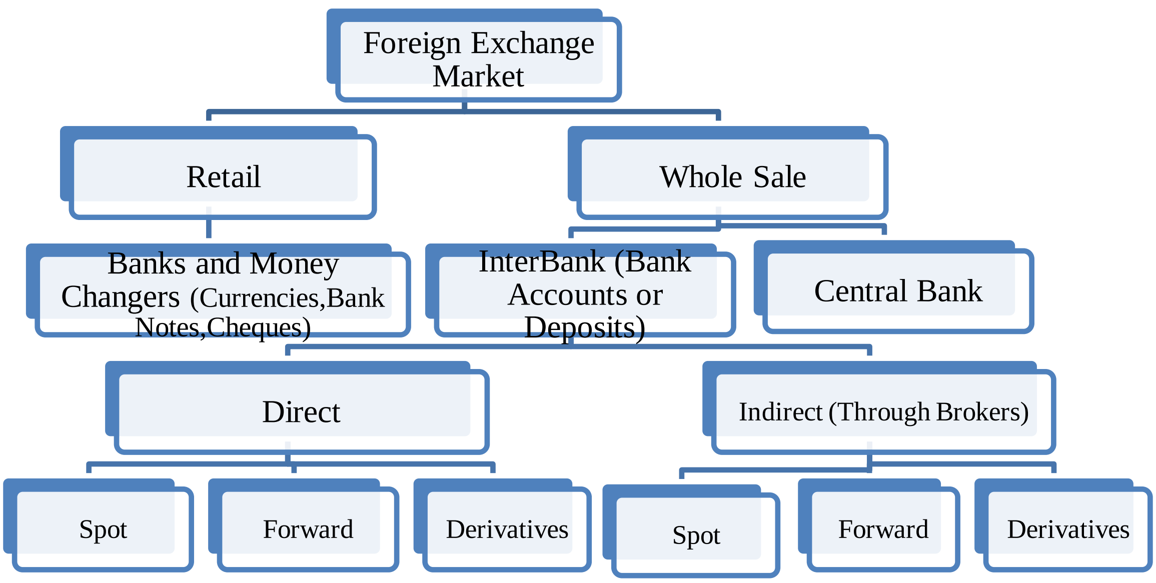
Retail Market :

Transactions are exchange of currency, bank draft, bank notes ordinary and traveler's cheques etc. Retail banking consists of a large number of small customers who consume personal banking and small business services. Retail banking is largely intra-bank the bank itself.

Whole sale markets :

The wholesale market comprises of commercial banks and investment banks. This is broadly classified as inter-bank market and central bank market. Wholesale banking typically involves a small number of very large customers such as large corporate and governments, Wholesale banking is largely interbank: banks use the inter -bank markets to borrow from or lend to other banks, to participate in large bond issues, and to engage in syndicated lending.

Structure of the Foreign Exchange Market



Inter-bank :

The interbank network consists of a global network of financial institutions that trade currencies between each other to manage exchange rate and interest rate risk. The largest participants in this network are private banks. Most transactions within the interbank network are for a short duration, anywhere between overnight to six months. The interbank market is not regulated.

Spot market : Spot market refers to the transactions involving sale and purchase of currencies for immediate delivery. In practice, it may take one or two days to settle transactions. Transactions are affected at prevailing rate of exchange at that point of time and delivery of foreign exchange is affected instantly. The exchange rate that prevails in the spot market for foreign exchange is called Spot Rate.

Forward Market : A market in which foreign exchange is bought and sold for future delivery is known as Forward Market. It deals with transactions (sale and purchase of foreign exchange) which are contracted today but implemented some times in future. Exchange rate that prevails in a forward contract for purchase or sale of foreign exchange is called Forward Rate. Thus, forward rate is the rate at which a future contract for foreign currency is made.

Derivatives : Within the fields of trading and finance, a derivative is considered to be an instrument used for investment via a contract. Its value is "derived" from (or based upon) that of another asset, typically referred to as the underlying asset or simply "the underlying." In other words, a derivative contract is an agreement that allows for the possibility to purchase or sell some other type of financial instrument or non-financial asset. Common types of derivative contracts include options, forwards, futures and swaps.

- **Future Market:** Standardized forward contracts are called futures contracts and traded on a futures exchange. A futures contract (more colloquially, futures) is a standardized contract between two parties to buy or sell a specified asset of standardized quantity and quality for a price agreed upon today(the futures price or strike price) with delivery and payment occurring at a specified future date.
- **Option Market:** A currency option gives an investor the right, but not the obligation, to buy or sell a quantity of currency at a pre-established price on or before the date that the option expires. The right to sell a currency is known as a "call option" and the right to buy is known as a "put option." Options can be understood as a type of insurance where buyers or sellers can take advantage of more favorable prices should market conditions change after the option is purchased.
- **Swap Market:** The idea of a swap by definition normally refers to a simple exchange of property or assets between parties. A currency swap also involves the conditions determining the relative value of the assets involved. That includes the exchange rate value of each currency and the interest rate environment of the countries that have issued them. A foreign exchange swap, forex swap, or FX swap is a simultaneous purchase and sale of identical amounts of one currency for another with two different value dates (normally spot to forward).

11.15 MARKET PARTICIPATES OF FOREIGN EXCHANGE MARKET :

The foreign exchange market assists international trade and investment by enabling currency conversion. For example, it permits a business in the United States to import goods from the European Union member states especially Euro zone members and pay Euros, even though its income is in United States dollars. The foreign exchange market is a form of exchange for the global decentralized trading of international currencies.

The Market Participants :

Commercial Bank : A commercial bank (or business bank) is a type of financial institution and intermediary. It is a bank that lends money and provides transactional, savings, and money market accounts and that accepts time deposit n order to facilitate international trade and development, commercial banks convert and trade foreign currencies. When a company is doing business in another country it may be paid in the currency of that country. While some of these revenues will be used to pay workers in that country and for administrative expense such as office rent, utilities and supplies, the company may need to purchase goods from a neighboring country in that country's currency, or convert cash to its native currency for return to the home office.

Central bank : National central banks play an important role in the foreign exchange markets. They try to control the money supply, inflation, and/or interest rates and often have official or unofficial target rates for their currencies. They can use their often substantial foreign exchange reserves to stabilize the market.

Foreign exchange fixing : Foreign exchange fixing is the daily monetary exchange rate fixed by the national bank of each country. The idea is that central banks use the fixing time and exchange rate to evaluate behavior of their currency. Fixing exchange rates reflects the real value of equilibrium in the market. Banks, dealers and traders use fixing rates as a trend indicator.

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

Investment management firms : Investment management is the professional management of various securities (shares, bonds and other securities) and assets (e.g., real estate) in order to meet specified investment goals for the benefit of the investors. These firms (who typically manage large accounts on behalf of customers such as pension funds and endowments) use the foreign exchange market to facilitate transactions in foreign securities.

Retail foreign exchange traders : One of the most important tools required to perform a foreign exchange transaction is the trading plat form providing retail traders and brokers with accurate currency quotes. Retail foreign exchange trading is a small segment of the large foreign exchange market.

Fluctuation in the exchange rate : A market-based exchange rate will change whenever the values of either of the two component currencies change. A currency will tend to become more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than available supply.

11.16 FOREIGN EXCHANGE RISK :

Foreign exchange:

Risk refers to the losses that an international financial transaction may incur due to currency fluctuations. Also known as currency risk, FX risk and exchange-rate risk, it describes the possibility that an investment‘s value may decrease due to changes in the relative value of the involved currencies. Investors may experience jurisdiction risk in the form of foreign exchange risk.

Understanding Foreign Exchange Risk :

The proceeds of a closed trade, whether it's a profit or loss, will be denominated in the foreign currency and will need to be converted back to the investor's base currency. Fluctuations in the exchange rate could adversely affect this conversion resulting in a lower than expected amount. An import/export business exposes itself to foreign exchange risk by having account payables and receivables affected by currency exchange rates. This risk originates when a contract between two parties specifies exact prices for goods or services, as well as delivery dates. If a currency‘s value fluctuates between when the contract is signed and the delivery date, it could cause a loss for one of the parties.

11.17 TYPES OF FOREIGN EXCHANGE MARKET :

1) **Spot market:** The spot market or cash market is a public financial market in which financial instruments or commodities are traded for immediate delivery. It contrasts with a futures market in which delivery is due at a later date. A spot market can be an organized market, an exchange or over the counter.
2) **Forward market:** The forward market is the informal over-the counter financial market by which contracts for future delivery are entered into. Standardized forward contracts are called futures contracts and traded on a future exchange contracts entered into in the forward market are binding on the parties involved.

11.18 TYPES OF FOREIGN EXCHANGE RISK :

There are three types of foreign exchange risk:

Transaction risk: This is the risk that a company faces when it's buying a product from a company located in another country. The price of the product will be denominated in the selling company's currency. If the selling company's currency were to appreciate versus the buying company's currency then the company doing the buying will have to make a larger payment in its base currency to meet the contracted price.

Translation risk: A parent company owning a subsidiary in another country could face losses when the subsidiary's financial statements, which will be denominated in that country's currency, have to be translated back to the parent company's currency.

Economic risk: Also called forecast risk, refers to when a company‘s market value is continuously impacted by an unavoidable exposure to currency fluctuations. Companies that are subject to FX risk can implement hedging strategies to mitigate that risk. This usually involves forward contracts, options, and other exotic financial products and, if done properly, can protect the company from unwanted foreign exchange moves.

$$\boldsymbol{EXCHANGE\ RATE\ FORMULA} = \frac{\boldsymbol{MONEY\ IN\ AFTER\ EXCHANGE}}{\boldsymbol{MONEY\ BEFORE\ EXCHANGE}}$$

11.19 EXCHANGE-RATE SYSTEM :

An exchange rate system in which some combination of exchange rate systems and intervention is used is called a managed floating exchange-rate system.

The exchange rate just discussed is the cost of currency for immediate (on-the-spot) delivery and so is referred to as the spot rate. There are a number of other types of foreign exchange transactions that are used by traders and investors to accomplish their objectives.

One of these is a forward transaction. A forward transaction in the foreign exchange market is an agreement to buy or sell foreign exchange for future delivery at a price determined today. For example, the current spot rate for pounds may be R=1.4, while the current forward rate, FR, might be FR=1.39. This says that pound may be bought or sold at today's forward rate, \$1.39/£, with settlement to occur in the future. Standard maturities of forward contracts are for one month, three months, and six months. If you agree to buy pounds in the one-month forward market and the current forward rate is FR=\$1.39/£, then in one month you will be obligated to buy the contracted number of pounds and deliver \$1.39 per pound bought. Notice that the forward rate locks in a price that does not change no matter what happens to the spot rate over the next month.

If the forward rate is less than the current spot rate, then forward currency is said to be selling at a forward discount. If the forward rate exceeds the current spot rate, then forward currency is selling at a forward premium. Forward discounts and premia are often expressed as a percentage of the spot rate, with an adjustment for the time period to express the result on an annual basis.

Foreign exchange futures are roughly equivalent to forward currency transactions. The principal difference is that futures are standardized with respect to denomination and the date at which the contract matures (rather than the length of maturity) and the size of the transaction. Also, futures transactions can be "undone" at any point before maturity while forward positions must be maintained until maturity.

A **currency swap** is a combination of a spot transaction and a forward transaction. In a currency swap, one party agrees to sell a currency at the current spot rate and to buy it back in the future at a price agreed upon today. (The other party to the transaction agrees to do the opposite.) Currency swaps can be ongoing rather than one-time transactions, meaning that the parties to the transaction agree to continually swap currencies every month. Ongoing currency swaps are equivalent to a series of spot and forward transactions. Currency swaps, especially ongoing currency swaps, are useful because there are fewer transactions, and therefore smaller transaction costs, than entering into a series of separate spot and forward transactions.

Foreign exchange options are similar to foreign exchange forward and futures transactions in that they allow future transactions at prices negotiated today, but they do differ in one crucial respect. Options confer the *right* to sell (a put option), or a *right* to buy (a call option) foreign exchange in the future, but not the obligation to buy or sell. That is, futures and forward contracts must be honored, but buyers of put options and buyers of call options can allow the option to lapse without completing the transaction. Sellers of put and call options, known as option writers, must honor if the buyer chooses.

11.20 SUMMARY :

As stated by this chapter's introductory quote, an international transaction means someone must deal in foreign currency. The exchange rate regime refers to an arrangement between nations to determine the exchange rate by mutual agreement and settle their payments by using the rate so determined. The exchange rate was determined by the mint parity of gold content in the currencies. The exchange control regime is the regime of direct control of the foreign exchange rate and foreign exchange transactions being confined to the central bank of the country. If a U.S. exporter sells goods, where the price of good is stated in foreign currency, then the U.S. exporter will receive foreign currency and will sell the foreign currency in exchange for dollars. If instead the U.S. exporter's contract is stated in dollars, then the foreign buyer must buy dollars by selling foreign currency. The purchase and sale of foreign exchange is conducted on the foreign exchange market.

11.21 TECHNICAL TERMS :

- **Exchange Rate :** At the most basic level, exchange rates are determined by demand and supply of one currency relative to the demand and supply of another. However differences in relative demand and supply explain the determination of exchange rates, they do it only in a superficial sense.
- **Forex Market: The foreign exchange market (also known as forex, FX, or the currencies** market) is an over-the-counter (OTC) global marketplace that determines the exchange rate for currencies around the world
- **Exchange Market:** The foreign exchange market is an over-the-counter (OTC) marketplace that determines the exchange rate for global currencies.
- **Forex Management:** It is a set of regulations that empowers the Reserve Bank of India to pass regulations and enables the Government of India to pass rules relating to foreign exchange in tune with the foreign trade policy of India.
- **Foreign Exchange Markets:** What Is the Foreign Exchange Market? The foreign exchange market (also known as forex, FX, or the currencies market) is an over-the-counter (OTC) global marketplace that determines the exchange rate for currencies around the world.
- **Foreign Exchange Risk:** What is foreign exchange risk? By definition, foreign exchange risk is the possibility for a company to be affected by a variation in the exchange rate between its local currency and the currency used in a transaction with a foreign country.

11.22 SELF ASSESSMENT QUESTIONS :

1. What are the Characteristics/Features of Foreign Exchange Market?
2. What is the Nature of Forex Management
3. What is the Scope of Forex Management
4. What is the Significance of Forex Management
5. What are the Functions of Foreign Exchange Markets
6. What is the Structure of The Foreign Exchange Market
7. What is the Market Participates of Foreign Exchange Market
8. What is the Foreign Exchange Risk
9. What are the Types of Foreign Exchange Market
10. What is meant by ‘Foreign Exchange Market’? What are its Characteristics?
11. Determinants of foreign exchange market?
12. Explain Forex market, its Structure and significance?

11.23 SUGESTED READINGS :

1. Vadilal Dagh: India’s Foreign Trade Jouav Such Foreign Trade and Economic development of under developed countries.
2. Lall G, S. : Financing of Foreign trade and
3. NCAER Export strategy for India
4. Jeevanandam: Foreign Exchange.
5. Jeevanandam: Foreign Exchange arithmetic

Dr. P. V. V. KUMAR

LESSON - 12

FOREIGN EXCHANGE THEORIES

OBJECTIVES :

The goal is to find an explicit functional form for St , say St = $\alpha+\beta$ Xt, where Xt. is a variable or set of variables determined by a theory. Different theories will have different Xt and or different:

STRUCTURE :

12.1. INTRODUCTION :

What is Foreign Exchange? : Foreign exchange (Forex or FX) is the conversion of one currency into another at a specific rate known as the foreign exchange rate. The conversion rates for almost all currencies are constantly floating as they are driven by the market forces of supply and demand. In a free economy, a country's currency is valued according to the laws of supply and demand. In other words, a currency's value can be pegged to another country's currency, such as the U.S. dollar, or even to a basket of currencies. A country's currency value may also be set by the country's government. However, many countries float their currencies freely against those of other countries, which keeps them in constant fluctuation.

Factors Affecting Currency Value : The value of any particular currency is determined by market forces based on trade, investment, tourism, and geopolitical risk. Every time a tourist visits a country, for example, they must pay for goods and services using the currency of the host country. Therefore, a tourist must exchange the currency of their home country for the local currency. Currency exchange of this kind is one of the demand factors for a particular currency. Foreign exchange, also known as forex, is the conversion of one country's currency into another. The value of any particular currency is determined by market forces related to trade, investment, tourism, and geopolitical risk. Foreign exchange is handled globally between banks and all transactions fall under the auspice of the Bank for International Settlements (BIS).

Another important factor of demand occurs when a foreign company seeks to do business with another in a specific country. Usually, the foreign company will have to pay in the local company's currency. At other times, it may be desirable for an investor from one country to invest in another, and that investment would have to be made in the local currency as well. All of these requirements produce a need for foreign exchange and contribute to the vast size of foreign exchange markets. Foreign exchange is handled globally between banks and all transactions fall under the auspice of the Bank for International Settlements (BIS).1

The most traded currencies in the world are the United States dollar, Euro, Japanese yen, British pound, and Australian dollar. The US dollar remains the key currency, accounting for more than 87% of total daily value traded.

Foreign Exchange Rate : Foreign Exchange Rate is defined as the price of the domestic currency with respect to another currency. The purpose of foreign exchange is to compare one currency with another for showing their relative values. Foreign exchange rate can also be said to be the rate at which one currency is exchanged with another or it can be said as the price of one currency that is stated in terms of another currency. Exchange rates of a currency can be either fixed or floating. Fixed exchange rate is determined by the central bank of the country while the floating rate is determined by the dynamics of market demand and supply.

Factors Affecting the Exchange Rate : Exchange rate is impacted by some factors which can be economic, political or psychological as well. The economic factors that are known to cause variation in foreign exchange rates are inflation, trade balances, government policies. Political factors that can cause a change in the foreign exchange rate are political unrest or instability in the country and any kind of political conflict. Psychological factors that impact the forex rate is the psychology of the participants involved in foreign exchange.

How Inflation Affects Foreign Exchange Rates : Inflation can have a major effect on the value of a country's currency and its foreign exchange rates with other currencies. While it is just one factor among many, inflation is more likely to have a significant negative effect on a currency's value and foreign exchange rate. A low rate of inflation does not guarantee a favorable exchange rate, but an extremely high inflation rate is very likely to have a negative impact. Inflation is also closely related to interest rates, which can influence exchange rates. The interrelationship between interest rates and inflation is complex and often difficult for currency-issuing countries to manage. Low interest rates spur consumer spending and economic growth, and generally positive influences on currency value. If consumer spending increases and demand grows to exceed supply, inflation may ensue, which is not necessarily a bad outcome. However, low interest rates don't usually attract foreign investment the way higher interest rates can. Higher interest rates attract foreign investment, which is likely to increase demand for a country's currency.

12.2 TYPES OF EXCHANGE RATE SYSTEMS :

There are three types of exchange rate systems that are in effect in the foreign exchange market and these are as follows:

A. **Fixed exchange rate System or Pegged exchange rate system:** The pegged exchange rate or the fixed exchange rate system is referred to as the system where the weaker currency of the two currencies in question is pegged or tied to the stronger currency. Fixed exchange rate is determined by the government of the country or central bank and is not dependent on market forces. To maintain the stability in the currency rate, there is purchasing of foreign exchange by the central bank or government when the rate of foreign currency increases and selling foreign currency when the rates fall. This process is known as pegging and that’s why the fixed exchange rate system is also referred to as the pegged exchange rate system.

Advantages of Fixed Exchange Rate System: Following are some of the advantages of fixed exchange rate system-

i. It ensures stability in foreign exchange that encourages foreign trade.
ii. There is a stability in the value of currency which protects it from market fluctuations.
iii. It promotes foreign investment for the country.
iv. It helps in maintaining stable inflation rates in an economy.

Disadvantages of Fixed Exchange Rate System: Following are some of the disadvantages of the fixed exchange rate system-

i. There is a constant need for maintaining foreign reserves in order to stabilise the economy.
ii. The government may lack the flexibility that is required to bounce back in case an economic shock engulfs the economy.

B. **Flexible Exchange Rate System**: Flexible exchange rate system is also known as the floating exchange rate system as it is dependent on the market forces of supply and demand. There is no intervention of the central banks or the government in the floating exchange rate system.

Advantages of Floating Exchange Rate System: Following are the advantages of the floating exchange rate system-

i. There is no need to maintain foreign reserves in this exchange system.
ii. Any deficiencies or surplus in Balance of Payment is automatically corrected in this system.

Disadvantages of Floating Exchange Rate System :

Following are some of the disadvantages of the floating exchange rate system

i. It encourages speculation that may lead to fluctuations in the exchange rate of currencies in the market.

ii. If the fluctuations in exchange rates are too much it can cause issues with movement of capital between countries and also impact foreign trade.
iii. It will discourage any type of international trade and foreign investment.

C. **Managed floating exchange rate system:** Managed floating exchange rate system is the combination of the fixed (managed) and floating exchange rate systems. Under this system the central banks intervene or participate in the purchase or selling of the foreign currencies.

12.3 RELATION BETWEEN INFLATION, INTEREST RATES AND EXCHANGE RATES:

While exchange rates can be subject to myriad factors in intraday trading-from market sentiment, breaking economic news, and cross-border trade and investment flows -inflation and interest rate policy are often important indicators for exchange rate trends-they can help traders gain an idea of what is likely to be a profitable trade for foreign exchange positions taken over longer periods.

Inflation is commonly thought to the pace at which prices increase in a given economy and determines the "worth" of money in relation to goods and services offered. If more money is perceived to be circulating at a given time, suppliers of goods and services typically react by adjusting their prices upward, meaning less can be purchased with a given unit of currency. Conversely, if the offer of money by consumers appears to be scarce, suppliers often react by lowering prices to attract buyers, meaning inflation will decelerate and money in that economy will gain relative value.

Measures of Inflation: Inflation is normally measured by governments using groups of price levels for goods in varying sectors known as price indices. These include measures such as a producer price index (PPI), which measures whole sale inflation, and a consumer price index (CPI), which measures inflation for consumers. Governments and central banks frequently use these indices to help determine their economic measures through instruments such as inflation-targeting strategies. Inflation in the economies of currencies being traded is an important factor to consider because it affects the relative value of those currencies internationally and because it can determine future policy adjustments by governments and central banks.

Interest Rates: Through use of monetary policy, national central banks attempt to adjust their base interest rates and available banking money reserves to control the rate of lending by banks within their economies. The theory is that when there is more, or cheaper, money perceived to be available in the economy through bank loans and other types of credit, consumers and businesses will spend more, sellers of goods and services will adjust prices upward, and inflation can accelerate. Conversely, when there is less, or more expensive, money available, consumers and businesses will restrict their spending, prices will fall, and inflation will decelerate. Thus, if central banks want to curb inflation, they will raise interest rates; and if they want to induce spending and economic activity, they will lower interest rates.

12.4 FOREIGN EXCHANGE THEORIES :

Portfolio Balance theory, International Arbitrage and Interest Parity, Interest Rate Parity, Relation between inflation ,interest rates and exchange rates, Interest rate Parity, Purchasing Power Parity, Problems, International Fisher Effect, Expectations Theory, Problems, etc, When a central bank conducts open market operations by buying domestic currency-denominated government bonds, money supply increases and the domestic currency declines in value (depreciates) against the selected foreign currency and the exchange rate changes. When the central bank buys government bonds their supply decreases. But since the domestic currency has depreciated, the domestic currency value of foreign currency-denominated bonds rises. This makes investors prefer foreign bonds to domestic bonds, and the demand for domestic bonds decreases.

Theory of Supply and Demand: This theory states that the exchange rate is the intersection of the supply of domestic currency (shown as the supply curve) and its demand (shown as the demand curve). The supply of domestic currency is determined by imports and the demand is determined by exports.

Monetary Theory : This theory links money supply and prices to the exchange rate. An increase in money supply leads to an increase in prices (inflation). According to the monetary theory, the exchange rate is the ratio of prices in two countries, so an increase in price causes the exchange rate to be reset. Consider two countries A and B. When the money supply in each country rises, the prices in each Country rise. If the growth of money supply in A is greater than the growth of money supply in B, then A experiences a higher inflation rate than B. According to the Purchasing Power Parity theory, the exchange rate is nothing but the ratio of prices between two countries. Since A has had a relatively greater rise in prices, A's currency depreciates, will fall, and a new exchange rate will get established. The monetary theory states that there is a direct connection between relative changes in money supply in two countries and the exchange rate between both countries, provided there are no transportation costs in moving goods between both countries.

Purchasing Power Parity Theory: Under the theory of Purchasing Power Parity, the change in the exchange rate between two countries' currencies is determined by the change in their relative price levels locally that are affected by inflation. It is generally agreed that this theory mostly holds true over the long run, but economists have found that it can suffer distortions over the short term because of trade and investment barriers, local taxation, and other factors. As a result of this relationship, one can expect the currencies of countries with higher inflation rates to weaken over time versus their peers, whereas currencies of countries with lower inflation rates tend to strengthen. In economies with weak production of local goods and services, the depreciation of the local currency can at times even be accelerated by the "pass-through effect" of importing foreign goods with relatively higher prices. When a country‘s inflation rate rises relative to that of another country, decreased exports and increased imports depress the high-inflation country‘s currency because of worsening trade and current account balances. Purchasing Power Parity(PPP) theory attempt to quantify this inflation-exchange rate relationship.

Interpretations of PPP : The absolute form of PPP is an extension of the law of one price. It suggests that the prices of the same products indifferent countries should be equal when measured in a common currency. The relative form of PPP accounts for market distortions like transportation costs, labor costs, tariffs, taxes, and quotas. It states that the rate of price changes should be similar. Rationale behind PPP Theory: Suppose U.S. inflation > U.K. inflation.- U.S. imports from U.K.- U.S. exports to U.K., and U.S. current account- Down ward pressure (depreciation) is placed on the \$.This shift in consumption and the \$‘s depreciation will continue until in the U.S.: $\text{price}_{\text{U.K.goods}} \geq \text{price}_{\text{U.S.goods}}$ and in the U.K.: $\text{price}_{\text{U.S.goods}} \leq \text{price}_{\text{U.K.goods}}$

International arbitrage and interest rate parity : Arbitrage can be defined as capitalizing on a discrepancy in quoted prices. The funds invested are not tied up and no risk is involved.

In response to the imbalance in demand and supply resulting from arbitrage activity, prices will realign very quickly, such that no further risk-free profits can be made. Locational arbitrage is the process of buying a currency at the location where it is priced cheap and immediately selling it at another location where it is priced higher. Locational arbitrage is possible when a bank‘s buying price (bid) is higher than another bank‘s selling price (ask) for the same currency. Triangular Arbitrage is which currency transactions are conducted in the spot market to capitalize on a discrepancy in the cross exchange rate between two currencies. This is possible, if quoted cross exchange rate differs from the appropriate cross exchange rate. When the exchange rates of the currencies are not in equilibrium, triangular arbitrage will force them back into equilibrium. Covered Interest Arbitrage is the process of capitalizing on the interest rate differential between two countries, while covering for exchange rate risk. Covered interest arbitrage tends to force relationship between forward rate premiums and interest rate differentials. As many investors capitalize on covered interest arbitrage, there is upward pressure on the spot rate and downward pressure on the 90-day forward rate. Once the forward rate has a discount from the spot rate that is about equal to the interest rate advantage, covered interest arbitrage will no longer be feasible.

Portfolio Balance Theory: The portfolio balance theory connects money supply, supply and demand for domestic securities, demand for foreign securities, and the exchange rate. Its assumptions are: Investors can hold only two types of assets currency and bonds (domestic bonds issued in domestic currency and foreign bonds issued in foreign currency).- Investors in two countries have identical asset preferences.-When the wealth of investors neither country increases, they would prefer to hold more of the asset that they already hold in excess. Investors in two countries prefer to hold more of bonds in the country where wealth (value of the portfolio) is higher when translated into domestic currency. This is called the preferred habitat version of the portfolio balance theory. Changes in money supply affect wealth which in turn, has an impact on the exchange rate. Open market operations bring about changes in money supply.

Interest Rate Parity (IRP): Sometimes market forces cause the forward rate to differ from the spot rate by an amount that is sufficient to offset the interest rate differential between the two currencies. Then, covered interest arbitrage is no longer feasible, and the equilibrium state achieved is referred to as interest rate parity (IRP).When IRP exists, it does not mean that both local and foreign investors will earn the same returns. What it means is that investors cannot use covered interest arbitrage to achieve higher returns than those achievable in their respective home countries. While directly related to inflation control policy, interest rates are also considered to have their own particular relevance for foreign exchange trading because of what is known as interest rate parity.

This theory posits that the real interest rates (interest rates less inflation) across borders tend to move toward equilibrium and those currencies in economies with higher interest rates tend to weaken over time. However, where capital is allowed to move freely across borders, investors will seek to put their money in countries where they can get the highest returns. Thus, if one country has a higher interest rate than another, money will tend to flow to the country with the higher interest rate, causing that country's weaker currency to once again appreciate over time. When the currency has risen to an equilibrium price level where its cost is no longer offset by gains from its higher interest rate, it reaches interest rate parity and further investment flows from a broad come to a halt. Currency traders, then, hope to predict future exchange rate movements by paying attention to the relative levels of inflation in the countries of their target currency pairs in addition to where each country is in its monetary policy cycle, and the size and pace of currency flows moving into and out of each country.

Asset Price Theory: The theory states that currency is an asset just as real estate or securities or gold. The desire to hold a particular type of asset is driven by the perception of the asset‘s future value. If the value is likely to rise, people will want to buy the asset now and sell it at a higher price so as to make a profit. Conversely, if they think the asset ‘s value will drop, all those holding the asset now will start selling the asset fearing a greater decline in price in the near future. Therefore, the asset‘s current attractiveness is a function of what the market believes its value is going to be in future. In other words, future expectations decide current buy/sell decisions. This is true even for currency.

If the market believes that the domestic currency is going to rise in value, everyone will start buying it. If the current exchange rate is Rs. 43/$, and the expectation is that the rupee will appreciate over the next six months. Participants will start purchasing the rupee and this will drive up demand. Because demand rises, the rupee will appreciate against the dollar, and the exchange rate will settle at Rs. 42/$. If on the other hand, the market expects the rupee to depreciate, there will be selling pressure and the rupee will depreciate, probably settling at Rs. 44/$. At any point in time, the current exchange rate contains market expectations of the future value of the domestic currency.

Expectations theory: Expectations theory attempts to predict what short-term interest rates will be in the future based on current long-term interest rates. The theory suggests that an investor earns the same amount of interest by investing in two consecutive one-year bond investments versus investing in one two-year bond today. The theory is also known as the "unbiased expectations theory."

Understanding Expectations Theory: The expectations theory aims to help investors make decisions based upon a forecast of future interest rates. The theory uses long-term rates, typically from government bonds, to forecast the rate for short-term bonds. In theory, long-term rates can be used to indicate where rates of short-term bonds will trade in the future.

Example of Calculating Expectations Theory: In this example, the investor is earning an equivalent return to the Let's say that the present bond market provides investors with a two-year bond that pays an interest rate of 20% while a one-year bond pays an interest rate of 18%. The expectations theory can be used to forecast the interest rate of a future one-year bond.

The first step of the calculation is to add one to the two-year bond‘s interest rate. The result is 1.2.The next step is to square the result or (1.2 * 1.2= 1.44). Divide the result by the current one-year interest rate and add one or ((1.44/1.18)+1 =1.22).

To calculate the forecast one-year bond interest rate for the following year, subtract one from the result or(1.22-1 = 0.22 or 22%).

Present interest rate of a two-year bond. If the investor chooses to invest in a one-year bond at 18% the bond yield for the following year‘s bond would need to increase to 22% for this investment to be advantageous.

12.5 INTERNATIONAL FISHER EFFECT (IFE):

According to the Fisher Effect, nominal risk-free interest rates contain a real rate of return and anticipated inflation $i_n = i_r +$ inflation. If all investors require the same real return on assets of similar risk and maturity, then differentials in interest rates may be due to differentials in expected inflation. The International Fisher Effect (IFE) theory suggests that currencies with higher interest rates will depreciate because the higher nominal rates reflect higher expected inflation. Hence, investors hoping to capitalize on a higher foreign interest rate should earn a return no higher than what they would have earned domestically According to the IFE, $E(r_f)$, the expected effective return on a foreign money market investment, should equal r_h, the effective return on a domestic investment.

$r_f = (1+ i_f)(1+e_f) - 1$

i_f = interest rate in the foreign country e_f = %

change in the foreign currency‘s value$r_h = i_h =$ interest rate in the home country

Setting $r_f = r_h$: $(1 + i_f)(1 + e_f) - 1 = i_h$

Solving for e_f: $e_f = (1+i_h) /1(1+ i_f)]-1$ $i_h > i_f$ □ $e_f > 0$

i.e. foreign currency appreciate $i_h < i_f$ □ $e_f < 0$

i.e. foreign currency depreciates

Example: Suppose $i_{U.S.} = 11\%$ and $i_{U.K.} = 12\%$.Then

$e_{U.K.} = [(1+ .11)/(1 + .12)] - 1 = -(.89)\%$.

This will make $r_f = r_h$

When the interest rate differential is small, the IFE relationship can be simplified as e_f □ $i_h - i_f$ If the British rate on 6-month deposits were 2% above the U.S. interest rate, the £ should depreciate by approximately 2% over 6 months. Then U.S. investors would earn about the same return on British deposits as they would on U.S. deposits.

If actual interest rates and exchange rate changes are plotted over time on a graph, we can see whether the points are evenly scattered on both sides of the IFE line. Empirical studies indicate that the IFE theory holds during sometime frames. However, there is also evidence that it does not hold consistently

To test the IFE statistically, apply regression analysis to historical exchange rates and nominal interest rate differentials: $e_f = a_0 + a_1 [(1+ i_h)/(1+i_f) - 1] +$□.

Then apply t-tests to the regression coefficients. (Test for $a_0 = 0$ and $a_1 = 1$.). IFE does not hold if any coefficient differs significantly from what was expected.

Since the IFE is based on PPP, it will not hold when PPP does not hold.

In particular, if there are factors other than inflation that affect exchange rates, exchange rates may not adjust in accordance with the inflation differential.

Example Problems : Law of one price for CPIs. CPI- basketUSA = USD 755.3, CPI-basketSWIT = CHF 1241.2; $\mathbf{S}_t^{PPP}$ = USD 755.3/CHF 1241.2 = 0.6085 USD/CHF. If St 0.6085 USD/CHF, there will be trade of the goods in the basket between Switzerland and US. Suppose St = 0.70 USD/CHF > $\mathbf{S}^{PPP}$ = 0.6085 USD/CHF.; Then CPI-basketSWIT (in USD) = CHF 1241.2*0.70 USD/CHF = USD 868.70 > CPI-basketUSA; “Things” –i.e., the components in the CPI basket- are, on average, cheaper in the U.S.

There is a potential profit from trading the CPI basket's components : Potential profit: USD 868.70 – USD 755.3 = USD 93.40; Traders will do the following "pseudo-arbitrage" strategy: i. Borrow USD ii. Buy the CPI-basket in the US (CPI-basketUSA ↑); iii. Sell the CPI-basket, purchase in the US, in Switzerland.(CPI-basketSWIT ↓) **S** $^{\mathbf{PPP}}$ ↑;iv. Sell CHF/Buy USD (St (USD/CHF) ↓); v. Repay the USD loan, keep the profits.; Note: Prices move and push St (market price) & **S** $^{\mathbf{PPP}}$ (equilibrium price) towards convergence. Under PPP, a USD buys the same amount of goods in the U.S. and in Switzerland. That is, a USD has the same *purchasing power* in the U.S. & in Switzerland. Vice versa, a CHF buys the same amount of goods in Switzerland and in the U.S.

Example : Suppose a basket –the Big Mac (sesame-seed bun, onions, pickles, cheese, lettuce, beef patty and special sauce)– costs CHF 6.50 and USD 4.93 in Switzerland and in the U.S., respectively. Pf = CHF 6.50; Pd = USD 4.93, St = 0.9909 USD/CHF., $\mathbf{R_t} = S_t\, P_{SWIT} / P_{US}$ = 0.9908 USD/CHF x CHF 6.50/USD 4.93 = **1.3065**. Taking the Big Mac as our basket, the U.S. is more competitive than Switzerland. Swiss prices are higher ($\mathbf{R_t}$ -1 = 30.7% higher!) than U.S. prices, after taking into account the nominal exchange rate. That is, with one USD, we consume 30.7% more in the U.S. than in Switzerland. To bring the economy back to equilibrium –no trade on Big Macs-, we expect the USD to appreciate against the CHF. According to PPP, the USD is undervalued against the CHF:

Trading signal: Buy USD/Sell CHF. Note: Obviously, we do not expect to see Swiss consumers importing Big Macs from the U.S.; but the components of the Big Mac are internationally traded. Trade would happen in the components!

Indicator of under/over-valuation: $\mathbf{R_t} > 1$ FC is overvalued. Note: In the short-run, we will not take our cars to Mexico to be repaired, because a mechanic's hour is cheaper than in the U.S. But in the long-run, resources (capital, labor) will move, likely to produce cars in Mexico to export them to the U.S. We can think of the over-/under-valuation as an indicator of movement of resources.

Remark: If S_t changes, but P_f & P_d move in such a way that $\mathbf{R_t}$ remains constant, changes in S_t do notaffect firms. There is no change in real cash flows.

Absolute PPP: Real v. Nominal Exchange Rates Economists think that monetary variables affect nominal variables, like prices and the nominal exchange rate, St. But, monetary variables do not affect real variables. In this case, only relative demands and supplies affect R_t.

For example, an increase in U.S. output relative to European output (say, because of a technological innovation) will decrease P_{US} relative to P_{EUR} $\mathbf{R_t}$ (a real depreciation of the USD). On the other hand, a monetary approach to exchange rates, predicts that an increase in the U.S. money supply willincrease P_{US} and, thus, an increase in S_t, but no effect on $\mathbf{R_t}$.

Absolute PPP: Does it hold? We use a basket of goods to test PPP. To get better results, it is a good idea to use the same basket (orcomparable baskets.

PROBLEMS :

An American investor purchased securities in Indian market investing one million dollars, at the time of investing exchange rate is 50/50.5 rs,while one year later the exchange rate is 53/54 rs. What is the rate of return to American investor if he rate of rs. return on Indian security is 20%. 25% and 50%.

Solution: If the rate is 20% Amount invested in India = 10, 00,000*50 = 50,000,000 (50million) Return = 100, 00,000 (1 million) After 1 year the amount to be repatriated = 60000000/54 = 11,11,111 Rate Return = 11, 11,111 / 10, 00,000 = 11.11%

If the rate Return = 25%

Amount invested in India = 10, 00,000*50 = 50,000,000 (50million)
At 25 % Return rate of return in Indian rupee = 5, 00, 00,000
*25 % = 1, 25, 00,000
At the closing rate = 6, 25, 00,000/54 = 11, 57,407
Rate Return = 11, 57,407 / 10, 00,000 = 15.47%

If the rate is 50% in Indian Rs term

Investment = 5, 00, 00,000
Return in Indian Rs = 5, 00, 00,000* 50 = 2, 50, 00,000 Rs
Total amount to be repatriated in Rs = 7, 50, 00,000/54 = 13, 88,888 $
Return on investment = 3, 88,889 /10, 00,000 + 38.89%

PROBLEM:

Walgreens Boots Alliance sold Omani Rial 3, 22,500 value spot to your customer at `167.43 per OMR & covered yourself in Uk stock exchange on the same day,
When the exchange rates were
GBP 1 = OMR 0.4901 0.4941
Local interbank market rates for GBP were
Spot GBP 1 = ` 80.71 80.86
Calculate cover rate and ascertain the profit or loss in the transaction. Ignore brokerage.

Solution :

The bank (Dealer) covers itself by buying from the market at market selling rate.
Rupee – GBP selling rate ` 80.86
Omani Rial – GBP OMR 0.4901
Rupee – Hong Kong cross rate ` 80.86 / 0.4901 `

164.9867

Profit / Loss to the Bank
Amount received from customer (3, 22,500 × 167.43) ` 539, 96,175
Amount paid on cover deal (3, 22,500 × 164.9867) ` 532, 08,211
Profit to Bank ` 7, 87,964

Problem:

If SFr / $ = 5.5971 / 5.5978 and $ / Can$ = 0.7555 / 0.7562, we are required to calculate Cross Rate i.e. SFr / Can$

1. (SFr / Can$) bid rate is the number of Swiss Francs which a bank would be ready to pay to buy one Can$. A dealer can sell 1 Can$ for $ 0.7555, whereas bank is ready to buy one

dollar for SFr 5.5971. Hence, for selling one Can$, the dealer will get 0.7555 x 5.5971 = 4.2286 SFr.

2. Similarly, (SFr / Can$) ask rate is the number of Swiss Francs the bank will require to be paid for selling one Can$. A bank would take 0.7562 $ to sell one Ca n$, whereas a dealer can buy one dollar for SFr 5.5978. Hence, the dealer can buy one Can$ for 5.5978 x 0.7562 = 4.2330 SFr.

Problem :

U.S. tourist wishes to buy JPY at LAX.

(A) Indirect quotation (JPY/USD).

A quote of JPY 110.34-111.09 means the dealer is willing to buy one USD for JPY 110.34 (*bid)* andsell one USD for JPY 111.09 (*ask*).

For each round-trip USD transaction, she makes a profit of JPY .75.

(B) Direct quotation (USD/JPY).

If the dealer at LAX uses directs quotations, the bid-ask quote will be .009002-.009063 USD/JPY. Note: S (direct) bid = 1/S (indirect) ask,S (direct) ask = 1/S (indirect) bid.

12.6 SUMMARY :

This Chapter states that the exchange rate is the intersection of the supply of domestic currency and its influencing factors. The market where one currency is traded for another is called forex market. Its primary function is to facilitate international trade and investment. The market consists of the interbank market in which major banks deal with each other and the retail market, in which banks deal with their commercial customers.

The supply of domestic currency is determined by imports and the demand is determined by exports. In theoretical aspect forex market and its transactions were discussed. In this chapter explained about portfolio theory, international arbitrage, purchasing power parity, and international fisher effect and with some of another theories explained the forex transactions.

12.7 TECHNICAL TERMS :

- **Foreign Exchange :** Foreign exchange, or forex, is the conversion of one country's currency into another. In a free economy, a country's currency is valued according to the laws of supply and demand. In other words, a currency's value can be pegged to another country's currency, such as the U.S. dollar, or even to a basket of currencies.
- **Portfolio Balance:** The portfolio-balance model of Tobin [1] provides a monetary theory of the interest rate. One models the portfolio demand for financial assets, and the interest rate adjusts to equilibrate the supply and the demand for financial assets.
- **International Arbitrage:** International arbitrage is the act of buying and selling the same quantity of an asset in two different markets simultaneously. International arbitrage works on the principle of price differential created due to the inefficiencies of the market.
- **Interest Rate Parity:** Interest rate parity is the fundamental equation that governs the relationship between interest rates and currency exchange rates. The basic premise of interest rate parity is that hedged returns from investing in different currencies should be the same, regardless of their interest rates.

- **Inflation:** Inflation is the rate of increase in prices over a given period of time. Inflation is typically a broad measure, such as the overall increase in prices or the increase in the cost of living in a country.
- **Purchasing Power Parity:** PPPs are the rates of currency conversion that equalize the purchasing power of different currencies by eliminating the differences in price levels between countries.

12.8 SELF ASSESSMENT QUESTIONS :

1. Briefly explain the foreign exchange theories?
2. What do you know about purchasing power parity?
3. Explain International fisher effect?
4. International Arbitrage and Interest Parity?
5. What is the Relation between inflation, interest rates and exchange rates?

12.9 SUGGESTED READINGS :

1. Vadilal Dagh: India’s Foreign Trade Jouav Such Foreign Trade and Economic development of under developed countries.
2. Lall G, S. : Financing of Foreign trade and
3. NCAER Export strategy for India
4. Jeevanandam: Foreign Exchange.
5. Jeevanandam: Foreign Exchange arithmetic

Dr. P. V. V. KUMAR

LESSON - 13
EXCHANGE CONTROL

AIMS AND OBJECTIVES :

After studying this lesson students should be able to

- To know the concept of exchange control
- To understand factors that lead to improve exchange controls
- To acquired knowledge on regulations
- To obtain knowledge on foreign exchange control
- To gain knowledge on FERA 1973
- To learn types of foreign exchange control

STRUCTURE OF THE LESSON :

13.1 INTRODUCTION OF EXCHANGE CONTROL :

Exchange controls are government-imposed limitations on the purchase and/or sale of currencies. These controls allow countries to better stabilize their economies by limiting in-flows and out-flows of currency, which can create exchange rate volatility.

Exchange controls are government-imposed limitations on the purchase and/or sale of currencies. These controls allow countries to better stabilize their economies by limiting in-flows and out-flows of currency, which can create exchange rate volatility. Not every nation may employ the measures, at least legitimately; the 14th article of the International Monetary Fund's Articles of Agreement allows only countries with so-called transitional economies to employ exchange controls.

13.2 UNDERSTANDING EXCHANGE CONTROL :

The foreign exchange pool is rationed to cater for “essential” or priority payments abroad. It involves controlling the trading of foreign currency and transfers across national borders. The government will determine how foreign exchange earned by individuals and businesses is spent. It will be mandatory for all earned foreign exchange to be sold at the central bank at a predetermined rate.

Limits on foreign currency amount that individuals and businesses can purchase from the central bank will also be put in place. Exchange control is also used to restrict non-essential imports, encourage the importation of priority goods, control the outflow of capital, and manage the country's exchange rate. Generally, countries use foreign exchange control to manage the value of the local currency.

It's not every nation that can legitimately introduce exchange control measures. According to the articles of agreement by the International Monetary Fund (IMF), only countries with transitional economies can apply exchange controls. Several western nations employed exchange control measures soon after World War II but gradually phased them out before the 1980s as their economies strengthened overtime.

The phasing out of exchange controls was also necessitated by trends towards globalization, free trade, and economic liberalization in the 1990s, which does not co-exist with the application of exchange controls. Presently, exchange controls are mostly utilized by developing countries with weak economies, low exports, are import-dependent, and with low foreign currency reserves.

Countries with history of Exchange Controls :

- United Kingdom – until 1979
- South Korea – 1985 to 1989
- Egypt – until 1995
- Argentina – 2011 to 2015; and
- Fiji, Mexico, Peru, Finland, Chile, Zimbabwe, among others

13.3 FACTORS THAT LEAD GOVERNMENTS TO IMPROVE EXCHANGE CONTROLS :

The justification and motivation for the imposition of foreign exchange controls vary from country to country and their respective economic situations. Below are some of the justifications:

- Capital flight at unprecedented levels, mainly due to speculative pressure on the local currency, fear, and extremely low confidence levels.
- A marked decline in exports resulting in a Balance of Payments (BOP) deficit
- Adverse shifts in terms of trade
- War/conflict budgeting. The BOP may be in disequilibrium due to war, drought, etc.
- Economic development and reconstruction

13.4 OBJECTIVE OF FOREIGN EXCHANGE CONTROL :

Restore the balance of payments equilibrium :

The main objective of introducing exchange control regulations is to correct the balance of payments equilibrium. The BOP needs realignment when it is sliding to the deficit side due to greater imports than exports. Hence, controls are put in place to manage the dwindling foreign exchange reserves by limiting imports to essentials items and encouraging exports through currency devaluation.

Protect the value of the national currency :

Governments may defend their currency's value at a certain desired level through participating in the foreign exchange market. The control of foreign exchange trading is the

government's way to manage the exchange rate at the desired level, which can be at an overvalued or undervalued rate.
The government can create a fund to defend currency volatility to stay in the desired range or get it fixed at a certain rate to meet its objectives. An example is an import-dependent country that may choose to maintain an overvalued exchange rate to make imports cheaper and ensure price stability.

Prevent capital flight :

- The government may observe increased trends of capital flight as residents and non-residents start making amplified foreign currency transfers out of the country. It can be due to changes in economic and political policies in the country, such as high taxes, low interest rates, increased political risk, pandemics, and so on.
- The government may resort to an exchange control regime where restrictions on outside payments are introduced to mitigate capital flight.

Protect local industry :

The government may resort to exchange control to protect the domestic industry from competition by foreign players that may be more efficient in terms of cost and production. It is usually done by encouraging exports from the local industry, import substitution, and restricting imports from foreign companies through import quotas and tariff duties.

Build foreign exchange reserves :

The government may intend to increase foreign exchange reserves to meet several objectives, such as stabilize local currency whenever needed, paying off foreign liabilities, and providing import cover.

13.5 CONSEQUENCES OF EXCHANGE CONTROLS :

Exchange controls can be effective in some instances, but they can also come with negative consequences. Often, they lead to the emergence of black markets or parallel markets in currencies. The black markets develop due to higher demand for foreign currencies that is greater than the supply in the official market. It leads to an ongoing debate about whether exchange controls are effective or not.

13.6 REGULATION :

Regulation has a variety of meanings that are not reducible to a single concept. In the field of public policy, regulation refers to the promulgation of targeted rules, typically accompanied by some authoritative mechanism for monitoring and enforcing compliance. Accordingly, for a long time in the United States, for example, the study of regulation has been synonymous with the study of the independent agencies enforcing it. In political economy, it refers to the attempt of the state to steer the economy, either narrowly defined as the imposition of economic controls on the behaviour of private business or, more broadly, to include other governmental instruments, such as taxation or disclosure requirements. The two meanings share a focus on the state's attempt to intervene in private activities.

A third definition of regulation moves beyond an interest in the state and focuses on all means of social control, either intentional or unintentional. This understanding is commonly applied in anthropology, sociolegal studies, and international relations because it includes mechanisms such as voluntary agreements or norms that exercise social control outside the reach of a sovereign state and not necessarily as an intentional act of steering.

Thus, different strands of regulation studies share an agreement on the subject of regulation (the state), the object (the behaviour of nongovernmental actors), the instruments (an authoritative set of rules), or the domain of application (e.g., the economy). However, they do not necessarily agree on all those elements. The concept of regulation points to the rules that structure the behaviour of individuals within a given context without postulating where the rules come from and how they are imposed.

Regulation as state activity :

The theoretical debates around the concept of regulation reflect different disciplines and research agendas and can be broadly divided into approaches to regulation as an act of government and perspectives on regulation as governance. Regulation as a governmental activity has been studied extensively, including the reasons for regulation and the process by which it is effected.

Public versus private interests :

The original justification of government intervention in economic interactions was public interest. This perspective considers the market as an efficient allocation mechanism of social and economic welfare while also cautioning against market failures. Market failures commonly include natural monopolies, externalities, public goods, asymmetric information, moral hazard, or transaction costs. Regulation was considered necessary to overcome those difficulties.

Conceiving regulation as a tool for overcoming market imperfections, however, has been criticized on a number of points. First, with the evolution of economic theory, several scholars have questioned the understanding of market failure underlying the explanation of government regulation. Second, economists have pointed out the often considerable transaction costs of imposing regulation, which might make it an ineffective policy tool and harmful to social or economic welfare. Finally, the market failure approach argues that regulation is put into place with the goal of achieving economic efficiency. However, this makes it hard to account for other objectives, such as procedural fairness or redistribution at the expense of efficiency.

The Chicago school of economics, known for its advocacy of laissez-faire economics, focused instead on private interests as the source of regulation. The principal aim of this perspective is to understand how private interests and public officials interact. A central claim made by theorists following this approach was that policy outcomes are most often contrary to societal or public interest because industry representatives lobby the government for benefits they might gain through protectionism or other forms of economic controls. Politicians are susceptible to these demands because they are interested in financial contributions that business actors can offer. Thus, interest groups compete for specific policies in a political market for governmental regulation. As long as interest groups exist, regulation can be expected, which impedes the achievement of maximal social and economic welfare.

The theory of economic regulation has been criticized for its risk of tautology. Regulation is in place because private interests lobbied for it effectively, and, as a consequence, one can only know who asked for it by determining who benefits from it. Therefore, a particular industry advantage is the cause and effect of regulation. Furthermore, if regulation is defined in a narrow sense as specific economic policies aimed at the control of prices or market entry and access, the decrease in regulation of several industries in the United States during the 1970s and ’80s seemingly refutes the theory. Nonetheless, as a model of business-government interactions, the theory of economic regulation directly or indirectly informs a large number of studies in the field of political economy.

Pragmatic-administrative analyses :

A large number of studies have also grappled with the empirical fact of regulation. Such pragmatic-administrative perspectives shed light on regulation as an act of policy making. The study of the politics of regulations is informed by the tools of public policy analysis, organizational sociology, and political science. In the 1950s American economist Marver H. Bernstein described the rhythm of regulation as a life cycle of regulatory commissions, with phases of gestation, youth, maturity, and old age. This view facilitated the analysis of the initial activism in the formulation of a regulatory policy approach and the specific management problems that occur in the course of its lifetime. Regulation had been classified as a specific type of public policy, indicating that policies should be categorized according to the degree and application of governmental coercion and that regulatory policy should be separated from distributive and redistributive policy making.

Other studies of regulation have aimed at characterizing different policy regimes or, more ambitiously, state capacity. The predominantly European literature on the regulatory state sought to show that governmental action was increasingly based on the use of authority, rules, and standard setting, rather than distributional or redistributional tasks, such as public service provision. In an extension of this debate to the European level, it was argued that the governmental capacity of the European Union (EU) was strongly biased toward regulation. As a political system, the EU could therefore develop into a regulatory state but not into an interventionist welfare state.

Regulation as governance :

In the context of economic globalization, regulatory studies moved away from focusing on independent agencies and governmental control of the economy only. Scholars recognized that some interactions of market participants, product standards, or processes were no longer regulated through state intervention. Rather, they were regulated through international agreements or even self-regulation arrangements between private actors. Because it seemed pertinent to address these new modes of economic governance, it became common to address regulation in the absence of direct governmental authority. Other studies pointed at patterns that govern the behaviour of certain actors without reference to a unitary subject of regulation.

Regulation without the state :

As in the context of the EU, scholars of regulatory reform also became interested in regulation at the international level. In certain sectors, such as e-commerce or telecommunications, international agreements had become decisive for controlling the market behaviour of individuals. Moreover, many studies pointed out the effect of self-regulation of firms or various sets of public-private partnerships for the elaboration, monitoring, or implementation of targeted rules. They showed how different forms of private authority structure the economic behaviour of firms in sectors as diverse as maritime transport, mineral markets, or financial services.

It is often difficult to identify exactly who or what leads to the rise or fall of regulatory reforms. While regulation and deregulation in the United States can be identified closely with specific political leaders and parties, a growing literature investigates what mechanisms lead to the diffusion of regulatory reforms across countries or policy contexts.

Animated by the desire to understand regulatory emulation, this research agenda connects the study of regulation with the ongoing debate about the roots and consequences of liberalization and globalization.

13.7 DEFINITION OF FOREIGN EXCHANGE CONTROL :

- In modern times various devices have been adopted to control international trade and regulate international indebtedness arising out of international workings and dealings.
- The spirit of economic nationalism induces every country to look primarily to its own economic interests. Foreign Exchange control is one of the devices adopted for the purpose.
- Foreign Exchange control is a system in which the government of the country intervenes not only to maintain a rate of exchange which is quite different from what would have prevailed without such control and to require the home buyers and sellers of foreign currencies to dispose of their foreign funds in particular ways.

Definition:

"Foreign Exchange Control" is a method of state intervention in the imports and exports of the country, so that the adverse balance of payments may be corrected". Here the government restricts the free play of inflow and outflow of capital and the exchange rate of currencies.

According to Crowther :

"When the Government of a country intervenes directly or indirectly in international payments and undertakes the authority of purchase and sale of foreign currencies it is called Foreign Exchange Control".

According to Haberler:

"Foreign Exchange Control in the state regulation excluding the free play of economic forces for the Foreign Exchange Market". The Government regulates the Foreign Exchange dealings by Consideration of national needs.

"Foreign Exchange Control means the monopoly of the government in the purchase and sale of foreign currencies in order to restore the balance of payments equilibrium and disregard the market forces in the decision of monetary authority". When tariffs and quotas do not help in correcting the adverse balance of trade and balance of payments the system of Foreign Exchange Control is restored to by Governments.

Objectives of Foreign Exchange Control:

Important objectives of Exchange Control are as follows:

- **Correcting Balance of Payments :** The main purpose of exchange control is to restore the balance of payments equilibrium, by allowing the imports only when they are necessary in the interest of the country and thus limiting the demands for foreign exchange up to the available resources. Sometimes the country devalues its currency so that it may export more to get more foreign currency.
- **To Protect Domestic Industries :** The Government in order to protect the domestic trade and industries from foreign competitions, resort to exchange control. It induces the domestic industries to produce and export more with a view to restrict imports of goods.
- **To Maintain an Overvalued Rate of Exchange :** This is the principal object of exchange control. When the Government feels that the rate of exchange is not at a particular level, it intervenes in maintaining the rate of exchange at that level. For this purpose the Government maintains a fund, may be called Exchange Equalization Fund to peg the rate of exchange when the rate of particular currency goes up, the

Government start selling that particular currency in the open market and thus the rate of that currency falls because of increased supply.

On the other hand, the Government may overvalue or undervalue its currency on the basis of economic forces. In over valuing, the Government increases the rate of its currency in the value of other currencies and in under-valuing; the rate of its over-currency is fixed at a lower level.

- **To Prevent Flight of Capital :** When the domestic capital starts flying out of the country, the Government may check its exports through exchange control.
- **Policy of Differentiation :** The Government may adopt the policy of differentiation by exercising exchange control. If the Government may allow international trade with some countries by releasing the required foreign currency the Government may restrict the trade import and exports with some other countries by not releasing the foreign currency.

13.8 THE FOREIGN EXCHANGE REGULATION ACT (FERA), 1973 :

Foreign Exchange Regulation Act (FERA) was promulgated in 1973 and it came into force on January 1, 1974. Section 29 of this Act referred directly to the operations of MNCs in India. According to the Section, all non-banking foreign branches and subsidiaries with foreign equity exceeding 40 per cent had to obtain permission to establish new undertakings, to purchase shares in existing companies, or to acquire wholly or partly any other company.

An Act to consolidate and amend the law regulating certain payments, dealings in foreign exchange and securities, transactions indirectly affecting foreign exchange and the import and export of currency, for the conservation of the foreign exchange resources of the country and the proper utilisation thereof in the interests of the economic development of the country.

Features of FERA :

- This Act may be called the Foreign Exchange Regulation Act, 1973.
- It extends to the whole of India.
- It applies also to all citizens of India outside India and to branches and agencies outside India of companies or bodies corporate, registered or incorporated in India.
- It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint in this behalf: Provided that different dates may be appointed for different provisions of this Act and any reference in any such provision to the commencement of this Act shall be construed as a reference to the coming into force of that provision.

Short title, extent, application and commencement:

1. This Act may be called the Foreign Exchange Regulation Act, 1973.
2. It extends to the whole of India.
3. It applies also to all citizens of India outside India and to branches and agencies outside India of companies or bodies corporate, registered or incorporated in India.
4. It shall come into force on such date1 as the Central Government may, by notification in the Official Gazette, appoint in this behalf: Provided that different dates may be appointed for different provisions of this Act and any reference in any such provision to the commencement of this Act shall be construed as a reference to the coming into force of that provision.

Definitions: In this Act, unless the context otherwise requires,

- “Appellate Board” means the Foreign Exchange Regulation Appellate Board constituted by the Central Government under sub-section (1) of section 52;
- “Authorised dealer” means a person for the time being au-thorised under section 6 to deal in foreign exchange;
- “Bearer certificate” means a certificate of title to securi-ties by the delivery of which (with or without endorsement) the title to the securities is transferable;
- “Certificate of title to a security” means any document used in the ordinary course of business as proof of the possession or control of the security, or authorising or purporting to author-ise, either by an endorsement or by delivery, the possessor of the document to transfer or receive the security thereby repre-sented;
- “Coupon” means a coupon representing dividends or interest on a security;
- “Currency” includes all coins, currency notes, bank notes, postal notes, postal orders, money orders, cheques, drafts, traveller’s cheques, letters of credit, bills of exchange and promissory notes;
- “Foreign currency” means any currency other than Indian currency;
- “Foreign exchange” means foreign currency and includes—
- all deposits, credits and balances payable in any foreign currency and any drafts, traveller’s cheques, letters of credit and bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency;

Any instrument payable, at the option of the drawee or holder thereof or any other party thereto, either in Indian currency or in foreign currency or partly in one and partly in the other;

- “foreign security” means any security created or issued elsewhere than in India, and any security the principal of or interest on which is payable in any foreign currency or elsewhere than in India.
- “Indian currency” means currency which is expressed or drawn in Indian rupees but does not include special bank notes and special one rupee notes issued under section 28A of the Reserve Bank of India Act, 1934 (2 of 1934);
- “Indian customs waters” means the waters extending into the sea to a distance of twelve nautical miles measured from the appropriate base line on the coast of India and includes any bay, gulf, harbour, creek or tidal river;
- “money-changer” means a person for the time being authorised under section 7 to deal in foreign currency;
- “overseas market”, in relation to any goods, means the market in the country outside India and in which such goods are intended to be sold;
- “owner”, in relation to any security, includes any person who has power to sell or transfer the security, or who has the custody thereof or who receives, whether on his own behalf or on behalf of any other person, dividends or interest thereon, and who has any interest therein and in a case where any security is held on any trust or dividends or interest thereon are paid into a trust fund, also includes any trustee or any person entitled to enforce the performance of the trust or to revoke or vary, with or without the consent of any other person, the trust or any terms thereof, or to control the investment of the trust moneys;

“Person resident in India” means

i. a citizen of India, who has, at any time after the 25th day of March, 1947, been staying in India, but does not include a citizen of India who has gone out of, or stays outside, India, in either case—
ii. For or on taking up employment outside India, or
iii. For carrying on outside India a business or vocation outside India, or
iv. For any other purpose, in such circumstances as would in-dicate his intention to stay outside India for an uncertain period;

- For or on taking up employment in India, or
- For carrying on in India a business or vocation in India, or
- For any other purpose, in such circumstances as would in-dicate his intention to stay in India for an uncertain period;

A person, not being a citizen of India, who has come to, or stays in, India, in either case

- For or on taking up employment in India, or
- For carrying on in India a business or vocation in India, or
- For staying with his or her spouse, such spouse being a person resident in India, or
- For any other purpose, in such circumstances as would in-dicate his intention to stay in India for an uncertain period;

a citizen of India, who, not having stayed in India at any time after the 25th day of March, 1947, comes to India for any of the purposes referred to in paragraphs (a), (b) and (c) of sub-clause (iii) or for the purpose and in the circumstances referred to in paragraph (d) of that sub-clause or having come to India stays in India for any such purpose and in such circum-stances. Explanation.—A person, who has, by reason only of paragraph (a) or paragraph (b) or paragraph (d) of sub-clause (iii) been resident in India, shall, during any period in which he is outside India, be deemed to be not resident in India;

- "Person resident outside India" means a person who is not resident in India;
- "Precious stone" includes pearl and semi-precious stone and such other stone or gem as the Central Government may for the purposes of this Act, notify in this behalf in the Official Gazette;
- "Prescribed" means prescribed by rules made under this Act;
- "Reserve Bank" means the Reserve Bank of India;
- "security" means shares, stocks, bonds, debentures, debenture-stock, Government securities as defined in the Public Debt Act, 1944 (18 of 1944), savings certificates to which the Government Savings Certificates Act, 1959 (46 of 1959), applies, deposit receipts in respect of deposits of securities, and units or sub-units of unit trusts and includes certificates of title to securities, but does not include bills of exchange or promissory notes other than Government promissory notes;

"Transfer", in relation to any security, includes transfer by way of loan or security.

Classes of officers of enforcement : There shall be the following classes of officers of Enforcement, namely:

i. Directors of Enforcement;
ii. Additional Directors of Enforcement;
iii. Deputy Directors of Enforcement;
iv. Assistant Directors of Enforcement; and
v. such other class of officers of Enforcement as may be appointed for the purposes of this Act.

Appointment and powers of officers of enforcement :

1. The Central Government may appoint such persons as it thinks fit to be officers of Enforcement.
2. Without prejudice to the provisions of sub-section (1), the Central Government may authorise a Director of Enforcement or an Additional Director of Enforcement or a Deputy Director of Enforcement or an Assistant Director of Enforcement to appoint officers of Enforcement below the rank of an Assistant Director of Enforcement.
3. Subject to such conditions and limitations as the Central Government may impose, an officer of Enforcement may exercise the powers and discharge the duties conferred or imposed on him under this Act.

Entrustment of functions of Director or other officer of enforcement :

The Central Government may, by order and subject to such conditions and limitations as it thinks fit to impose, authorise any officer of customs or any Central Excise Officer or any police officer or any other officer of the Central Government or a State Government to exercise such of the powers and discharge such of the duties of the Director of Enforcement or any other officer of Enforcement under this Act as may be specified in the order.

Authorised dealers in foreign exchange :

1. The Reserve Bank may, on an application made to it in this behalf, authorise any person to deal in foreign exchange.
2. An authorisation under this section shall be in writing and
   i. May authorise dealings in all foreign currencies or may be restricted to authorising dealings in specified foreign currencies only;
   ii. May authorise transactions of all descriptions in foreign currencies or may be restricted to authorising specified transactions only;
   iii. May be granted to be effective for a specified period or within specified amounts;
   iv. May be granted subject to such conditions as may be specified therein.
3. Any authorisation granted under sub-section (1) may be revoked by the Reserve Bank at any time if the Reserve Bank is satisfied that,

It is in the public interest to do so; or

   i. the authorised dealer has not complied with the conditions subject to which the authorisation was granted or has contravened any of the provisions of this Act or of any rule, notification, direction or order made thereunder: Provided that no such authorisation shall be revoked on the ground specified in clause
   ii. unless the authorised dealer has been given a reasonable opportunity for making a representation in the matter.

4. An authorised dealer shall, in all his dealings in foreign exchange and in the exercise and discharge of the powers and of the functions delegated to him under section 74, comply with such general or special directions or instructions as the Reserve Bank may, from time to time, think fit to give, and, except with the previous permission of the Reserve Bank, an authorised dealer shall not engage in any transaction involving any foreign exchange which is not in conformity with the terms of his authorisation under this section.

5. An authorised dealer shall, before undertaking any transaction in foreign exchange on behalf of any person, require that person to make such declarations and to give such information as will reasonably satisfy him that the transaction will not involve, and is not designed for the purpose of, any contravention or evasion of the provisions of this Act or of any rule, notification, direction or order made thereunder, and where the said person refuses to comply with any such requirement or makes only unsatisfactory compliance therewith, the authorised dealer shall refuse to undertake the transaction and shall, if he has reason to believe that any such contravention or evasion as aforesaid is contemplated by the person report the matter to the Reserve Bank.

Money-changers :

- The Reserve Bank may, on an application made to it in this behalf, authorise any person to deal in foreign currency.
- An authorisation under this section shall be in writing and
- May authorise dealings in all foreign currencies or may be restricted to authorising dealings in specified foreign currencies only;
- May authorise transactions of all descriptions in foreign currencies or may be restricted to authorising specified transactions only;
- May be granted with respect to a particular place where alone the money-changer shall carry on his business;
- May be granted to be effective for a specified period, or within specified amounts;
- May be granted subject to such conditions as may be specified therein.

Any authorisation granted under sub-section (1) may be revoked by the Reserve Bank at any time if the Reserve Bank is satisfied that

- It is in the public interest to do so; or
- the money-changer has not complied with the conditions subject to which the authorisation was granted or has contravened any of the provisions of this Act or of any rule, notification, direction or order made thereunder: Provided that no such authorisation shall be revoked on the ground specified in clause (ii) unless the money-changer has been given a reasonable opportunity for making a representation in the matter.

(4) The provisions of sub-sections (4) and (5) of section 6 shall in so far as they are applicable, apply in relation to a money-changer as they apply in relation to an authorised dealer. Explanation.—In this section “foreign currency” means foreign currency in the form of notes, coins, or traveller’s cheques and “dealing” means purchasing foreign currency in the form of notes, coins or traveller’s cheques or selling foreign currency in the form of notes or coins.

Restrictions on dealing in foreign exchange :

1) Except with the previous general or special permission of the Reserve Bank, no person other than an authorised dealer shall in India, and no person resident in India other than an authorised dealer shall outside India, purchase or otherwise acquire or borrow from, or sell, or otherwise transfer or lend to or exchange with, any person not being an authorised dealer, any foreign exchange: Provided that nothing in this sub-section shall apply to any purchase or sale of foreign currency effected in India between any person and a money-changer. Explanation. For the purposes of this sub-section, a person, who deposits foreign exchange with another person or opens an account in foreign exchange with another person, shall be deemed to lend foreign exchange to such other person.

2) Except with the previous general or special permission of the Reserve Bank, no person, whether an authorised dealer or a money-changer or otherwise, shall enter into any transaction which provides for the conversion of Indian currency into foreign currency or foreign currency into Indian currency at rates of exchange other than the rates for the time being authorised by the Reserve Bank.
3) Where any foreign exchange is acquired by any person, other than an authorised dealer or a money-changer, for any particular purpose, or where any person has been permitted conditionally to acquire foreign exchange, the said person shall not use the foreign exchange so acquired otherwise than for that purpose or, as the case may be, fail to comply with any condition to which the permission granted to him is subject, and where any foreign exchange so acquired cannot be so used or the conditions cannot be complied with the said person shall, within a period of thirty days from the date on which he comes to know that such foreign exchange cannot be so used or the conditions cannot be complied with, sell the foreign exchange to an authorised dealer or to a money-changer.
4) For the avoidance of doubt, it is hereby declared that where a person acquires foreign exchange for sending or bringing into India any goods but sends or brings no such goods or does not send or bring goods of a value representing the foreign exchange acquired, within a reasonable time or sends or brings any goods of a kind, quality or quantity different from that specified by him at the time of acquisition of the foreign exchange, such person shall, unless the contrary is proved, be presumed not to have been able to use the foreign exchange for the purpose for which he acquired it or, as the case may be, to have used the foreign exchange so acquired otherwise than for the purposes for which it was acquired.
5) Nothing in this section shall be deemed to prevent a person from buying from any post office, in accordance with any law or rules made thereunder for the time being in force, any foreign exchange in the form of postal orders or money orders.

Restrictions on payments :

- Save as may be provided in, and in accordance with any general or special exemption from the provisions of this sub-section which may be granted conditionally or unconditionally by Reserve Bank, no person in, or resident in, India shall—
- Make any payment to or for the credit of any person resident outside India;
- receive, otherwise than through an authorised dealer, any payment by order or on behalf of any person resident outside India; Explanation.—For the purposes of this clause, where any person in, or resident in, India receives any payment by order or on behalf of any person resident outside India through any other person (including an authorised dealer) without a corresponding inward remittance from any place outside India, then, such person shall be deemed to have received such payment otherwise than through an authorised dealer;
- draw, issue or negotiate any bill of exchange or promissory note or acknow-ledge any debt, so that a right (whether actual or contingent) to receive a payment is created or transferred in favour of any person resident outside India;
- Make any payment to, or for the credit of, any person by order or on behalf of any person resident outside India;
- Place any sum to the credit of any person resident outside India;
- Make any payment to, or for the credit of, any person or receive any payment for, or by order or on behalf of, any person as consideration for or in association with—
- The receipt by any person of a payment or the acquisition by any person of property outside India,

- The creation or transfer in favour of any person of a right (whether actual or contingent) to receive payment or acquire property outside India;
- (g) draw, issue or negotiate any bill of exchange or promissory note, transfer any security or acknowledge any debt, so that a right (whether actual or contingent) to receive a payment is created or transferred in favour of any person as consideration for or in association with any matter referred to in clause (f).
- (2) Nothing in sub-section (1) shall render unlawful—
- the making of any payment already authorised either with foreign exchange obtained from an authorised dealer or a money-changer under section 8 or with foreign exchange retained by a person in pursuance of an authorisation granted by the Reserve Bank;
- The making of any payment with foreign exchange received by way of salary or payment for services not arising from any business in, or anything done while in, India.
- (3) Save as may be provided in, and in accordance with, any general or special exemption from the provisions of this sub-section, which may be granted conditionally or unconditionally by the Reserve Bank, no person shall remit or cause to be remitted any amount from any foreign country into India except in such a way that the remittance is received in India only through an authorised dealer.
- (4) Nothing in this section shall restrict the doing by any person of anything within the scope of any authorisation or exemption granted under this Act.
- (5) For the purposes of this section and section 19, "security" includes coupons or warrants representing dividends or interest and life or endowment insurance policies.

Blocked accounts:

- Where an exemption from the provisions of section 9 is granted by the Reserve Bank in respect of payment of any sum to any person resident outside India and the exemption is made subject to the condition that the payment is made to a blocked account.
- The payment shall be made to a blocked account in the name of that person in such manner as the Reserve Bank may by general or special order direct;
- The crediting of that sum to that account shall, to the extent of the sum credited be a good discharge to the person making the payment.
- No sum standing at the credit of a blocked account shall be drawn or except in accordance with any general or special permission which may be granted conditionally or otherwise by the Reserve Bank.
- In this section, "blocked account" means an account opened, whether before or after the commencement of this Act, as a blocked account at any office or branch in India of a bank authorised in this behalf by the Reserve Bank, or an account blocked, whether before or after such commencement, by order of the Reserve Bank.

Restrictions on import and export of certain currency and bullion :

The Central Government may, by notification in the Official Gazette, order that, subject to such exemption, if any, as may be specified in the notification, no person shall, except with the general or special permission of the Reserve Bank and on payment of the fee, if any, prescribed, bring or send into India, any foreign exchange or any Indian currency. Explanation.—For the purposes of this sub-section, the bringing or sending into any port or place in India of any such article as aforesaid intended to be taken out of India without being removed from the ship or conveyance in which it is being carried shall nonetheless be deemed to be a bringing, or, as the case may be, sending, into India of that article.

No person shall, except with the general or special permission of the Reserve Bank or the written permission of a person authorised in this behalf by the Reserve Bank, take or send out of India any Indian currency or foreign exchange other than foreign exchange obtained by him from an authorised dealer or from a money-changer.

Acquisition by Central Government of foreign exchange :

The Central Government may, by notification in the Official Gazette, order every person in, or resident in, India:

who owns or holds such foreign exchange as may be specified in the notification, to offer it, or cause it to be offered for sale to the Reserve Bank on behalf of the Central Government or to such person, as the Reserve Bank may authorise for the purpose, at such price as the Central Government may fix, being a price which is not less than the price calculated at the rate of exchange for the time being authorised by the Reserve Bank;

who is entitled to assign any right to receive such foreign exchange as may be specified in the notification, to transfer that right to the Reserve Bank on behalf of the Central Government on payment of such consideration therefor as the Central Government may fix having regard to the rate for the time being authorised by the Reserve Bank in pursuance of sub-section (2) of section 8 for conversion into Indian currency of the foreign currency in which such foreign exchange is expressed:

Provided that the Central Government may, by the said notification or by a separate order, exempt any person or class of persons from the operation of the order made in the said notification: Provided further that nothing in this section shall apply to any foreign exchange acquired by a person from an authorised dealer or from a money-changer and retained by him with the permission of the Reserve Bank for any purpose.

13.9 TYPES OF FOREIGN EXCHANGE CONTROL :

There may be five types of Exchange Control:

i. **Mild System of Exchange Control :** Under mild system of exchange control, also known as exchange pegging, the Government intervenes in maintaining the rate of exchange at a particular level. Under this system, the Government maintains on 'Exchange Equalization Fund' in foreign currencies.

The British Exchange Equalization Account and U.S. Exchange Stabilisation Fund were two examples of mild control. In case the demand for dollar goes up and as a result the value of pound falls, the U.K. Government would sell dollars for pounds and thus restrict the fall in the value of pound by increasing the supply of dollars.

ii. **Full Fledged System of Exchange Control :** Under this system, the Government does not only Peg the Rate of Exchange but have complete control over the entire foreign exchange transactions. All receipts from exports and other transactions are surrendered to the control authority i.e., Reserve Bank of India. The available supply of foreign exchange is then allocated to different buyers of foreign exchanges on the basis of certain pre-determined criteria. In this way the Government is the sole dealer in foreign exchange.

iii. **Compensating Arrangement :** A compensating arrangement per-takes of the character of the old-fashioned barter deal. An example would be the sale by India of cotton goods of a particular value to Pakistan, the latter agreeing to supply raw cotton of the same value to India at a mutually agreed exchange rate. Imports thus compensate for exports, leaving no balance requiring settlement in foreign exchange.

iv. **Clearing Agreement :** A clearing agreement consists of an understanding by two or more countries to buy and sell goods and services to each other, at mutually agreed exchange rates against payments made by buyers entirely in their own currency.

The balance of outstanding claims are settled as between the central banks at the end of stipulated periods either by transfers of gold or of an acceptable third currency, or the balance might be allowed to accumulate for another period, pending an arrangement whereby the creditor country works of the balance by extra purchases from the other country.

V. **Payments Arrangements :** In a payments arrangement the usual procedure of making foreign payments through the exchange market is left intact. But each country agrees to establish a method of control whereby its citizens are forced to purchase goods and services from the other country in amounts equal to the latter's purchase from the first country. Another type of payments agreement is one designed to collect past debts.

13.10 CONDITIONS NECESSITATING FOREIGN EXCHANGE CONTROL :

The exchange control device is not effective in all cases. Only in selective cases, this measure of curbing imports is effective.

The following are conditions where exchange control can be resorted:

- The exchange control is necessary and should be adopted to check the flight of capital. This is especially important when a country's currency is under speculative pressure. In such cases tariffs and quotas would not be effective. Exchange control being direct method would successfully present the flight of capital of hot money.
- Exchange control is effective only when the balance of payment is disturbed due to some temporary reasons such as fear of war, failure of crops or some other reasons. But if there are some other underlying reasons, exchange control device would not be fruitful.
- Exchange Control is necessary when the country wants to discriminate between various sources of supply. Country may allow foreign exchange liberally for imports from soft currency area and imports from hard currency areas will be subject to light import control. This practice was adopted after Second World War due to acute dollar shortage.

Even in India, many import licenses were given for use in rupee currency areas only, i.e., countries with which India had rupee-trade arrangements. Thus in above cases, the exchange control is adopted. In such cases quotas and tariffs do not help in restoring balance of payment equilibrium.

13.11 SUMMARY :

After studying this lesson students should be able to know the concept of exchange control , understand factors that lead to improve exchange controls, acquired knowledge on regulations, obtain knowledge on foreign exchange control, gain knowledge on FERA 1973, and learn types of foreign exchange control . Further, it is also emphasized on . Factors that lead governments to improve Exchange Controls, Objective of Foreign Exchange Control, Consequences of Exchange Controls, Regulations . Definition of Foreign Exchange Control,
The Foreign Exchange Regulation Act (FERA) 1973,Types of Foreign Exchange Control
And Conditions Necessitating Foreign Exchange Control.

13.12 TECHNICAL TERMS :

- **arbitrage:** the simultaneous purchase or sale of a financial product in order to take
- advantage of small price differentials between markets.
- **asian central banks:** refers to the central banks or monetary authorities of asian
- **ask (offer) price:** the price at which the market is prepared to sell a product. prices
- are quoted two-way as bid/ask. the ask price is also known as
- the offer.
- **base currency:** the first currency in a currency pair. it shows how much the base
- currency is worth as measured against the second currency.
- **base rate:** the lending rate of the central bank of a given country.
- **basing:** a chart pattern used in technical analysis that shows when demand and supply of a
- product are almost equal. it results in a narrow trading range and the merging of
- support and resistance levels.
- **bond:** a name for debt which is issued for a specified period of time.
- **book:** in a professional trading environment, a book is the summary of a trader's or desk's
- total positions.
- **bulls:** traders who expect prices to rise and who may be holding long positions.
- **buy:** taking a long position on a product.
- **call option:** a currency trade which exploits the interest rate difference between two
- currency with a high rate of interest, the trader will receive the interest
- difference between the two countries while this trade is open.
- **Control:** Control refers to having sufficient amount of voting shares of a company to
- make all corporate decisions.
- **Exchange:** An exchange is a marketplace where stocks, bonds, commodities, options
- and futures are traded.
- **International Business:** International Business refers to the trade of goods, services,
- technology, capital and/or knowledge across national borders and at
- a global or transnational scale.
- **Regulation:** Regulation is broadly defined as imposition of rules by government, backed by
- the use of penalties that are intended specifically to modify the economic
- behaviour of individuals and firms in the private sector.
- **System:**A business system is a defined set of principles, practices and procedures that
- are applied to specific activities to achieve a specific result.

13.13 SELF-ASSESSMENT QUESTIONS :

1. Define exchange control and explain factors of exchange control?
2. Explain objectives of exchange control?
3. Discuss foreign exchange control?
4. Briefly discuss FERA 1973?

13.14 SUGGESTED READINGS :

1. Vadilal Dagh: India’s Foreign Trade Jouav Such Foreign Trade and Economic development of under developed countries.
2. Lall G, S. : Financing of Foreign trade and
3. NCAER Export strategy for India
4. Jeevanandam: Foreign Exchange.
5. Jeevanandam: Foreign Exchange arithmetic

Dr. MEERAVALI SHAIK

LESSON - 14
FOREIGN EXCHANGE MARKET IN INDIA

AIMS AND OBJECTIVES :

After studying this lesson students should be able to

- To know the concept of foreign exchange.
- To understand Indian forex market.
- To acquired knowledge on exchange rate arithmetic.
- To obtain knowledge on Nostro and Vostro.
- To learn types of foreign exchange markets in India.
- To knowledge on foreign exchange markets.

STRUCTURE :

14.1 Introduction
14.2 Some Basic Exchange Rate Arithmetic
14.3 Forward Exchange Rates
14.4 Introduction to Nostro Account
14.5 Vostro Account
14.6 Foreign Exchange Market in India
14.7 The main functions of foreign exchange market.
14.8 Purchase and Sale of Spot Foreign Exchange
14.9 Summary
14.10 Technical terms
14.11 Self assessment question
14.12 Suggested Readings

14.1 INTRODUCTION :

Foreign Exchange is the trading of one currency for another. For example, one can swap the U.S. dollar for the Indian Rupees. Foreign exchange transactions can take place on the foreign exchange market, also known as the Forex Market. There are three fundamental aspects of this general mechanism of foreign exchange. Almost every country has its own currency (legal tender, distinctive unit of account) and the useful possession of the currency, can normally be had only in that country, in which it passes. The exchange from one currency for another is, mostly, put though by the banks by means of bookkeeping entries carried out in the two centres concerned. Almost all exchanges of one currency for another are affected with the help of credit instruments.

The exchange rate movements in the Indian forex market do not necessarily follow the international trend, particularly in the short run. The main reason for this is the restriction on the free flow of capital into or out of the country. Prior to the method 'Liberalised Exchange Rate Management System' (LERMS) the Reserve Bank fixed the buying and selling rates and the market would remain within the ceiling and the floor, thus fixed by the Reserve Bank. However, at present, the forces of demand and supply in the local interbank market derive the Exchange rate.

Direct and Indirect Quote : The quote is direct when the price of one unit of foreign currency is expressed in terms of the domestic currency. The quote is indirect when the price of one unit of domestic currency is expressed in terms of Foreign currency.

Since the US dollar (USD) is the most dominant currency, usually, the exchange rates are expressed against the US dollar. However, the exchange rates can also be quoted against other countries' currencies, which is called as cross currency.

Now, a lower exchange rate in a direct quote implies that the domestic currency is appreciating in value. Whereas, a lower exchange rate in an indirect quote indicates that the domestic currency is depreciating in value as it is worth a smaller amount of foreign currency.

14.2 SOME BASIC EXCHANGE RATE ARITHMETIC :

Cross Rate : A person wants to remit Euros from India, and as a banker, and for argument sake, rupees/ Euros are not normally quoted and therefore, what we have to do is first buy dollars against the rupees and the same dollars will be disposed off overseas to acquire the Euros.

If a rate in Mumbai market are US 1 Dollar- Rs 60.8450/545 and rates in London market are US 1 Dollar=Euros 0.7587 we will gets US 1 dollar for Rs 60.8545 and for one Us dollar we will get Euro 0.7587, thus we can form a sort of chain rule as under;

How many Rs.= 1 Euro

If 0.7587 Euro= US 1 dollar

Therefore, 1 Euro= Rs. 60.8545/0.7587

Or 1 Euro= Rs. 80.21

If an export customer has a bill for 100000 pound, the bank has purchase the Pound from him and give an equivalent amount in rupees to the customer. Presuming the inter-bank market quotations for spot delivery are as follows:

US 1 dollar= Rs 60.8450/545

The London market is quoting cable (STG/DLR) as

1 pound= US 1.9720/40 Dollar

The bank has to sell pound in the London market at US 1.9720, ie. The market's buying rate for Pound 1. The US dollars so obtained have to be disposed off in the local inter-bank market at US 1 dollar= Rs 60.8450 (market's buying rate) for US dollar.

By chain rule, we get:

Pound 1= 1.9720*60.8450 = Rs 119.9863

- **Chain Rule:** Calculation of the cross rate is based on common sense approach. However, it can be reduced to a rule known as the chain rule with similar steps.
- **Value Date:** The value date is a date on which the exchange of currencies actually takes place. Based on this concept, we have the following types of exchange rates.
- **Cash/ready:** it is the rate when an exchange of currencies takes place on the date of the deal.
- **TOM:** When the exchange of currencies takes place on the place on the next working day, i.e, tomorrow it is called the TOM rate.
- **Forward Rate:** If the exchange of currencies takes place after period of spot date, it is called the forward rate. Forward rates generally are expressed by indicating a premium/ discount for the forward period.

- **Premium:** When a currency is costlier in forward or say, for a future value date, it is said to be at a premium. In the case of the direct method of quotations, the premium is added to both the selling and buying rate.
- **Discount:** If currency is cheaper in the forward of for a future value date, it is said to be at a discount. In the case of a direct quotation, the discount is (deducted) subtracted from both the rates, i.e buying and selling rates.

14.3 FORWARD EXCHANGE RATES :

The forward exchange rate (also referred to as forward rate or forward price) is the exchange rate at which a bank agrees to exchange one currency for another at a future date when it enters into a forward contract with an investor.

- **Forward Rate :**
- The Exchange rate for settlement on a date beyond the spot is naturally different and the same is called the forward rate.
- **Forward rate has two components :**
- **Spot Rate :**
-

Forward point reflecting the interest rate differentials adjustment for different settlement dates.

(i)Forward Point

Let us suppose that spot rate of US$/Euro is

Spot Euro 1= US$ 1.3180

The exchange rate three months forward is

3 months Euro 1= US $1.3330

The difference of 150 points referred to is the forward point

The following factors determine the forward point:

Supply and demand for the currency for the settlement date. If there are more buyers for a particular date then sellers, the forward point will be different from the situation if there were more sellers than buyers for that particular settlement date.

Market view, i.e. expectations, about the future and developments likely to take place in interest rates and foreign exchange.

The interest rate differential between the countries. For the period in question, whose currencies are being exchanged.

Calculating forward points :

We can the approximate forward points for a given forward period with the help of the following information:

Spot exchange rate= 15000

Interest rate differential= 3% per annum

Forward period= 90 days

No. of days in a year (360 or 365)= 365 days

The formula is as

Spot rate ×Interest rate differential ×Forward period/100×No. of days in the year

1500×3×90/100×360= 0.01125

Forward differential, is also known as the “Swap Rate”. Three months forward rate for a US$/ Euro can be calculated by adjusting spot rate with the forward differential.

Interest differential from forward points:

The formula for calculating the interest rate differential from the forward point is as under:

Interest rate differential = Forward points ×No. of days in the year ×100/ Spot rate× Forward period

Continuing the above example, we have

=0.01125×360×100/1.50×90=3% annum

Forward differential formula = Spot rate- Forward rate

(ii)Arbitrage: Arbitrage is an operation by which one can make risk free profits by undertaking off setting transactions Arbitrage can be in interest rates, i.e. borrow in one centre and lend in another at a higher rate. Arbitrage can occur in exchange rates also. However, with the present day efficient communication system, arbitrage opportunities are very rare.

In the above example forward rate, i.e Euro 1= US dollar 1.5436, would perfectly offset the interest rate differential and can be calculated as follows:

Principal+ interest of US dollar investment = US $ 159

Principal + interest of Euro loan= Euro 103

Therefore, Euro 103

Or Euro 1= US$ 159/103=US$ 1.5436

14.4 INTRODUCTION TO NOSTRO ACCOUNT :

A bank account conducted by a British bank with a foreign bank, usually in the foreign currency.

A Nostro account is a bank account that a bank holds with a foreign bank in the currency of the country where the funds are held. The term “nostro” is a Latin word that means “ours,” and it is used to facilitate foreign exchange and international trade transactions involving foreign currencies. It is the opposite of the term “vostro,” which is a Latin word for “yours.”

Understanding Nostro Account :

A bank ‘A’ in India has an account with Bank ‘Q’ in Australia, for example. And the currency in bank A’s bank account in Bank Q is maintained in Australian Dollars. This account with Bank Q is what is called a Nostro Account for Bank A. Such accounts are most commonly seen in Exim related banks that oversee a lot of overseas transactions and in large amounts. Due to the existence of a Nostro account, transactions within the country initiated by bank A become simpler, just as if it’s a regular transfer of funds from one account to another. Bank Q will facilitate these transactions in home currency. This process saves a lot of hassle. Suppose the entity opening the account or the bank (A) itself doesn’t have a physical presence in another country (Australia in this case), it can still open an account and carry out necessary transactions.

How a Nostro Account Works :

- A Nostro account is a mechanism that banks use to keep track of all funds being held in other banks in the currency of the country where the funds are held. The Nostro account is maintained in a foreign currency that can be converted for use in foreign exchange and foreign trades.

- For example, assume that Bank X maintains an account in Bank Y's home currency. To Bank X, the account will be treated as a Nostro account, while Bank Y will treat the account as a Vostro account.
- When opening a Nostro account, the client bank elects to open an account with another bank that it has a banking relationship with in a foreign country. The foreign bank, in this case, is referred to as the facilitator bank. Once the bank has secured an account with the facilitator bank, the latter will assist the former in making payments for transactions using its home currency.
- The facilitator bank uses its clearing network with the central bank to carry out the transaction. If the facilitator bank does not have access to the primary clearing arrangements with the central bank, it can facilitate the payments for the transaction through another bank in the same country that is a primary clearing member of the central bank.
- Usually, banks use Nostro accounts when buying or selling in another country where it does not have a physical presence, and instead uses an established bank in the foreign country to carry out the transaction on its behalf.

Summary :

- ❖ A Nostro account is a bank account that a bank holds with a foreign bank in the domestic currency of the country where the funds are held.
- ❖ It is used to facilitate the settlement of international trade and foreign exchange transactions.
- ❖ The account is mainly held by banks or large corporations that regularly engage in international trade transactions.

14.5 VOSTRO ACCOUNT :

A vostro account is an account a correspondent bank holds on behalf of another bank. These accounts are an essential aspect of correspondent banking in which the bank holding the funds acts as custodian for or manages the account of a foreign counterpart.

Understanding Vostro Accounts :

A vostro account is established to enable a foreign correspondent bank to act as an agent or provide services as an intermediary for a domestic bank. These services include executing wire transfers, withdrawals, and deposits for customers in countries where the domestic bank does not have a physical presence.

The foreign correspondent bank might also perform treasury services, execute foreign exchange transactions, and expedite international trade on behalf of the domestic bank. The correspondent bank charges the domestic bank for the services associated with the vostro account.

Vostro Accounts in an Agency Relationship :

For most banks, the cost of building physical branches in every country their customers might need banking services is prohibitive. As a solution, domestic banks can initiate agency relationship agreements with correspondent banks to transact business for customers who are traveling, living abroad, or who own companies that do business abroad. As an agent of the domestic bank, the correspondent bank is authorized to perform certain agreed-upon financial transactions, acting as a fiduciary in the relationship.

Vostro Accounts in an Intermediary Relationship :

When funds are wired between a domestic and a foreign bank that do not have a direct relationship, a correspondent bank acts as the financial intermediary in the transaction. To facilitate the wire, the originator of the transfer sends the amount of the wire plus applicable fees to the vostro account held on its behalf by the correspondent bank. The correspondent bank deducts the fees and the amount of the wire from the vostro account and executes a domestic wire to the receiving bank.

Example of a Vostro Account :

With a vostro account relationship in place, the customer of a domestic bank can walk into the office of a correspondent bank to withdraw or deposit funds. For example, to process a customer's withdrawal of funds at a correspondent bank, the domestic bank deducts the withdrawal amount plus any fees from the customer's account and executes a transfer to the vostro account held by the correspondent bank. The funds are converted to the local currency, deducted from the vostro account, and paid to the domestic bank's customer, minus the applicable fees.

14.6 FOREIGN EXCHANGE MARKET IN INDIA :

The market in which international currency trade takes place i.e. where foreign currencies are bought and sold simultaneously is called the Foreign Exchange (Forex) Market. It is the organisational framework within which banks, merchants, firms, investors, individuals and government exchange foreign currencies for one another.

The foreign exchange market in India started when in 1978 the government allowed banks to trade foreign exchange with one another. Foreign Exchange Market in India operates under the Central Government of India and executes wide powers to control transactions in foreign exchange. The Foreign Exchange Management Act, 1999 or FEMA regulates the whole Foreign Exchange Market in India. Before the introduction of this act, the foreign exchange market in India was regulated by the Reserve Bank of India through the Exchange Control Department, by the Foreign Exchange Regulation Act or FERA, 1947. Interbank foreign exchange Trading is regulated by the Foreign Exchange Dealers Association of India (FEDAI) created in 1958, a self-regulatory voluntary association of dealers or banks specializing in the foreign exchange activities in India that regulates the governing rules and determines the commissions and charges associated with the interbank foreign exchange business. Since 2001, clearing and settlement functions in the foreign exchange market are largely carried out by the Clearing Corporation of India Limited (CCIL) that handles transactions of approximately 3.5 billion US dollars a day, about 80% of the total transactions.

The foreign exchange market in India consists of 3 segments or tires. The first consists of transactions between the RBI and the authorized dealers (AD). The latter are mostly commercial banks. The second segment is the interbank market in which the AD's deal with each other. And the third segment consists of transactions between AD's and their corporate customers. As in any market essentially the demand and supply for a particular currency at any specific point in time determines its price (exchange rate) at that point. Prior to 1990s fixed Exchange rate of the rupee was officially determined by RBI.

During the early years of liberalization, the Rangarajan committee recommended that India's exchange rate be flexible. India moved from a fixed exchange rate regime to "market determined" exchange rate system in 1993. This is explained as under.

A country's currency exchange rate is typically affected by the supply and demand for the country's currency in the international foreign exchange market. Let's take the example of Rupee Dollar exchange. The rupee/dollar rate is a two-way rate which means that the price of 1 dollar is quoted in terms of how much rupees it takes to buy one dollar. The value of one currency against another is based on the demand of the currency. If the demand for dollar increases, the value of dollar would appreciate. As the quotation for Rs/$ is a two way quote, an appreciation in the value of dollar would automatically mean the depreciation in Indian rupee and vice-versa. Besides the primary powers of demand and supply, the Indian exchange rate is affected by following factors:

- **RBI Intervention :** When there is too much volatility in the rupee-dollar rates, the RBI prevents rates going out of control to protect the domestic economy. The RBI does this by buying dollars when the rupee appreciates too much and by selling dollars when the rupee depreciates way too much.
- **Inflation :** When inflation increases there will be less demand of domestic goods and more demand of foreign goods i.e. increases demand for foreign currency), thus value of foreign currency increases and home currency depreciates thus negatively affecting exchange rate of home currency.
- **Imports and Exports :** Importing foreign goods requires us to make payment in foreign currency thus strengthening the foreign currency's demand. Increase in demand increases the value of foreign currency and exports do the reverse.
- **Interest rates :** The interest rates on Government bonds in emerging countries such as India attract foreign capital to India. If the rates are high enough to cover foreign market risk, money would start pouring in India and thus would provide a push to rupee demand thus appreciating rupee value for exchange.
- **Operations :** The major sources of supply of foreign exchange in the Indian foreign exchange market are receipts on account of exports and invisibles in the current account, drafts, traveller's cheque and inflows in the capital account such as foreign direct investment (FDI), portfolio investment, external commercial borrowings (ECB) and non-resident deposits. On the other hand, the demand for foreign exchange rises from imports and invisible payments in the current account, amortisation of ECB (including short-term trade credits) and external aid, redemption of NRI deposits and outflows on account of direct and portfolio investment.

14.7 THE MAIN FUNCTIONS OF FOREIGN EXCHANGE MARKET :

The function of Transfer : The primary purpose of the foreign exchange market is to make it easier to convert one currency into another or to make buying power transfers between nations. A number of credit instruments, such as telegraphic transfers, bank draughts, and foreign bills, are used to transmit purchasing power. The foreign exchange market performs the transfer function by making international payments by clearing debts in both directions at the same time, similar to domestic clearings.

For example, if an Indian exporter imports products from the United States and the payment is to be paid in dollars, FOREX will simplify the conversion of the rupee to the dollar. Credit instruments such as bank draughts, foreign exchange bills, and telephone transfers are used to carry out the transfer function.

The function of Credit : Another important role of the foreign exchange market is to facilitate international trade by providing credit, both domestic and international**.** When foreign bills of exchange are used in overseas payments, a credit of around three months is necessary before they mature. The FOREX provides importers with short-term loans in order to promote the flow of goods and services between countries. The importer can fund international imports with his own credit.

Hedging Function: Hedging foreign exchange risks is a third function of the foreign exchange market. Hedging is the process of avoiding foreign currency risk. When the exchange rate, or the price of one currency in terms of another currency, changes in a free exchange market, the party involved may earn or lose money. If there are large amounts of net claims or net liabilities that must be satisfied in foreign currency, a person or a company takes on a significant exchange risk.

As a whole, exchange risk should be avoided or minimized. For this, the exchange market offers forward contracts in exchange as a means of hedging potential or present claims or liabilities. A three-month forward contract is a contract to purchase or sell foreign exchange against another currency at a price agreed upon today for a defined period in the future. At the moment of the deal, no money is exchanged. However, the contract allows you to ignore any potential changes in the currency rate. As a result of the presence of a forward market, an exchange position can be hedged.

Benefits of the Foreign Exchange Market :

- **Flexibility:** The forex market offers traders a great deal of freedom. This is due to the fact that the **quantity of money that may be traded is unlimited**. Moreover, market regulation is essentially non-existent.
- **Transparency:** The Forex market is enormous in size and spans many time zones. Despite this, information about the Forex market is freely available. Additionally, neither government nor the central bank has the authority to corner the market or set prices for an extended period of time. **Because of the temporal lag** in transferring information, some entities may get short-term benefits. The magnitude of the Forex market makes it fair and efficient!
- **Options Trading:** Traders can choose from a wide range of trading alternatives on the forex markets. Traders have lots of different currency pairs to select from. Investors can also choose between spot trading and signing a long-term contract. As a consequence, the Forex market has a remedy for any budgetary and investor’s risk appetite.

Features of Foreign Exchange Market :

This kind of exchange market does have characteristics of its own, which are required to be identified. The features of the Foreign Exchange Market are as follows:

High Liquidity: The foreign exchange market is the most easily liquefiable financial market in the whole world. This involves the trading of various currencies worldwide. The traders in this market are free to buy or sell the currencies anytime as per their own choice.

Market Transparency: There is much clarity in this market. The traders in the foreign exchange market have full access to all market data and information. This will help to monitor different countries’ currency price fluctuations through the real-time portfolio.

Dynamic Market: The foreign exchange market is a dynamic market structure. In these markets, the currency values change every second and hour.

Operates 24 Hours: The Foreign exchange markets function 24 hours a day. This provides the traders the possibility to trade at any time.

Who are the Participants in a Foreign Exchange Market : The participants in a foreign exchange market are as follows:

- **Central Bank:** The central bank takes care of the exchange rate of the currency of their respective country to ensure that the fluctuations happen within the desired limit and this participant keeps control over the money supply in the market.
- **Commercial Banks:** Commercial banks are the channel of forex transactions, which facilitates international trade and exchange to its customers. Commercial banks also provide foreign investments.
- **Traditional Users:** The traditional users consist of foreign tourists, the companies who carry out business operations across the globe.
- **Traders and Speculators:** The traders and the speculators are the opportunity seekers who look forward to making a profit through trading on short-term market trends.
- **Brokers:** Brokers are considered to be the financial experts who act as a sure intermediary between the dealers and the investors by providing the best quotations.

Advantages of Foreign Exchange Market : The whole world economy is relying upon this foreign exchange market for obvious advantageous reasons. Let us check what are the advantages gained in the foreign exchange market-

- There are very few restrictive rules, this allows the investors to invest in this market freely.
- There are no central bodies or clearinghouses that head the Foreign Exchange Market. Hence, the intervention of the third party is less.
- Many investors are not required to pay any commissions while entering the Foreign Exchange Market.
- As the market is open 24 hours, the investors can trade here without any time-bound.
- The market allows easy entry and exit to the investors if they feel unstable.

Types of Foreign Exchange Market : The Foreign Exchange Market has its own varieties. We will know about the types of these markets in the section below:
The Major Foreign Exchange Markets

- Spot Markets
- Forward Markets
- Future Markets
- Option Markets
- Swaps Markets

Spot Market : These are the quickest transactions involving currency in the foreign exchange market. This market provides immediate payment to the buyers and sellers as per the current exchange rate. The spot market account for almost one-third of all currency exchange, and trades usually take one or two days to settle transactions. This allows the traders open to the volatility of the currency market, which can raise or lower the price, between the agreement and the trade.

There is an increase in volume of spot transactions in the foreign exchange market. These transactions are primarily in forms of buying and selling of currency notes, cash-in of traveller’s cheque and transfers through banking systems. The last category accounts for almost 90 percent of all spot transactions are carried out exclusively for banks.

As per the Bank of International Settlements (BIS) estimate, the daily volume of spot transaction is about 50 percent of all transactions in foreign exchange markets. London is the hub of foreign exchange market. It generates the highest volume and is diverse with the currencies traded.

Forward Market : In the forward market, there are two parties which can be either two companies, two individuals, or government nodal agencies. In this type of market, there is an agreement to do a trade at some future date, at a defined price and quantity.

Future Markets : The future markets come with solutions to a number of problems that are being encountered in the forward markets. Future markets work on similar lines and basic philosophy as the forward markets.

Option Market : An option is a contract that allows (but is not as such required) an investor to buy or sell an instrument that is underlying like a security, ETF, or even index at a determined price over a definite period of time. Buying and selling 'options' are done in this type of market.

What is an option : An option is a contract, which gives the buyer of the options the right but not the obligation to buy or sell the underlying at a future fixed date (and time) and at a fixed price. A call option gives the right to buy and a put option gives the right to sell. As currencies are traded in pair, one currency is bought and another sold.

Currency Options : Currency options is a part of the currency derivatives, which emerged as an important and interesting new asset class for investors. Currency option provides an opportunity to take call on Exchange Rate and fulfill both investment and hedging objectives.

Swap Market : A swap is a type of derivative contract through which two parties exchange the cash flows or the liabilities from two different financial instruments. Most swaps involve these cash flows based on a principal amount.

14.8 PURCHASE AND SALE OF SPOT FOREIGN EXCHANGE :

This type of transactions covers both spot foreign exchange purchase and spot foreign exchange sale. Spot foreign exchange purchase means that designated foreign exchange banks buy foreign exchange from enterprises and institutions or individuals at exchange rates in purchase and sale of foreign exchange markets on the very day, and pay corresponding RMB. Spot foreign exchange sale means that designated foreign exchange banks sell foreign exchange to enterprises and institutions or individuals at exchange rates in purchase and sale of foreign exchange markets on the very day, and charge corresponding RMB.

Foreign Currency Transactions : Individual investors who are considering participating in the foreign currency exchange (or "forex") market need to understand fully the market and its unique characteristics. Forex trading can be very risky and is not appropriate for all investors.It is common in most forex trading strategies to employ leverage. Leverage entails using a relatively small amount of capital to buy currency worth many times the value of that capital. Leverage magnifies minor fluctuations in currency markets in order to increase potential gains and losses.

By using leverage to trade forex, you risk losing all of your initial capital and may lose even more money than the amount of your initial capital. You should carefully consider your own financial situation, consult a financial adviser knowledgeable in forex trading, and investigate any firms offering to trade forex for you before making any investment decisions.

Foreign Currency Exchange Rates, Quotes, and Pricing : A foreign currency exchange rate is a price that represents how much it costs to buy the currency of one country using the currency of another country. Currency traders buy and sell currencies through forex transactions based on how they expect currency exchange rates will fluctuate. When the value of one currency rises relative to another, traders will earn profits if they purchased the appreciating currency, or suffer losses if they sold the appreciating currency. As discussed below, there are also other factors that can reduce a trader's profits even if that trader "picked" the right currency.

Currencies are identified by three-letter abbreviations. For example, USD is the designation for the U.S. dollar, EUR is the designation for the Euro, GBP is the designation for the British pound, and JPY is the designation for the Japanese yen.

Forex transactions are quoted in pairs of currencies (*e.g.*, GBP/USD) because you are purchasing one currency with another currency. Sometimes purchases and sales are done relative to the U.S. dollar, similar to the way that many stocks and bonds are priced in U.S. dollars. For example, you might buy Euros using U.S. dollars. In other types of forex transactions, one foreign currency might be purchased using another foreign currency. An example of this would be to buy Euros using British pounds - that is, trading both the Euro and the pound in a single transaction. For investors whose local currency is the U.S. dollar (*i.e.*, investors who mostly hold assets denominated in U.S. dollars), the first example generally represents a single, positive bet on the Euro (an expectation that the Euro will rise in value), whereas the second example represents a positive bet on the Euro and a negative bet on the British pound (an expectation that the Euro will rise in value relative to the British pound).

There are different quoting conventions for exchange rates depending on the currency, the market, and sometimes even the system that is displaying the quote. For some investors, these differences can be a source of confusion and might even lead to placing unintended trades.

Currency exchange rates are usually quoted using a pair of prices representing a "bid" and an "ask." Similar to the manner in which stocks might be quoted, the "ask" is a price that represents how much you will need to spend in order to purchase a currency, and the "bid" is a price that represents the (lower) amount that you will receive if you sell the currency. The difference between the bid and ask prices is known as the "bid-ask spread," and it represents an inherent cost of trading - the wider the bid-ask spread, the more it costs to buy and sell a given currency, apart from any other commissions or transaction charges.

Generally speaking, there are three ways to trade foreign currency exchange rates :

1. **On an exchange that is regulated by the Commodity Futures Trading Commission (CFTC).** An example of such an exchange is the Chicago Mercantile Exchange, which offers currency futures and options on currency futures products. Exchange-traded currency futures and options provide traders with contracts of a set unit size, a fixed expiration date, and centralized clearing. In centralized clearing, a clearing corporation acts as single counterparty to every transaction and guarantees the completion and credit worthiness of all transactions.
2. **On an exchange that is regulated by the Securities and Exchange Commission (SEC).** An example of such an exchange is the NASDAQ OMX PHLX (formerly the Philadelphia Stock Exchange), which offers options on currencies (*i.e.*, the right but not the obligation to buy or sell a currency at a specific rate within a specified time).

Exchange-traded options on currencies also provide investors with contracts of a set unit size, a fixed expiration date, and centralized clearing.

3. **In the off-exchange market.** In the off-exchange market (sometimes called the over-the-counter, or OTC, market), an individual investor trades directly with a counterparty, such as a forex broker or dealer; there is no exchange or central clearinghouse. Instead, the trading generally is conducted by telephone or through electronic communications networks (ECNs). In this case, the investor relies entirely on the counterparty to receive funds or to be able to trade out of a position.

Risks of Forex Trading :

The forex market is a large, global, and generally liquid financial market. Banks, insurance companies, and other financial institutions, as well as large corporations use the forex markets to manage the risks associated with fluctuations in currency rates.

The risk of loss for individual investors who trade forex contracts can be substantial. The only funds that you should put at risk when speculating in foreign currency are those funds that you can afford to lose entirely, and you should always be aware that certain strategies may result in your losing even more money than the amount of your initial investment. Some of the key risks involved include:

- **Quoting Conventions Are Not Uniform.** While many currencies are typically quoted against the U.S. dollar (that is, one dollar purchases a specified amount of a foreign currency), there are no required uniform quoting conventions in the forex market. Both the Euro and the British pound, for example, may be quoted in the reverse, meaning that one British pound purchases a specified amount of U.S. dollars (GBP/USD) and one Euro purchases a specified amount of U.S. dollars (EUR/USD). Therefore, you need to pay special attention to a currency's quoting convention and what an increase or decrease in a quote may mean for your trades.
- **Transaction Costs May Not Be Clear.** Before deciding to invest in the forex market, check with several different firms and compare their charges as well as their services. There are very limited rules addressing how a dealer charges an investor for the forex services the dealer provides or how much the dealer can charge. Some dealers charge a per-trade commission, while others charge a mark-up by widening the spread between the bid and ask prices that they quote to investors. When a dealer advertises a transaction as "commission-free," you should not assume that the transaction will be executed without cost to you. Instead, the dealer's commission may be built into a wider bid-ask spread, and it may not be clear how much of the spread is the dealer's mark-up. In addition, some dealers may charge both a commission and a mark-up. They may also charge a different mark-up for buying a currency than selling it. Read your agreement with the dealer carefully and make sure you understand how the dealer will charge you for your trades.
- **Transaction Costs Can Turn Profitable Trades into Losing Transactions.** For certain currencies and currency pairs, transaction costs can be relatively large. If you are frequently trading in and out of a currency, these costs can in some circumstances turn what might have been profitable trades into losing transactions.
- **Trading Systems May Not Operate as Intended.** Though it is possible to buy and hold a currency if you believe in its long-term appreciation, many trading strategies capitalize on small, rapid moves in the currency markets. For these strategies, it is common to use automated trading systems that provide buy and sell signals, or even automatic execution, across a wide range of currencies. The use of any such system

requires specialized knowledge and comes with its own risks, including a misunderstanding of the system parameters, incorrect data that can lead to unintended trades, and the ability to trade at speeds greater than what can be monitored manually and checked.

- **Fraud.** Beware of get-rich-quick investment schemes that promise significant returns with minimal risk through forex trading. The SEC and CFTC have brought actions alleging fraud in cases involving forex investment programs. Contact the appropriate federal regulator to check the membership status of particular firms and individuals.

Special Risks of Off-Exchange Forex Trading :

As described above, forex trading in general presents significant risks to individual investors that require careful consideration. Off-exchange forex trading poses additional risks, including:

- **There Is No Central Marketplace.** Unlike the regulated futures and options exchanges, there is no central marketplace in the retail off-exchange forex market. Instead, individual investors commonly access the forex market through individual financial institutions - or dealers - known as "market makers." Market makers take the opposite side of any transaction; for example, they may be buying and selling the same foreign currency at the same time. In these cases, market makers are acting as principals for their own account and, as a result, may not provide the best price available in the market. Because individual investors often do not have access to pricing information, it can be difficult for them to determine whether an offered price is fair.
- **There Is No Central Clearing.** When trading futures and options on regulated exchanges, a clearing organization can act as a central counter-party to all transactions in a way that may afford you some protection in the event of a default by your counterparty. This protection is not available in the off-exchange forex market, where there is no central clearing.

14.9 SUMMARY :

After studying this lesson students should be able to know the concept of foreign exchange, understand Indian forex market, acquired knowledge on exchange rate arithmetic. obtain knowledge on Nostro and Vostro, learn types of foreign exchange markets in India, and knowledge on foreign exchange markets. Further it is revealed about Indian Forex Market, Some Basic Exchange Rate Arithmetic,Forward Exchange Rates, Introduction to Nostro Account, Vostro Account, Foreign Exchange Market in India, The main functions of foreign exchange market.Types of Foreign Exchange Market, Purchase and Sale of Spot Foreign Exchange

14.10 TECHNICAL TERMS :

maturity: the date of settlement or expiry of a financial product.
net position: the amount of currency bought or sold which has not yet been offset by opposite transactions.
offered: if a market is said to be trading offered, it means a pair is attracting heavy selling interest, or offers.
option: a derivative which gives the right, but not the obligation, to buy or sell a product at a specific price before a specified date.
order: an instruction to execute a trade.

paid: refers to the offer side of the market dealing.
portfolio: a collection of investments owned by an entity.
position: the net total holdings of a given product.
premium: the amount by which the forward or futures price exceeds the spot price.
price transparency: describes quotes to which every market participant has equal access.
put option: a product which gives the owner the right, but not the obligation, to sell it at a specified price.
quote: an indicative market price, normally used for information purposes only.
rally: a recovery in price after a period of decline.
range: when a price is trading between a defined high and low, moving within these two boundaries without breaking out from them.
rate: the price of one currency in terms of another, typically used for dealing purposes.
risk: exposure to uncertain change, most often used with a negative connotation of adverse change.
sell: taking a short position in expectation that the market is going to go down.
spot market: a market whereby products are traded at their market price for immediate exchange.

14.11 SELF-ASSESSMENT QUESTIONS :

1. Explain Foreign exchange Arithmetic?
2. Discuss Indian forex market?
3. Briefly explain Nostro and Vostro?
4. Discuss types of foreign exchange markets in India?
5. Explain functions of foreign exchange market?

14.12 SUGGESTED READINGS :

1. Vadilal Dagh: India’s Foreign Trade Jouav Such Foreign Trade and Economic development of under developed countries.
2. Lall G, S. : Financing of Foreign trade and
3. NCAER Export strategy for India
4. Jeevanandam: Foreign Exchange.

Dr. MEERAVALI SHAIK

MODEL QUESTION PAPER

FINANCE OF FOREIGN TRADE

Max. Marks: 70 **Time: 3 hrs.**

SECTION A (Total: 5x3=15 Marks)

(Answer the following questions. Each answer carries 3 marks)

1. a)Trade off	(OR)	b) Meaning of Foreign Trade
2. a)Foreign Banks	(OR)	b) Balance of trade
3. a) Trade Settlements	(OR)	b) International trade settlements
4. a) Rate of Dividend	(OR)	b) problems on Rate of Exchange
5. a) Foreign Exchange control	(OR)	b) Foreign Exchange regulations

SECTION B (Total: 5x8 = 40 Marks)

(Answer the following questions. Each answer carries 8 marks)

6. a) Explain briefly about Commercial terms used in delivery for payments.

. (or)

b) Discuss briefly about commercial terms used in the delivery of goods.

7. a) What is Balance of payment? Explain the importance of Balance of payment.

(or)

b) Discuss about the role of RBI in financing of foreign trade.

8. a) What is Risk? Explain the role of risk in foreign trade

(or)

c) Discuss about the methods of international settlements through banks.

9. a) What is Exchange Rate? Explain about the types of Exchange Rates.

(or)

b) Briefly explain about theories and problems on exchange rates.

10. a) Explain briefly about Nastro & Vostro exchange arithmetic

(or)

b) Discussed briefly about Foreign Exchange Regulation Act, 1973.

SECTION C (Total: 1x15 =15 Marks)

11. a) What is Spot and forward deals ? How to calculate it with hypothetical example.

(or)

b) What is the importance of Finance of Foreign Trade in Indian perspective.